NEW YORK CITY BAR

REPORT OF THE TASK FORCE ON THE LAWYER'S ROLE IN CORPORATE GOVERNANCE

NOVEMBER 2006

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
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REPORT

NEW YORK CITY BAR ASSOCIATION

TASK FORCE ON THE LAWYER'S ROLE IN CORPORATE GOVERNANCE

Introduction

In March 2005, Bettina Plevan, then President of the New York City Bar Association (the "Association"), appointed this Task Force with the following charge:

> The Task Force will examine the role of counsel, both in-house and outside, with respect to counseling about corporate conduct. The Task Force will examine all aspects of the role of individual lawyers and law firms by examining recent failures to perform that role effectively as alleged by government agencies, Congress and the courts. The Task Force will also consider the interplay between ethical rules, privileges and the evolving enforcement climate. It will include within its focus an examination of decision-making within law firms, and the possible need for enhanced procedures to strengthen the oversight by law firms of the conduct of their attorneys.

The Task Force, with a diverse membership of 30,[1] has examined this broad subject through interviews with many knowledgeable lawyers (government, in-house and law firm),[2]

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1 The membership of the Task Force includes: four present or former general counsel to public companies; sixteen partners, counsel and associates of law firms (eleven litigators, three of whom were formerly on the enforcement staff of the Securities and Exchange Commission ("SEC"), four transactional lawyers, and one expert in legal ethics); two plaintiffs class action attorneys; two professors of law specializing in corporate law and legal ethics, respectively; three government attorneys; one federal judge; one general counsel to a major auditing firm; and one non-attorney who has served on the audit committees of two public companies.

2 The interviewees included two former SEC Commissioners (Richard Breeden and Harvey Goldschmid) and present and former SEC Directors of Enforcement (Stephen Cutler and Linda Thomsen). Appendix A lists the individuals interviewed by the Task Force or its various subcommittees. These interviews were conducted with the understanding that no remarks would be attributed to specific speakers, in order to encourage free and open

(footnote continued)

analysis of the publicly known facts concerning recent corporate scandals, review of relevant case law and ethical standards, and survey of the extensive relevant literature.[3] In addition, the Task Force conducted a CLE program at the Association on February 28, 2006, and conducted an open hearing at the Association on May 9, after posting its preliminary draft recommendations on the Association's website. After the May 9 hearing the Task Force received written comments from other Association committees, business and professional associations, and practitioners. The Task Force's full draft report was submitted for comment to relevant Association committees. This final report incorporates some, but not all, of the comments in the two letters received that took issue with points made in the draft.[4]

The Task Force's focus has been on public companies, not privately held firms.[5] Further, with the exception of internal investigations, the Task Force has examined only the role of

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discussion. Individuals are cited in the report only with respect to statements already in the public record.

3 Appendix B is a Table of Authorities for this report. These authorities, to the extent not generally available, will be on file at the Association.

4 Not all members of the Task Force endorse each recommendation and every view expressed in this report, but the report taken as a whole reflects a consensus of the members of the Task Force.

We note that some prior reports issued by Association committees have taken positions that differ from certain of our recommendations, such as on whether a lawyer should have the right, as a matter of ethics, to report out a threatened client financial fraud. We believe such changes in position, following similar changes by the ABA implemented by 2003 amendments to its Model Rules, are warranted given the many recent significant corporate scandals, the resulting heightened focus on the lawyer's role in corporate governance, and the mandatory reporting up provisions of the SEC's lawyer conduct rules promulgated in 2003 under the Sarbanes-Oxley Act (see p. 22, below).

5 As used in this Report, the term "public company" means generally a corporation that has a class of stock sufficiently widely held as to require registration under Section 12 of the Securities Exchange Act of 1934 (the "1934 Act") or the filing of reports pursuant to Section 15(d) of that Act.

lawyers as corporate advisors and transactional attorneys. This report does not deal with the quite different role of lawyers who represent public companies in adversary proceedings.[6]

The Task Force has addressed itself generally to the question of how lawyers, whether in-house or outside counsel, can be more effective in helping the public companies they advise avoid problematic conduct that, as Enron, WorldCom and other recent scandals have dramatically emphasized, can injure many thousands of investors and employees. Lawyers are often in a position to influence or facilitate the conduct of their corporate clients. Thus the question of what role lawyers can and should play to minimize wrongdoing by their public company clients is an important one.[7]

Often this subject, in the literature and public forums, gets reduced to the single question of whether a lawyer who learns of a client fraud (past, present or planned) should be obligated to "blow the whistle" to avert or mitigate the fraud. Under what circumstances, for example, should lawyers be permitted or required to "report up" wrongful conduct by management officers to the Board of Directors, or "report out" the conduct to regulators when the Board fails or refuses to act. Although we do address this whistle-blowing question below, the subject of the lawyers' role in corporate governance is far broader.

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6 The Task Force has not given specific attention to the possibly different roles played by lawyers representing auditing firms or underwriters, except in the due diligence context (<u>see</u> pp. 135-42, below). The Task Force also has not focused on the unique regulatory setting of management investment companies registered under the Investment Company Act of 1940, or the roles of lawyers advising these companies, their directors or independent directors. Finally, issues unique to the representation of foreign private issuers are beyond the scope of this report.

7 The extensive academic commentary on this subject has reached no apparent consensus. For example, <u>compare</u> John C. Coffee, Jr., <u>Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms</u>, 84 B.U.L. Rev. 301 (2004) (urging imposition of several client-monitoring responsibilities on lawyers), <u>with</u> Jill E. Fisch & Kenneth M. Rosen, <u>Is There a Role for Lawyers in Preventing, Future Enrons</u>?, 48 Vill. L. Rev. 1097 (2003) (arguing against the utility of imposing such responsibilities on lawyers).

The subject is also a complex one, involving three different sources of rules or guidelines that speak to a lawyer's role in advising public companies. The first source flows from legal duty, defined by statutes, regulations and common law concepts, the breach of which can subject a lawyer to liability in civil, regulatory or criminal proceedings. This report, generally, does not speak to questions of liability,[8] except to review the state of the law, unsettled in several areas, as a matter of background (see pp. 30-50, below).

Ethical rules are the second source, the breach of which can subject a lawyer to disciplinary charges and, possibly, liability claims based on departures from customary professional standards. These rules form the backdrop for recommendations in this report (see pp. 51-56) In addition, we advance some specific recommendations for New York in this area, namely that it embrace a series of 2003 amendments to the Model Rules of Professional Conduct ("Model Rules") of the American Bar Association ("ABA") that speak to the lawyer's responsibilities when confronted with violations of law affecting her client (see pp. 72-96, below).

The third source consists of suggestions, neither ethically nor legally mandated, of "best practices", i.e., recommendations to help lawyers steer their public company clients away from fraudulent or illegal behavior, or conduct that approaches perilously close to the line separating right from wrong. We advance best practice recommendations below for General Counsel and other in-house lawyers, for outside counsel and for law firms as institutions, and also for lawyers dealing with auditors and financial disclosure issues and, finally, for lawyers conducting internal investigations (see pp. 96 et seq., below).

[8] For an analysis of the possible theories of lawyer liability in connection with the Enron affair, see Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 Bus. Law. 143 (2002).

Executive Summary of Recommendations

A lawyer's legal duties: confidential advisor to clients

The subject of the lawyers' role in advising public companies has been an active subject of debate for many decades (see pp. 30-40, below). It has received heightened focus as a result of the spate of recent major corporate scandals, which have again raised the oft-asked question, "where were the lawyers"?, i.e., why were such scandals not averted by either inside or outside lawyers? The Task Force reviewed the available public record concerning nine recent scandals in an attempt to answer this question on an empirical basis.

Our conclusion, necessarily a tentative one absent definitive fact-finding, is that lawyers, either in-house or outside, appear to have been strategically positioned with respect to a significant number of these scandals. Though not necessarily culpable in any actual wrongdoing, a matter for determination by courts or other tribunals, lawyers often were sufficiently familiar with aspects of client conduct later alleged to have been fraudulent to have asked questions about that conduct. They appear to have done so in certain instances. Where questions were not asked or pressed, it is reasonable to believe that more assertive action might have avoided or mitigated wrongdoing in some of these situations. (see pp. 21-30, and Appendix D below).

This conclusion suggests that lawyers are potential "whistleblowers" or "gatekeepers" with respect to incipient or past client wrongdoing, thus posing the question of whether they should be duty-bound to play that role for the protection of the investing public. The Task Force does not recommend that lawyers be required to play such a role. (See pp. 57-64, below). To the contrary, we believe that to impose general whistle-blowing or gatekeeping duties on lawyers, so contrary to their traditional role as confidential advisors to their clients, would be counterproductive. It probably would result in a chilling of client-lawyer communications, the exclusion of lawyers from some strategic meetings, and generally degrade the ability of lawyers to render well-informed advice to their corporate clients.[9] It might also lead to a defensive advising on the part of lawyers concerned about the possibility of their own liability.

The traditional limitation of the lawyer's duties of loyalty to his or her client, and the correlative obligation to preserve client confidences, is in the public interest as facilitating the rendition of well-informed legal advice to public companies. By rendering well-informed legal advice, even in the face of client or employer pressures to the contrary, lawyers can play their most productive role in avoiding future corporate scandals. The forthright rendition of such advice is every lawyer's duty. The professional courage necessary to press such advice, sometimes at the risk of losing a client or a job, is indispensable to a lawyer's ability to play an effective role in corporate governance (<u>see</u> pp. 95-96, below).

Thus we do not recommend a fundamental change in a lawyer's responsibilities, such as by recognizing a general legal (or ethical) duty to the investing public.[10] However, because the lawyer's public company client has clear legal duties to the investing public, including its share-holders, the effect of corporate action on the investing public must be a matter of active concern for the lawyer in advising the client (<u>see</u> pp. 65-67, below).

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[9] We recognize that the SEC's mandatory reporting up rules under SOX, and permissive reporting out rules, which we support, also may produce these impacts to some degree. <u>See</u> n. 68 and pp. 70-72, 86-91, below.

[10] Of course lawyers, in common with all other participants and advisers involved in the offering of securities by public companies, do have legal duties to the public to the extent prescribed by regulations and statutes, such as the SEC's Rule 10b-5. For example, a lawyer cannot, any more than a corporate officer, make materially misleading representations to the public in connection with a client's offering of securities.

Nor should a lawyer restrict his or her advice to narrow questions of legal compliance. Much conduct that may not violate the law nonetheless may harm the client, or appear to the lawyer to be unfair or unjust. The lawyer's role properly includes advice on such broader questions (see pp. 67-70, below).

Changes in the ethical rules

Notwithstanding the central importance to the lawyer's role of preserving client confidences, limited exceptions to that duty have always existed that recognize other important values. The prevention and mitigation of corporate fraud, particularly in instances where a client has used a lawyer's services in the wrongdoing, is one such value.[11] In this context we recommend that New York's proposed Rules of Professional Conduct, currently under consideration by the House of Delegates of the New York State Bar Association ("NYSBA"), include a series of 2003 amendments to the ABA Model Rules of Professional Conduct ("Model Rules").[12] Specifically, we recommend that New York adopt the 2003 amendments to:

> ABA Model Rule 1.13(b), requiring, presumptively, a lawyer for a corporate client who learns of an ongoing impending violation of law likely to cause substantial injury to the client to report the matter up through the corporate hierarchy, including to the Board of Directors if necessary;

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[11] In this and in several other respects we follow and second the recommendations in the thoughtful report issued in 2003 by the ABA's Task Force on Corporate Responsibility ("ABA Task Force Report"), 59 Bus. Law. 145 (2003).

[12] The proposed New York rules have been put before the NYSBA House of Delegates by the Committee on Standards of Attorney Conduct ("COSAC") in a two volume Report and Recommendations dated September 30, 2005 ("COSAC Report"). Contrary to the views of this Task Force, the COSAC Report does not recommend that New York adopt the "reporting out" features of the ABA 2003 amendments to Model Rules 1.13(c) and 1.6(b)(2) and (3).

ABA Model Rule 1.13(c), permitting a lawyer, if the Board insists upon or fails to address a clear violation of law, to make limited disclosures of client confidences (such as to regulatory bodies) to the extent necessary to prevent substantial injury to the corporate client;

ABA Model Rule 1.13(e), requiring a lawyer who believes he has been discharged for reporting up pursuant to Rule 1.13(b), or who withdraws for related reasons, to insure that the Board is informed of this fact;

ABA Model Rules 1.6(b)(2) and (3), permitting a lawyer to make limited disclosures of client confidences (such as to regulatory bodies) to prevent, or to rectify or mitigate, crimes or frauds in which the lawyer's services have been used (see pp. 71-95, below).

Best practices

Most of our recommendations consist of "best practices": suggestions concerning the preferred way for lawyers to act, within the framework of law and ethical rules but usually beyond the minimum obligations they impose, to enhance their role in corporate governance and better secure their clients' compliance with the law. Because of the wide variation in the size and other characteristics of America's over 9,400 active public companies,[13] and of the law firms and in-house legal staffs that advise them, very few of these recommendations should be seen as having universal applicability: one size generally does not fit all.

i) the role of General Counsel

The role of the General Counsel of a public company is central to an effective system of corporate governance. We offer a series of suggestions to strengthen and facilitate the General

13 Some 4,958 public companies, 52.6% of the 9,428 public companies, have a market capitalization of $128.2 million or less, and are termed "microcap" companies by the SEC's Advisory Committee on Smaller Public Companies. Final Report, Apr. 23, 2006, at 5, 7 n.13. Another 2,444 public companies, termed "smallcap" by the Advisory Committee, have a market capitalization of between $128.2 million to $787.1 million. The remaining 2,026 larger companies, with a market cap of above $787.1 million, constitute only 21.5% of all public companies, but embody 94% of total U.S. equity market capitalization (Id.).

Counsel's role, involving as it does the difficult challenge of reconciling service as a member of a company's senior management with the task of securing management's compliance with the law and the company's articulated ethical standards (see pp. 96-112, below).

To strengthen the General Counsel's ability to discharge her compliance responsibilities, the Board of Directors should review the tenure and terms of compensation of the General Counsel. Specifically, the Board should approve the hiring and compensation of the General Counsel, articulate its expectations as to General Counsel's role and approve any decision to discharge the General Counsel.

The General Counsel's role should be clearly defined by the Board to include alerting it and other appropriate decision-makers to potential significant law violations and potential damage to the company.

Structures, processes, and procedures should be put into place to emphasize the importance of the General Counsel's function in promoting compliance with the law and ethical standards, and to ensure that the General Counsel has the resources and authority necessary to perform this role.

The General Counsel, to be effective, must be seen as a senior, influential, and respected officer of the corporation and member of the company's senior management, recognized as having strong qualities of independence, judgment and discretion. His or her reporting relationships, access to management and the Board, and compensation all need to be consistent with senior status in the company.

The General Counsel must have sufficient direct access to senior management and to the Board so that problems can be elevated and dealt with at the appropriate level. The General Counsel should report to one of the highest ranked company executives, typically the CEO. He or she should have ready access, as well, to any other executives or directors responsible for compliance, governance or ethics issues, and to any company ombudsman.

The General Counsel should have opportunities to meet with the independent (non-management) members of the Board separately from management, on a regular basis, as distinguished from only ad hoc meetings initiated by the General Counsel when a special need for consultation arises. The regularity of such meetings would facilitate the raising and discussion of important issues.

In most if not all companies, the General Counsel should regularly attend meetings of the full Board, the Audit Committee, and any legal compliance committee.

When internal lawyers are assigned to subsidiaries or discrete business units, and have their direct reporting relationship to a business manager, they should have at least a “dotted line” reporting relationship to the General Counsel, who should have a significant voice in their hiring, firing and compensation.

Processes and procedures should be put into place to ensure that internal lawyers of appropriate seniority are involved in decisions on matters involving disclosure or other legal risk. For example, a company should insure that internal lawyers are present at appropriate meetings or are members of relevant committees.

A company should clearly inform employees to whom within the internal legal department they can bring concerns. It should also establish employee hotlines, and ensure that lawyers are involved in resolving any legal issues presented through that medium.

Junior lawyers should have training specific to their position and have access to sufficiently senior and experienced internal lawyers – if necessary including the General Counsel – to obtain support and to discuss and elevate issues where required.

The compensation of internal lawyers should not be determined in a manner that undermines the independence of their legal advice, and deters them from raising and appropriately dealing with issues. Such a situation might be presented, for example, were the compensation of a lawyer to be determined solely by a business manager to whom she reported. The Board, as stated above, should review the compensation of the General Counsel, and the General Counsel should have a substantial role in reviewing the compensation of other internal lawyers.

The General Counsel should have ultimate authority with respect to the selection of the principal external lawyers retained by the company and should clearly define their roles. The General Counsel's expectations of outside counsel, including to "report up" any apparent wrongdoing by corporate agents, must be clearly understood by outside firms.

The General Counsel (or his/her designee) should consider meeting regularly, at least once a year if not more often, with any outside firm performing substantial ongoing work for the company.

ii) <u>the role of outside counsel</u>

The role of outside counsel has evolved in recent decades from a general counseling role to one more focused on specific transactions and on projects that require special expertise. This narrowing of the role of each outside counsel creates the risk that such counsel may render certain services without a full understanding of the context in which the services are requested or to be used.

Another change in the profession over this period has been its evolution toward a more competitive, bottom line orientation, with client relationships often in play and critical to the compensation of partners. This environment creates pressures on law firms and lawyers to acquiesce in questionable client conduct rather than place the client relationship at risk by pressing unwelcome advice. Consequently, it is important for the profession to adhere to professional standards that support the rendition of forthright advice and the rejection of clearly improper client conduct (see pp. 112-18, below).

Outside counsel, through dialogue with the company's General Counsel or management, should endeavor to be aware of the context in which and the purpose for which her services are being requested and used. Counsel cannot guarantee that her services will not be put to some improper purpose, but she can reduce this risk through appropriate inquiries when circumstances suggest some reason for concern.

When in the course of the representation outside counsel becomes seriously concerned about the legality of the company's actual or intended conduct, counsel should make reasonable inquiry of the company, regardless of whether the concern rises to the level of requiring a report under the SEC's lawyer conduct rules (17 C.F.R. § 205) promulgated under Section 307 of the Sarbanes-Oxley Act ("SOX"), Public Law 107-204, 15 U.S.C. § 7245, or comparable state ethical rules. If such inquiries and subsequent counseling do not allay the concern, counsel should seriously consider withdrawing from the representation.

In the rare situation when a company's Board of Directors declines to consider or take action in response to counsel's report of a threatened or ongoing clear and material violation of law by the company, counsel should seriously consider reporting such violation to the appropriate regulatory or governmental authorities (as permitted, under specified circumstances, by the SEC's lawyer conduct rules, ABA Model Rules 1.6(b) and 1.13(c) and the ethics rules of most states). The case for reporting out will be especially compelling if a substantial reason exists to doubt the independence of the company's directors.

When a company asks a law firm or lawyer to succeed other counsel in connection with corporate advice or a transaction, and the circumstances suggest that the predecessor firm's withdrawal or discharge may have involved an issue concerning the client's conduct, before accepting the engagement successor counsel should request that the company permit it to discuss with prior counsel the reasons for its withdrawal or discharge. A refusal by the company so to permit should usually disincline successor counsel from accepting the engagement.

iii) the role of law firms

The responsibility of law firms as institutions has recently received increased attention in discussions of the ethical responsibilities of the profession.[14] The SEC's lawyer conduct "reporting up" rules appear to have stimulated a heightened focus by firms on their responsibilities to provide ethical guidance to their attorneys in the rendition of legal services. We offer several suggestions for law firms in this area (see pp. 121-27, below).

Every firm with significant public company representations should adopt written procedures for implementing the "up-the-ladder" obligations imposed by applicable ethical rules and the SEC's lawyer conduct rules.

Firm procedures should include, among other things: mechanisms within the firm to report possible violations; clear assurance that lawyers – especially junior attorneys – will be protected against any retaliatory action by reason of reporting up a perceived problem; education and training sessions; and the establishment of designated senior lawyers or committees to facilitate compliance. (One example of such procedures is set forth in Appendix F).

[14] See generally Elizabeth Chambliss & David E. Wilkins, A New Framework for Law Firm Discipline, 16 Geo. J. Legal Ethics 335 (2003); Symposium, How Should We Regulate Large Law Firms? Is a Law Firm Disciplinary Rule the Answer?, 16 Geo J. Legal Ethics 203, 210-12 (2002).

Because a law firm's culture has a significant impact on how ethics rules are interpreted and enforced within a firm, firms should also adopt for the guidance of their attorneys a statement of best practices in advising public companies. (One example of such a statement is set forth in Appendix G).

Firms are encouraged to designate a partner (or other senior lawyer), committee or outside counsel as an ethics adviser available to consult with all firm attorneys and otherwise to advance the firm's promotion of high ethical standards.

The attorney-client privilege should be applied to protect consultations between lawyers and their law firm's in-house ethics counsel (or specially retained outside counsel) on matters of professional conduct, including issues pertaining to clients. This protection will facilitate compliance with applicable rules and statutes, and enable the firm to enforce its ethical standards internally, thereby strengthening the lawyer's role in corporate governance. We recommend that the courts review such privilege issues in light of this strong public interest.

iv) <u>the lawyer-auditor relationship and financial disclosures</u>

Almost all of the recent high-profile corporate scandals have involved financial frauds, typically focused on accounting manipulations. This lends urgency to the need to examine the role of lawyers with respect to client financial disclosures, including the manner in which lawyers and auditors work together, or fail to do so, as they render their respective services to a common client (<u>see</u> pp. 127-35, below).

The distinctly different roles of auditors and lawyers, the former independent of the client and owing direct duties to the investing public, and the latter confidential advisors owing their sole duties to their clients, precludes any facile notion of collaboration between the two. Each relationship necessarily must be controlled by the client. The present climate surrounding the auditing of public companies, with the risk of litigation or regulatory action ever present, likely means, regrettably, a continuation of the traditional arm's-length relationship between auditors and lawyers.

Nonetheless, lawyers do have a role to play in connection with a client's financial disclosures. Because accounting concepts are so frequently central to disclosure issues and other matters on which companies require legal advice, a basic familiarity with the relevant accounting concepts is essential for a lawyer advising a public company on financial disclosure and financial structuring. Law firms (and companies) should provide adequate training programs for their attorneys in these areas.

Lawyers should be actively consulted on matters of financial disclosure, as many accounting issues have taken on legal overtones. Processes and procedures should be set up (for example, the now frequently utilized "disclosure committee" format) to insure that disclosure issues are properly vetted among all who have relevant input, including lawyers.

In designing internal controls and procedures, pursuant to Section 404 of SOX, companies should require that the relevant internal and/or external counsel be consulted in connection with preparation of the company's financial statements to insure that information possessed by counsel relevant to the accuracy of those statements is adequately communicated to the financial personnel responsible for their preparation.

The process a company develops to support the CEO and CFO certifications of financial statements mandated by SOX Section 302 also should include input from the company's lawyers as to matters on which they have been engaged that are material to the financial statements.

The 1975 ABA-AICPA "Treaty," providing guidance as to how lawyers should respond to auditors' inquiries concerning asserted and unasserted claims (loss contingencies), need not be modified in light of such recent developments as adoption of the SEC's lawyer conduct rules and the 2003 amendments to the ABA Model Rules. Those new rules, however, can impact lawyer conduct consistent with the Treaty, such as by requiring a report up if management resists the lawyer's advice that a clearly material unasserted claim be disclosed to its auditors and in its financial statements.

As recommended in the Treaty, outside counsel confirm in their responses to auditors' letters that their practice is to consult with clients when they learn of unasserted claims that may require financial statement disclosure. These consultations typically occur only with company management. This practice should be modified in one respect, consistent with the spirit if not the literal requirements of the SEC's lawyer conduct rules: counsel should insure that the Audit Committee is also made aware of such unasserted claims, and of any advice, if rendered to management, that such claims should be disclosed.

Due diligence with respect to financial (and other) disclosures, including in public offerings of securities, is also an important concern that may not be receiving sufficient attention from issuers, underwriters, their respective lawyers and the SEC (see pp. 135-42, below). Lawyers play an essential role in due diligence programs for both issuers and underwriters. Law firms should review the adequacy of their due diligence training programs and practices, including the need to assign qualified personnel to lead due diligence teams. Issuer's inside counsel and (where involved) outside counsel should advise the client's Board or Audit Committee and management on the extent of due diligence work done in connection with the client's public disclosure documents and its material corporate transactions. Oversight of issuer due diligence practices by Audit Committees and other independent directors is part of sound corporate governance.

The SEC's accelerated securities offering procedures, available since the early 1980s for many frequent (or "well seasoned") issuers, leave little time for traditional due diligence by underwriters. This creates a risk that whatever diligence is performed with respect to such issuers, even if sufficient to sustain the underwriters' due diligence defense to claims under § 11 of the Securities Act of 1933 (the "1933 Act"), may not adequately protect the issuers from absolute liability, or purchasers in the offering from harm, as a result of inaccurate or incomplete disclosure. The SEC has provided no meaningful guidance on this subject since adoption of its Rule 176, promulgated 24 years ago.

When the SEC authorized these accelerated procedures, it expected that many eligible issuers, in collaboration with their chosen underwriters and their lawyers, would adopt "continuous" due diligence programs. However, the number of companies today using such continuous due diligence programs appears not to be extensive, and opinions vary on their effectiveness.

Lawyers and their public company and underwriter clients should focus on the development of new techniques, better suited than traditional due diligence to the current realities of the marketplace, which could serve as a sound basis for SEC rulemaking in the future.

v) <u>the role of lawyers conducting internal investigations</u>

The frequency with which inside counsel and law firms are called on to conduct internal investigations for public companies, either at the company's initiative or the initiative of the SEC, some other regulatory agency, or the company's auditors, has sharply increased in recent years. The ethical parameters of such investigative assignments have not yet been clearly delineated. However, the perceived failure of a number of such investigations has highlighted some important basic ground rules (<u>see</u> pp. 143-79, below).

Before undertaking any investigation, outside counsel should consider, and discuss with the company, the following:

Any prior or current relationships of counsel (or counsel's firm) with the company, or with any of its officers, directors, or principal employees, and whether those relationships, including any role of counsel or counsel's firm as the company's regular outside counsel, will undermine the fact or appearance of counsel's independence and thus adversely affect how the investigation will be viewed by regulators and others;

To whom counsel should report in connection with the investigation, and whether the reporting relationship will undermine the fact or appearance of counsel's independence or otherwise affect the investigation;

The scope of the investigation, including any limitations on the scope;

To whom and the manner in which the results of the investigation will be disclosed.

While the scope of an investigation is a client decision, and can be limited by a number of valid considerations, counsel must be alert to any restriction motivated by factors contrary to law or the company's interest, such as an attempt to cover up apparent wrongdoing. Any such concerns need to be elevated within the company.

Counsel should be authorized to communicate to regulators the scope of the investigation, whether any limitations have been placed on the scope, and to whom counsel is reporting in the company.

Counsel should continually reassess whether the company has a reporting obligation to the regulators, or the markets, or others, and discuss with the company the pros and cons of voluntary self-reporting.

Counsel should exercise independent judgment in determining whether improper conduct has occurred and should be cognizant of pressures that might cause counsel to "under charge" (i.e., be too lenient in judging corporate conduct) or "over charge" (i.e., be too quick to find a violation).

In giving its advice, counsel should always consider the fiduciary duties of the company's officers and directors to safeguard the best interests of the company and should offer advice consistent with those interests, as opposed to any differing interests of individual officers and directors, or counsel's own interest in his or her reputation or career.

The extent of the General Counsel's involvement in internal investigations must depend upon the facts (including the existence of conflicts) and the capabilities of the relevant in-house department. The General Counsel and/or internal lawyers can and often should be involved in many internal investigations. However, the Board might well decide that certain investigations, such as those involving a material allegation concerning the CEO or other senior management, should be conducted by independent external counsel engaged by the Board, given the position of General Counsel and the inherent conflicts such an investigation would present. The advantages and disadvantages of involving the General Counsel in such investigations should be discussed with the Board.

The corporation should also take into account conflicts (or the appearance of conflicts) in determining whether an internal lawyer should be in charge of an investigation of a peer, or of another officer with whom counsel conducts significant business, or of a matter on which the internal lawyer rendered significant legal advice. Where an apparent conflict could compromise an investigation, the investigation should be handled by an outside counsel or another internal lawyer who would not be similarly conflicted.

Other issues

We have reviewed a number of other suggestions that have been made with respect to the lawyer's role in corporate governance, but for various reasons do not recommend them. In this category are proposals that lawyers should be required to certify the accuracy of their clients' SEC filings or other public disclosures, a concept that we think would not be cost-effective and would be inconsistent with the traditional and valued role of lawyers as counselors (see pp. 118-19 below).

We also considered whether New York should enact a statute protecting lawyers (and others) from retaliatory discharge as a result of the reporting of client wrongdoing. This is an issue we recommend be further considered by this Association, including by reviewing of the experience of other states that do provide such protections (see pp. 180-83, below).

Finally, we reflected on whether aiding and abetting liability in civil litigation under the securities laws should be reestablished by Congress, reversing the impact of the Supreme Court's decision eliminating such liability in Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A., 511 U.S. 164 (1994). We believe that consideration of such legislation at this time would be premature (see pp. 183-88, below). It is important, first, to assess the impact on lawyer conduct of the SEC's interpretation and enforcement of its lawyer conduct rules. In addition, the courts need to resolve the present uncertainty concerning the extent to which lawyers (and other "secondary actors") may be held as primary violators of the securities laws for conduct previously thought to constitute aiding and abetting (see pp. 42-45, below).

I. <u>**"Where Were the Lawyers?": Nine Scandals Examined**</u>

A. <u>The question</u>

Over the recent decades, whenever major corporate scandals have disrupted the securities markets a cry often has gone up from the media, and sometimes from the courts, legislators, regulators and academia: "Where were the Lawyers"? The question asks why in-house and outside lawyers for the company failed to discern and prevent the wrongdoing before it metastasized into a major scandal, sometimes even destroying the corporation itself. [15]

For example, in examining transactions contributing to the savings and loans scandals of the late 1980s, District Judge Stanley Sporkin, a former SEC Director of Enforcement, wrote the following concerning the "scores of accountants and lawyers" who had knowledge of those transactions:

> Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?
>
> Why didn't any of them speak up or disassociate themselves from the transactions?
>
> Where also were the outside accountants and attorneys when these transactions were effectuated?

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[15] To some extent the question is unfair. Any role for a public company's lawyers in protecting it from management fraud or other illegality is secondary to the responsibilities of the company's directors. Further, since nearly all of the recent frauds were centered on accounting manipulations, it is the auditing profession that would appear to have been in the best position to have discovered and averted them. Finally, substantial compliance with the securities laws, as is true with any regulatory scheme, necessarily depends on meaningful oversight by effective enforcement agencies.

> What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.

Lincoln Savings & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

This question was given renewed currency in 2001-02 when numerous major corporate scandals erupted, including Enron and WorldCom. These scandals renewed a long simmering debate concerning the extent to which lawyers had the ability, and should be assigned a responsibility, to detect and report wrongdoing by their corporate clients, i.e., what is sometimes termed a "gatekeeping" role.[16]

The most tangible result of this debate was the enactment in 2002 of Section 307 of the Sarbanes-Oxley Act ("SOX"), Public Law 107-204, 15 U.S.C. § 7245, and the implementing lawyer conduct rules adopted by the SEC, 17 C.F.R. § 205, imposing on lawyers a federal obligation to "report up" the corporate ladder, under certain circumstances, evidence of actual or impending corporate wrongdoing (see pp. 70-72, below).

The Senators responsible for Section 307, in their remarks on the Senate floor, indicated they had arrived at their own answer to the "Where were the Lawyers" question. Senator John Edwards, the principal sponsor of Section 307, stated as follows:

> The truth is that executives and accountants do not work alone. Anybody who works in corporate America knows that wherever you see corporate executives and accountants working, lawyers are

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16 The seminal article on gatekeeping, though not principally focusing on lawyers, is Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986). The most thorough exploration of the subject, including the potential for lawyers to act as gatekeepers, is the recently published book by John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance (2006).

This report generally avoids using the term "gatekeeping" because of its ambiguity and potentially overbroad implications.

> virtually always there looking over their shoulder. If executives and/or accountants are breaking the law, you can be sure that part of the problem is that the lawyers who are there and involved are not doing their jobs.

148 Cong. Rec., S 6524-02, & S 6551 (daily ed. July 10, 2002) (Statement of Sen. Edwards (emphasis added).

Senator John Corzine, the former head of Goldman Sachs, gave a similar answer:

> ...in our corporate world today – and I can verify this by my own experience – executives and accountants work day to day with lawyers. They give them advice on almost each and every transaction. That means when executives and accountants have been engaged in wrongdoing, there have been some other folks at the scene of the crime – and generally they are lawyers.

(Id. at S. 6556) (emphasis added).[17]

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17 Similar conclusory statements, many citing to Enron as the only specific example, are found in the relevant literature. E.g., Susan P. Koniak, The Lawyer's Responsibility to the Truth, 26 Harv. J. L. & Pub. Pol'y 195 (2003):

> The hidden dirty secret of corporate scandals is that without lawyers, few corporate scandals would exist and fewer still would succeed long enough to cause any significant damage.

Robert W. Gordon, A New Role for Lawyers?: The Corporate Counselor After Enron, 35 Conn. L. Rev. 1185, 1190 (2003):

> Such fraud [at Enron and "other companies"] could not have been carried out without the lawyers' active approval, passive acquiescence, or failure to inquire and investigate.

Bevis Longstreth, The Corporate Bar as It Appears to a Retired Practitioner, Speech Before the American Law Institute ("ALI"), May 17, 2005 ("Longstreth Speech"), at 10:

> Looking closely at the [recent] frauds, it is apparent that lawyers were important, if not essential, facilitators.

Stephen M. Bainbridge & Christine J. Johnson, Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307, 2004 Mich. St. L. Rev. 299, 301 (2004) ("All too often, lawyers acted as facilitators and enablers of management impropriety" [in recent corporate governance scandals]; Enron only scandal cited). But see id. at 322 ("in many recent corporate scandals, the misconduct was committed by a small group of senior managers who took considerable

(footnote continued)

The impact of Section 307 and the SEC's lawyer conduct rules on the bar is not yet clear, and no enforcement actions have yet been brought invoking these provisions. But before considering the wisdom of these enactments, and possible extensions of lawyer responsibility, we attempted to answer on an empirical basis the Where Were the Lawyers question. We wanted to determine with respect to the recent spate of scandals, as best we could based on the publicly available information, whether lawyers seem to have been as strategically positioned with respect to corporate wrongdoing as Senators Edwards and Corzine seem to believe. If not -- for example, if most corporate scandals took the form of accounting schemes well hidden from the gaze of lawyers -- then there would be little purpose in even considering assigning lawyers a whistle-blowing role.

B. A tentative answer

Our answer can only be tentative, given the incomplete and disputed factual record concerning most of these scandals, and the limited nature of our review. Admitting these limitations, our answer is that lawyers do appear to have been in a position to have questioned management's conduct in a significant number of the recent corporate scandals, though by no means all of them. This tentative conclusion makes more than academic the question of whether

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pains to conceal their actions from outside advisors such as legal counsel"; only Rite Aid cited as example).

This suspicion of lawyer acquiesence or facilitation of client wrongdoing is not of recent vintage. In 1934 Justice Harlan F. Stone had this to say about the corporate abuses preceding the depression:

> . . . such departures from the fiduciary principle do not usually occur without active assistance of some member of our profession, and . . . their increasing recurrence would have been impossible but for the compliance of the Bar. . . .

The Public Influence of the Bar, 48 Harv. L. Rev. 1, 9 (1934).

lawyers should be held responsible for monitoring and reporting on their clients' conduct (a question we answer in the negative below).

What follows is a summary review of nine recent scandals.[18] Further details are found in Appendix D. We stress that in none of these nine instances, except in the two where the lawyers consented to SEC sanctions,[19] are we implying that the lawyers involved were complicit in any actual (or alleged) fraudulent conduct. The public record is insufficient to support any such judgment, and we have not interviewed any of the lawyers involved concerning the facts.

1. Enron

Books and major reports have been written about this monumental collapse of America's seventh largest (in 2000) corporation (Appendix D at D-1 – D-3). Much is known about the conduct of Enron's inside and outside lawyers since the company in bankruptcy waived its attorney-client privilege, making essentially all files of its lawyers available to the court-appointed examiner. The resulting report by the examiner, another detailed report to Enron's Board, and other reporting by the media leave little doubt that both outside and inside counsel were centrally involved in, inter alia, the structuring of the special purpose entities, and the issuance of opinion letters and review of company disclosures concerning them, that were important aspects of the subsequently alleged corporate wrongdoing. The lawyers were thus in a position to have questioned

18 These nine scandals were selected as both recent and prominent, and as allegedly involving significant wrongful conduct by management. All, save perhaps TV Azteca, are part of the recent "unique concentration of financial scandals . . . all involving the common denominator of accounting irregularities". Coffee, 84 B.U.L. Rev. at 302.

19 Only in Livent and Waste Management have any SEC enforcement actions been commenced that accuse counsel -- General Counsel in both instances -- of any culpable conduct. Civil claims have been filed against lawyers in several of the other scandals, but we are aware of no merits findings in any of those cases.

various aspects of management's conduct. Indeed a number did so, but reportedly did not bring their concerns to the Board of Directors. See p. 102, below.

2. WorldCom

This second-largest fraud in U.S. history presents a contrast with Enron in terms of the positioning of counsel with respect to the particular accounting fraud that, when uncovered by WorldCom's internal auditors in 2002, caused WorldCom's collapse. (Appendix D at D-3 – D-7). That specific admitted fraud, the charging of line-cost expenses to capital accounts, was tightly concealed by CFO Scott Sullivan and his subordinates in the financial area. There seems no reason to believe that any outside or inside lawyers had knowledge of it.

Counsel's lack of knowledge may have been a consequence of a general effort by CEO Bernard Ebbers to prevent any effective lawyer oversight of senior management. At Ebbers' direction, WorldCom's in-house legal department was splintered into geographically dispersed groups, several of which had General Counsels who did not report to WorldCom's General Counsel for much of the relevant period. This purposeful decentralization, combined with a corporate culture that discouraged anyone -- including counsel -- from closely scrutinizing transactions favored by Ebbers, effectively disabled counsel from exercising any meaningful oversight of the business and financial functions of the company (see pp. 100-01, below). [20]

[20] The lawyers, however, appear to bear some responsibility for WorldCom's problems. Both inside and outside counsel reportedly were aware of breaches of fiduciary duty and potential regulatory violations by management, and of what the Bankruptcy Examiner described as "a disregard for the most basic principles of corporate governance." Given this knowledge, counsel could have been more assertive in questioning management and advising the Board, though we cannot know if such actions would have prevented the specific Sullivan-led fraud that caused WorldCom's collapse. (Appendix D at D-6 - D-7).

3. Adelphia

This alleged fraud centered, generally, on the failure to separate the finances and assets of Adelphia from the personal interests of the Rigas family, its controlling shareholders (Appendix D at D-8 – D-10). Among other matters, Adelphia became obligated on co-borrowing agreements benefiting the Rigases, but its exposure allegedly was not adequately disclosed in its financial statements.

Adelphia's regular outside counsel, a defendant in pending securities fraud litigation, appears to have drafted or reviewed the co-borrowing agreements and Adelphia's disclosure documents. We are not aware of any information concerning the role of any Adelphia inside counsel.

4. Global Crossing

Global Crossing entered into numerous reciprocal purchases and sales of fiber optic transmission capacity with other telecommunication companies, and Global Crossings' in-house lawyers and/or outside counsel actively advised management concerning many of these transactions. (Appendix D at D-11 – D-15). A purported whistle-blower's letter later alleged improper accounting and disclosure concerning these transactions. A number of these allegations were later disputed by a Global Crossing internal investigation. The SEC's ultimate enforcement proceeding alleged disclosure violations, and did not implicate any lawyers.

5. HealthSouth

This accounting fraud extended over six years and involved the admitted participation of no less than five CFOs. (Appendix D at D–15 - D-18). HealthSouth, like WorldCom, presents as a company run by a dominant CEO who kept the General Counsel at arm's length, and as a result uninformed concerning the ongoing fraud in the financial area (see p. 101, below).

6. Livent

This fraud, orchestrated by the company's two co-founders, proceeded for some eight years. One aspect of it, the concealment of side letters with counter-parties that rendered improper the recognition of revenue from what appeared to be arm's length agreements, involved the General Counsel. He settled by consent an SEC enforcement action charging securities fraud (Appendix D at D-19 – D-21).

7. Qwest

Like Global Crossing, Qwest engaged in reciprocal purchases and sales of transmission capacity with other carriers. However, Qwest's more aggressive accounting for these transactions, and related conduct, led to far more serious charges of wrongdoing by the SEC. (Appendix D at D-22 – D-24). Other alleged improprieties included the receipt by Qwest executives of discounted stock from vendors in return for directing business to these vendors. The General Counsel appears to have known about the reciprocal transactions, but not necessarily about the problematic accounting for them. He also was one of the recipients of vendor discounted stock. No SEC charges have been brought against him.

8. TV Azteca

In this instance a law firm, learning of an undisclosed related-party transaction, took action (Appendix D at D-24 – D-27). Akin Gump, handling a bond offering, advised the company of its obligation to disclose the interest of its controlling shareholder in an entity that had purchased company debt at a deep discount, and then sold it back at a significant profit. When management, including the General Counsel, resisted making this disclosure, Akin Gump withdrew and, citing the SEC's reporting up requirement in its lawyer conduct rules, wrote a letter to the Board of

Directors explaining its withdrawal, and reserving the right to report its concerns to the SEC. A month later the company, in a press release, did disclose the controlling shareholder's interest.

9. Waste Management

The General Counsel (also serving as Senior Vice President and Secretary) appears to have been centrally involved, and certainly knowledgeable, about several aspects of what the SEC termed "one of the most egregious accounting frauds we have seen." (Appendix D at D-27 – D-29). He benefited by receiving bonuses reflecting the company's inflated reported earnings. The General Counsel settled SEC charges by a Consent Decree requiring disgorgement of the bonuses, a $200,000 civil penalty and a bar on serving as officer or director of a public company.

C. Conclusion

These nine scandals, and other publicized scandals (see nn. 53, 156, below), fall into no uniform pattern with respect to the role of lawyers. But it does appear that in at least seven of these situations -- WorldCom and HealthSouth being apparent exceptions -- lawyers were well positioned to have asked questions concerning the specific client conduct that was later claimed (rightly or wrongly) to have been fraudulent. They clearly did ask such questions in some instances, and may well have done so in others not revealed by the public record. Where questions were not asked, or not escalated to the Boards of Directors, we cannot know whether more assertive action would have in fact uncovered or otherwise aborted any wrongful conduct. It seems reasonable to conclude that there could have been such an impact in some of these situations.

Extrapolating from the above learning, at least three generalizations may be drawn. First, any suggestion that lawyers invariably are in a position to know about their clients' ongoing or impending wrongdoing is mistaken. Second, lawyers often do participate, in greater or lesser degree, in types of corporate transactions and disclosures that are susceptible to abuse, and thus may be, depending on the circumstances, in a position potentially to prevent conduct that might lead to fraud or other illegality. In fact, we believe that lawyers frequently do just that in counseling their corporate clients. These everyday instances of effective lawyering necessarily never become public. Third, the chances that lawyers actually will be in such a position, will recognize the issues confronting them and will take effective action to prevent wrongdoing, are seriously diminished if a corporation fails to establish and consistently implement effective corporate governance procedures.

We agree, then, with the observation that lawyers "have a critical role to play in preventing future Enrons." Fisch & Rosen, 48 Vill. L. Rev. at 1138. The question is how lawyers can most effectively fulfill that role. As will be apparent from the remainder of this report, generally we favor the traditional role of lawyers as confidential advisors to their clients (see pp. 57-64, below). Most of our recommendations are designed to enhance the lawyer's role as such. To impose on lawyers general whistle-blowing duties as a means of preventing corporate fraud would likely be self-defeating, creating a distance between lawyers and their clients disabling lawyers from acting as effective confidential advisors. However, we also agree with the narrow exceptions to this general rule of confidentiality recognized in the ABA's Model Rules, and the ethics codes of most states: when a lawyer's services have been (or are being) used by the client to commit a crime or fraud, or when the client's board of directors fails to address a clear material ongoing (or impending) violation of law by corporate officers, the interest in client confidentiality may yield to the compelling public interest in preventing or rectifying such conduct (see pp. 74-95, below).

II. A Lawyer's Role in Advising a Public Company

A. The limited learning from SEC enforcement actions and court decisions

While this report is not concerned with questions of liability, to provide background and context to an assessment of the lawyer's role in corporate governance we reviewed past and more recent SEC pronouncements and enforcement proceedings and court decisions concerning lawyers advising public companies.

1. SEC pre-Enron proceedings

Over the recent decades America has seen several rashes of corporate scandals each of which, among other things, has elicited controversy over the role of lawyers, and specifically over whether they should be viewed as having duties to the investing public requiring them to disclose actual or threatened securities violations by their clients.

However, relatively few SEC decisions discuss this subject. In part this is because most claims against lawyers were settled. Further, the SEC's attempts in the 1970s to establish rules for lawyer conduct, through enforcement proceedings and proceedings under its rules of practice, were rather quickly abandoned in the face of strong opposition from the organized bar. Nonetheless, a review of this historical background is instructive.

The suggestion that securities lawyers might have duties to the public that should moderate their duties of confidentiality and loyalty to their clients was prominently advanced by SEC Commissioner A.A. Sommer, Jr., in a January 1974 address. A.A. Sommer Jr., The Emerging Responsibilities of the Securities Lawyer, [1973-74 Tr. Binder] (CCH) Fed. Sec. L Rep. ¶79, 631 ("Sommer").[21] Sommer, a prominent securities lawyer before his appointment to the SEC, started from the proposition that the role of the securities lawyer was central to the effectuation of securities transactions:

> If he gives an opinion that an exemption is available, securities get sold; if he doesn't give the opinion, they don't get sold. If he judges that certain information must be included in a registration statement, it gets included (unless the client seeks other counsel or the attorney

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21 Sommer's speech followed the SEC's commencement in 1972 of its highly controversial enforcement action against two major law firms in the National Student Marketing case. (See pp. 33-34, below).

> crumbles under the weight of client pressure); if he concludes it need not be included, it doesn't get included (Id. at 83,689).[22]

In this context, Sommer challenged the continued validity of any bright line distinction between the responsibilities of attorneys and those of independent auditors. He urged that the "pervading judicial and legislative concern for the interest of the consumer" would reduce the gap between the functions of these two classes of professionals:

> I would suggest that in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of the auditor than to that of the advocate. This means several things. It means he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of his responsibility to the public who engage in security transactions that would never come about were it not for his professional presence. It means he will have to adopt a healthy skepticism toward the representations of management which a good auditor must adopt. It means he will have to do the same thing the auditor does when confronted with an intransigent client – resign.

Id. at 83,689-90.

Sommer confessed no easy answers to the delineations of such an altered role for lawyers. He contented himself with the general suggestion that "increasingly the attorney involved in the securities marketing process must be alert to the interests of the public and recognize the critical importance of his role in determining whether that public is treated fairly or not". (Id. at 83,692-93.)

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22 See United States v. Benjamin 328 F.2d 854, 863 (2d Cir. 1964):

> In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.

The SEC had proceeded along a similar line in its unprecedented 1972 complaint in the National Student Marketing case. SEC v. National Student Marketing Corp., [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360 (D.D.C. 1972). This was the first instance, as Sommer noted, in which the SEC had ever proceeded against major law firms, i.e., "old firms of recognized competence and integrity" (Sommer, p. 31 above, at 83,687). The SEC charged that White & Case, representing National Student Marketing Corp. ("NSMC") in an acquisition and merger, and Lord, Bissel & Brook, representing the acquired company (Interstate), had been obligated to call a halt to the merger (by withholding their opinion letters that were conditions to closing) once they learned that NSMC's financial statements, on the basis of which Interstate's shareholders had approved the merger, contained material misstatements. If their clients had resisted this course, the SEC alleged the lawyers were obligated to withdraw and report the wrongdoing to the SEC. The lawyers' failure to take any of these actions was deemed to have aided and abetted the securities fraud of their clients.[23]

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[23] Several years later in 1978, after an evidentiary hearing with respect to the conduct of Interstate's counsel, Lord, Bissel & Brook, the court agreed with the SEC to the extent it had alleged the lawyers had been obligated to halt the merger until there was proper disclosure. SEC v. National Student Marketing Corp. 457 F. Supp. 682 (D.D.C. 1978). In view of the "obvious materiality" of the false financials, "the attorneys' responsibilities to their corporate client required them to take steps to ensure that the [corrected] information would be disclosed to the [Interstate] shareholders." Id., 457 F. Supp. at 713. The court denied the SEC's motion for injunctive relief, however, finding it had shown no likelihood of future misconduct. Id., 457 F. Supp. at 715-17.

By the time of the cited decision White & Case had settled with the SEC. Id., 457 F. Supp. at 687 n.2. The settlement included an agreed series of firm procedures designed to ensure, inter alia, thorough ventilation within the firm of difficult judgment calls relating to public companies. SEC v. National Student Marketing Corp., [1977-78 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,027 (D.D.C. May 2, 1977). For example, the procedures required the "responsible partner" for a client to consult with and obtain the concurrence of at least two other partners concerning "the need of the Firm to withdraw from employment or take other appropriate action" if a client failed to comply with its disclosure obligations. Id., White & Case letter to SEC ¶ 4.

These claims caused a storm of controversy, as the bar vehemently protested the SEC's position that lawyers could be obligated to blow the whistle on wrongdoing clients.[24] See, e.g., Dennis J. Block & Jonathan M. Hoff, SEC Moves Against Attorneys under the Remedies Act, N.Y.L.J., Sept. 23, 1993 at 5 (referring to the NSMC and similar proceedings as constituting a "reign of terror"). The ABA's House of Delegates in 1975 adopted a "Statement of Policy" resolution hotly contesting the SEC's position, urging that "the lawyer cannot, consistently with his essential role as a legal adviser, be regarded as a source of information concerning possible wrongdoing by clients." 31 Bus. Law. 543, 544 (1975).[25]

The next landmark, albeit one soon to be essentially abandoned, was the SEC's 1981 decision in In re Carter & Johnson, SEC Release No. 34-17597, 1981 SEC LEXIS 1940 (SEC Feb.

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24 The court in its 1978 decision viewed the controversy as beneficial:

> The filing of the complaint in this proceeding generated significant interest and an almost overwhelming amount of comment within the legal profession on the scope of a securities lawyer's obligations to his client and to the investing public. The very initiation of this action, therefore, has provided a necessary and worthwhile impetus for the profession's recognition and assessment of its responsibilities in this area.
>
> National Student Marketing Corp., 457 F. Supp. at 714.

25 In Commissioner Sommer's view, this ABA resolution "fairly breathed fire," and obscured what he viewed as a potential consensus between the SEC and the bar, based on the SEC's duty to protect the investing public and the ABA's then ethical rule, DR 7-102(B)(1), requiring a lawyer learning of a client fraud to inform the victim (see pp. 75-76, below). The consensus, as Sommer proposed it, was that a lawyer was obligated to report to the SEC a client's settled intention, rejecting the lawyer's advice, to engage in clearly illegal conduct -- conduct "not clouded with legitimate uncertainty" -- such as the issuance of a clearly misleading prospectus. To fail to so report, in Sommer's view, would both constitute aiding and abetting the client fraud and violate the ABA's DR 7-102(B)(1). Address of A.A. Sommer, Jr., to Dallas Bar Ass'n, Corporate Counsel Section, Two Problems for Lawyers, Nov. 4, 1975, at 4-12.

Far from embracing this proposed consensus, the ABA soon construed and amended its ethics rules to eliminate any required reporting out of client fraud (see pp. 76-77, below).

28, 1981). Respondents Carter and Johnson, partners in the Brown Wood firm, were the principal outside counsel for National Telephone Company, and either prepared or reviewed many of National's SEC filings and other public disclosures. They rendered repeated advice to management that the company's disclosures were materially misleading, especially in not disclosing its serious cash flow difficulties, and urged that further disclosures be made. The company's CEO rejected this advice, and eventually the company stopped submitting its draft disclosures for Brown Wood's review. The lawyers did not pursue the issue. Notably, they did not convey their disclosure advice to National's independent directors, who were themselves actively concerned about National's disclosures.

After an exhaustive review of the factual record and relevant caselaw, the Commission, reversing an Administrative Law Judge's decision, ruled that the conduct of respondents did not support a finding of willful aiding and abetting liability. With respect to respondents' failure to inform the Board of their disclosure advise, the Commission noted the conflicting caselaw on when "inaction or silence" may constitute "substantial assistance" to the primary wrongdoer, a necessary element of aiding and abetting liability. Absent a duty of disclosure to the Board -- today such a duty presumably would be well founded on the SEC's lawyers conduct rules -- liability depended on a showing that respondents consciously intended to assist the wrongdoing. The Commission concluded that respondents had no such intent: "Rather, they seemed to be at a loss for how to deal with a difficult client" (Id. at *88).

The Commission, however, then proceeded to consider whether respondents had violated its Rules of Practice, specifically Rule 2(e). Rule 2(e), now Rule 102(e), authorizes the SEC to discipline lawyers appearing before it for, inter alia, "unethical or improper professional conduct." Rule 102(e)(1)(ii). The Commission found no violation, but on the basis that no clear standards of conduct theretofore had been established.[26] It then attempted to end this ambiguity by adopting prospectively the following standard to govern corporate lawyers advising public companies on their disclosure obligations:

> When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance

In re Carter & Johnson. 1981 SEC LEXIS 1940 at *98.

The Commission emphasized that not every disagreement between lawyer and client over a disclosure issue would violate its new standard:

> . . . [T]he lawyer is only an adviser, and the final judgment -- and, indeed, responsibility -- as to what course of conduct is to be taken must lie with the client. Moreover, disclosure issues often present difficult choices between multiple shades of gray, and while a lawyer's judgment may be to draw the disclosure obligation more broadly than his client, both parties recognize the degree of uncertainty involved. Id. at *95.

Thus a rule holding a lawyer guilty of misconduct simply because a client rejected his disclosure advice would be undesirable:

> Such a finding would inevitably drive a wedge between reporting companies and their outside lawyers; the more sophisticated members of management would soon realize that there is nothing to gain in consulting outside lawyers. Id. at *96.

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26 Id. at *90-*91:

> The ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws have not been so firmly and unambiguously established that we believe all practicing lawyers can be held to an awareness of generally recognized norms.

A finding of misconduct required more than an initial disagreement over disclosure:

> Initially, counseling accurate disclosure is sufficient, even if his advice is not accepted. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure. Id. at *99.

Such affirmative "prompt action", the Commission stated, might take many forms, including a report to the Board or resignation.[27] Notably, the SEC expressly stated it was not dealing with when a lawyer had a duty to report out a client's intention to commit "fraud or an illegal act." Id. at *101 n. 78.

The SEC solicited public comment on whether the Carter & Johnson standard should be expanded or modified. This proposal, and the Carter & Johnson opinion itself, elicited vehement opposition from the bar, principally challenging the SEC's power to promulgate standards of

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[27] The Commission viewed resignation as an undesirable and "rare" step:

> Premature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws. The lawyer's continued interaction with his client will ordinarily hold the greatest promise of corrective action. So long as a lawyer is acting in good faith and exerting reasonable efforts to prevent violations of the law by his client, his professional obligations have been met. In general, the best result is that which promotes the continued, strong-minded and independent participation by the lawyer.

We recognize, however, that the "best result" is not always obtainable, and that there may occur situations where the lawyer must conclude that the misconduct is so extreme or irretrievable, or the involvement of his client's management and board of directors in the misconduct is so thoroughgoing and pervasive that any action short of resignation would be futile. We would anticipate that cases where a lawyer has no choice but to resign would be rare and of an egregious nature. Id. at *100-01.

professional conduct for lawyers.[28] The bar urged that such matters should be left to the states and their disciplinary bodies. See, e.g., ABA Ad Hoc Committee, Comments on the SEC Rule Proposal, 37 Bus. Law. 915 (1981-82); see also ABA Section of Corporation, Banking and Business Law, Response to Securities Exchange Act Release No. 16045 (July 31, 1979), A Report of Ad Hoc Committee on Georgetown Petition, 35 Bus. Law. 605 (1979-80) (opposing, on similar grounds, a proposal by a public interest organization to require various certifications by an issuer concerning its lawyers, including that it had instructed the lawyers to report any probable violations of law to the Board).

In the face of this opposition, and reflecting a change in the Commission's political orientation, the SEC stepped back. From the early 1980s, it refrained from using Rule 2(e) to develop standards of professional conduct, but rather proceeded only after a lawyer had been found culpable of violating state ethical rules, or of violations law in a criminal or civil proceeding.[29] As a

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28 The SEC's statutory authority to use its Rules of Practice to promulgate standards of professional conduct for lawyers was strongly challenged after Carter & Johnson. See generally, Robert W. Emerson, Rule 2(e) Revisited: SEC Disciplining of Attorneys Since In Re Carter, 29 Am. Bus. L.J. 155 (1991). Some of the vast literature (through 1998) on the subject of the SEC's proceedings against lawyers and accountants, either in enforcement actions or in proceedings under Rule 2(e), is collected in SEC Release No. 33-7593, Final Rule: Amendment to Rule 102(e) of the Commission's Rules of Practice (Oct. 19, 1998), Dissenting Statement of Commissioner Norman S. Johnson, n.17.

Today the SEC's authority to promulgate "minimum standards of professional conduct" for lawyers is expressly established by SOX § 307, making highly relevant the SEC's substantive comments on lawyers' conduct in Carter & Johnson.

29 The policy was in effect announced in a 1982 speech to the New York County Lawyers Association by Edward F. Greene, then General Counsel of the SEC. Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission, 14 SEC Reg. & L. Rep. (BNA) (Jan. 13, 1982) ("Greene Speech"). Greene stated his view that the SEC should proceed against lawyers under Rule 2(e) only if the misconduct alleged was a violation of established state law ethical or professional misconduct rules and had a direct impact on the Commission's internal processes, such as where the lawyer participated in the preparation of disclosure documents filed with the SEC. Greene stated that if the conduct were an outright

(footnote continued)

result, from 1982 forward the SEC made no further attempt to define the obligations of lawyers representing public companies under its rules of practice.[30] Although the SEC seems never to have abandoned the Carter & Johnson standard, it left it in limbo.[31]

violation of the securities laws, a federal injunctive action would be more appropriate, and only in rare instances would a Rule 2(e) proceeding be appropriate.

This policy was reaffirmed in a 1988 SEC release:

> With respect to attorneys, the Commission generally has not sought to develop or apply independent standards of professional conduct. The great majority of Rule 2(e) proceedings against attorneys involve allegations of violations of the law (not of professional standards); thus, the Commission, as a matter of policy, generally refrains from using its administrative forum to conduct de novo determinations of the professional obligations of attorneys.

Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, SEC Release No. 33-6783, 53 Fed. Reg. 26427 at 26431 (July 15, 1988).

30 SEC enforcement proceedings against lawyers did not entirely cease (see pp. 45-49, below). One noteworthy such case, initiated in 1987, was In re Kern (Allied Store Corporation), Fed Sec. L. Rep. ¶ 84,342 (CCH)(Nov. 14, 1988). An Administrative Law Judge found that Kern, a Sullivan & Cromwell partner, had "caused" Allied Store's failure to amend its Schedule 14D-9 to reflect more recent developments during a tender offer. The fact situation was unusual in that the company had delegated to Kern complete decision-making authority with respect to such amendments. In any event, no order issued because by the time of the decision Kern was no longer in a position to correct Allied Store's earlier filings, the only relief authorized by Section 15(c)(4).

Another SEC proceeding touching on a lawyer's duties was In re Gutfreund, SEC Rel. No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶85,067 (Dec. 3, 1992). The SEC ruled that a company's chief legal officer, knowing that a trader had submitted false bids on Treasury securities, and advising on management's response to this problem, was "obligated to take affirmative steps to ensure" that the misconduct was adequately addressed. (Id. at 83,609). Those steps, might include "disclosure of the matter to the entity's board of directors, resignation from [the representation], or disclosure to regulatory authorities." (Id.) The SEC added that applicable state ethics rules "may bear upon what course of conduct [the] individual may properly pursue." (Id. at 83,609 n.26). The SEC did not take any action against the lawyer, simply reciting his conduct and its shortcomings.

31 See SEC Rel. No. 33-6783, n. 29 above, 53 Fed. Reg. at 26431 n. 31:

(footnote continued)

2. Patterns in the pre-Enron court decisions

Our analysis of pre-Enron judicial decisions concerning lawyer conduct and liability focused on some 16 cases, spanning over 40 years.[32] We sought to discover common fact patterns and challenges faced by lawyers.

Cases in which the lawyers were clearly acting unlawfully and knew it offered only obvious lessons (e.g., lawyers who knowingly facilitate frauds will not receive any special treatment from the SEC or criminal authorities by virtue of their profession). The allegations or findings in the cases not involving conscious wrongdoing usually involved one of four types of lawyer failure:[33]

> [In Carter & Johnson] . . . the Commission announced a standard of professional conduct to be applied prospectively. In addition, the Commission solicited public comment on whether the standard should be expanded or modified. The Commission has not formally addressed the expansion or modification of the standard enunciated in Carter & Johnson and intends to take no further action in that regard. Since Carter & Johnson, the Commission has not attempted to set professional standards of conduct in Rule 2(e) proceedings, but has relied on a showing of violations of the securities laws.

32 These cases are listed in Appendix C.

33 In a somewhat unique category are the claims against numerous law firms arising out of the savings and loan scandals of the late 1980s. See generally Harris Weinstein, Attorney Liability in the Savings and Loan Crisis, 1993 U. Ill. L. Rev. 53 (1993); ABA Working Group on Lawyers' Representation of Regulated Clients, Laborers in Different Vineyards?; The Banking Regulators and the Legal Profession (Discussion draft Jan. 1993); Developments in the Law–Lawyers' Responsibilities and Lawyers' Responses, 107 Harv. L. Rev. 1547, 1606-14 (1994) ("Developments"). The Office of Thrift Supervision ("OTS") litigation against Kaye Scholer, in particular, generated much scholarly commentary. See, e.g., In re Kaye, Scholer, Fierman, Hayes & Handler: A Symposium on Government Regulations, Lawyer's Ethics and the Rule of Law, 66 S. Cal. L. Rev. 977 (1993). This controversy, somewhat off point to the focus of this report, centered on whether Kaye Scholer, in representing Lincoln Savings Bank in connection with an OTS audit, had acted too much in an advocacy mode, obstructing or failing to make full disclosure to the regulatory agency of facts it was entitled to know. No judicial decision was rendered before the matter was settled, in 1992. Shortly thereafter, the Departmental Disciplinary

(footnote continued)

Lawyers who failed to maintain a level of critical distance from the corporate managers with whom they dealt, too closely identifying with the needs of management, resulting in the lawyers' exercising poor judgment from the point of the interest of their corporate client.[34]

Lawyers who possessed good judgment (maintaining a proper critical distance) and recognized the appropriate legal advice, but then failed to give the advice in a sufficiently firm and forthright manner. [35]

Lawyers who did not discern the line between aggressive opinions and indefensible ones, perhaps because they acted solo, failing to reach out to other lawyers for their expertise.[36]

Committee for the Appellate Division, First Department, opened sua sponte an investigation into what it deemed to be the most serious allegations against partners of the firm. After an extensive year-long investigation, it determined that there was no basis for any disciplinary action with respect to those allegations and dismissed the complaint. (See letter from Hal R. Lieberman, Chief Counsel of the Committee, to Peter M. Fishbein, Kaye Scholer, Aug. 9, 1993).

34 E.g., FDIC v. Clark, 978 F.2d 1541 (10th Cir. 1992) (lawyers accepted bank President's explanation, and failed to make further inquiries which would have revealed President's complicity in fraudulent loan scheme).

35 E.g., Klein v. Boyd, No. 97-1143, 1998 WL 55245 (3d Cir. Feb. 12, 1998), rehearing en banc granted and judgment vacated (March 9, 1998) (lawyer advised promoters of limited partnership to disclose their past securities law violations to potential investors, but continued representation when they refused to make disclosure).

36 E.g., SEC v. Fehn, 97 F.3d 1276, 1281-82, 1294 (9th Cir. 1996) (lawyer's advice that disclosure of certain facts was not required in Form 10-Qs was not "reasonable" in view of well-established disclosure requirements).

> Lawyers who failed to inquire further when learning of information casting serious doubt on the legality of a client's conduct ("red flags").[37]

These typical failures are instructive in formulating best practices for corporate practitioners. They emphasize the need clearly to identify the client as the company, to provide advise in a forthright manner, to consult with more senior or expert colleagues as necessary, and to take action when confronted with strong indications of likely client wrongdoing (see pp. 55-56, 93-96 below).

Most of the above decisions concerned the potential aiding and abetting liability of lawyers. In general, aiding and abetting liability requires proof that the defendant rendered "substantial assistance" to the primary wrongdoer, knowing of the wrong and intending to assist it. See, e.g., SEC v. National Marketing Corp., 457 F. Supp. at 712-13; see also p. 52-53, below. The cases offer no consistent guidance as to when a lawyer's "behind the scenes" services, such as drafting or reviewing a disclosure statement, constitute "substantial assistance," or whether a lawyer's knowing acquiescence in an obvious client fraud using the lawyer's services can be a basis for liability. See generally Donald C. Langevoort, Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud, 46 Vand. L. Rev. 75, 84-94 (1993) (highlighting pre-Central Bank cases narrowly construing a lawyer's duties in aiding and abetting cases); Peter C. Kostant, Sacred Cows or Cash Cows: The Abuse of Rhetoric in Justifying Some Current Norms of Transactional Lawyering, 36 Wake Forest L. Rev. 49, 63-78 (2001) (reviewing decided cases from 1990s). Compare Schatz v. Rosenberg, 943 F.2d 485, 497 (4th Cir. 1991) (no duty to disclose client's misrepresentation, absent fiduciary duty to victim, where lawyers "did no more than 'paper

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37 E.g., Ackerman v. Schwartz, 947 F.2d 841, 843-44 (7th Cir. 1991) (lawyer issuing opinion letter concerning tax shelter failed to verify facts asserted by promoters, despite "warning signals" that assertions might be false).

the deal' or act as a scrivener"), with SEC v. Forma, 117 F.R.D. 516, 526 (S.D.N.Y. 1987) (lawyer's "silence consciously intended to facilitate a fraud can create secondary liability").

Further judicial development of aiding and abetting liability in private civil litigation was halted in 1994 when the Supreme Court, in Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A., 511 U.S. 168 (1994), held that the securities laws did not support aiding and abetting liability. While Congress one year later restored such liability in SEC proceedings under the 1934 Act, in 15 U.S.C. § 78t(f), it remains unavailable to civil plaintiffs.

Central Bank recognized that some "secondary actors," a category including lawyers, would still be subject to primary liability if the facts established all the necessary elements for such liability. 511 U.S. at 191. Since Central Bank many attempts have been made to plead primary liability claims against lawyers and other secondary actors. See Jill E. Fisch, The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants, 99 Colum. L. Rev. 1293, 1300-03 (1999). Such a pleading survived a motion to dismiss by Vinson & Elkins in the Enron class action. In re Enron Corp. Sec., Deriv. & ERISA Litig., 235 F. Supp. 2d 549, 705 (S.D. Tex. 2002) ("Enron") (firm was "essentially a co-author of [misleading] documents it created for public consumption"). See also In re Software Toolworks, 50 F.3d 615, 628 n.3 (9th Cir. 1994) ("significant role" in drafting and editing misleading disclosure is "sufficient to sustain a primary cause of action under section 10(b)"); Klein v. Boyd, n.35, above (similar). Other courts, including the Second Circuit, have rejected such theories as barred by Central Bank. They employ a "bright line" test for liability, requiring that the defendant have made a public misrepresentation or that such a statement was publicly attributed to it. See, e.g., Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability under the [1934 Act]

. . . for a statement not attributed to that actor at the time of its dissemination.”).[38] See generally, Enron, 235 F. Supp. 2d at 583-92, 598-604 (discussing authorities).[39]

Other litigants have pleaded causes of action based on “scheme liability”, i.e., allegations that a secondary actor’s participation in a fraud, even though any public misstatements were made by others, constitutes an actionable “device, scheme or artifice to defraud” under Section 10(b) and Rule 10b-5(a) and (c). See generally, R. Bret Beattie, The New Minefield: The Scheme Theory of Primary Liability Comes of Age in the Post-Enron Era, 34 Sec. Reg. L. J. 92 (2006).[40] Several district courts have held that lawyers and other secondary actors, such as a company’s auditors and business partners, can be liable under the “scheme” framework. See, e.g., In re Parmalat Sec. Litig., 383 F. Supp. 2d 616, 625 (S.D.N.Y. 2005) (allowing claims to proceed against

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38 The Second Circuit’s “bright line” test may have been dimmed somewhat by several subsequent decisions. See In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 75-76 (2d Cir. 2001) (upholding lower court ruling that company vice president could be liable for misstatements not attributed to him where he was “primarily responsible” for communications with investors and was “involved in drafting, producing, reviewing and/or disseminating” the misstatements); In re Global Crossing Ltd. Sec. Litig., 322 F. Supp. 2d 319, 333-334 (S.D.N.Y. 2004) (finding that Arthur Andersen could be liable for misstatements not attributed to it where auditor had “prepared, directed or controlled, helped create or materially assisted in preparing false statements issued by Global Crossing”) (internal quotations omitted).

39 Among the more significant motions sub judice challenging such primary liability theories is Buchanan Ingersoll’s long-pending motion to dismiss the claims pleaded against it in the Adelphia securities litigation. In re Adelphia Comm. Corp. Sec. & Deriv. Litig., 03 MD 1529 (LMM), S.D.N.Y., motion filed Mar. 9, 2004. However, the Judge in that case recently ordered the claims against Buchanan to be submitted to mediation. Order, Sept. 15, 2006.

40 The theory preceded Central Bank. Note, The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct, 29 Vand. L. Rev. 1233, 1241 (1976):

> Participation apparently lies somewhere between a primary violation and aiding and abetting and involvement in the fraudulent conduct is more direct than with conspiracy or aiding and abetting.

company's lawyer for having structured improper transaction that "was designed to allow Parmalat to book as receivables obligations it knew would not be paid"); In re Global Crossing, 322 F. Supp. 2d at 335-336 (finding that Arthur Andersen could be liable under Rule 10b-5(a) and (c) for having "masterminded" Global Crossing's "misleading accounting" and having "actively participated in structuring" several "sham swap transactions used to circumvent GAAP"); In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161, 167-68, 172-174 (D. Mass. 2003) (denying motions to dismiss by L&H's business partners who had "participated in setting up, funding and operating shell companies, knowing that these companies were designed solely to inflate artificially L&H's bottom line"). However, the two circuit court decisions that have addressed the issue declined, based on the facts before them, to extend scheme liability to issuers' "business partners." See Simpson v. AOL Time Warner, Inc., 452 F.3d 1040, 1048 (9th Cir. 2006) ("We hold that to be liable as a primary violator of § 10(b) for participation in a "scheme to defraud," the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a transaction in which the defendant was involved had a deceptive purpose and effect; the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect.") (emphasis in original); In re Charter Comm., Inc. Sec. Litig., 443 F.3d 987, 992-93 (8th Cir. 2006) ("To impose liability . . . on one party to an arm's length business transaction . . . would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.").

Likely it will take another Supreme Court decision to resolve these splits in authority.

3. Recent SEC enforcement actions

While the SEC, after Carter & Johnson, abandoned (until SOX) its efforts to develop rules of conduct for lawyers, it continued to enforce the securities laws against lawyers alleged to have violated them. The Task Force analyzed some 74 more recent SEC enforcement actions against lawyers[41], as well as a helpful compilation and report prepared for the Association of Corporate Counsel.[42] This exercise yielded these generalizations about when the SEC has chosen to proceed against lawyers retained or employed by companies that in some manner violated the securities laws:

> The cases against lawyers are virtually all ancillary to cases against their corporate clients or employers and other individuals (primarily officers);
>
> Many of the cases involve outright frauds or insider trading, rather than misrepresentations involving financial disclosures or statements;
>
> Lawyers charged by the SEC generally had a central role in the conduct at issue, often serving as corporate officers or directors;
>
> In financial fraud cases, the lawyers either had actual knowledge of the circumstances relating to the financial statements or notice of facts that constituted "red flags" suggesting the likelihood of fraud;
>
> Lawyers were seldom, if ever, charged merely for providing bad legal advice; they also had taken some action facilitating the conduct at issue.

The SEC proceeds much more frequently against in-house counsel than outside counsel,[43] with enforcement proceedings against large law firms or their lawyers especially

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41 These actions are listed in Appendix C.

42 John K. Villa, SEC and Criminal Proceedings Against Inside Corporate Counsel (Sept. 2005) ("Villa Report") (collecting all SEC and criminal proceedings brought against inside counsel from 1998 to date of paper). The Villa Report is published on the website of the Association of Corporate Counsel (for members only).

43 The difference in the SEC's approach to outside counsel as compared to in-house lawyers is evident, as one observer has noted:

(footnote continued)

rare.[44] Regardless of the nature of the respondents, the SEC's proceedings, most of them settled cases, nearly always have focused on rather clear instances of knowing misconduct by lawyers providing affirmative assistance to client/or employer wrongdoing.

A few recent exceptions, however, may suggest a more expansive SEC view of lawyer responsibility. In particular, two settled cases against General Counsels of public companies, neither involving fraudulent conduct, are noteworthy: Isselmann[45] and Drummond.[46] These cases may suggest a willingness by the SEC to proceed against attorneys who, though not active participants in the corporate misconduct, are deemed to have been insufficiently proactive upon learning of the wrongdoing.

In Isselmann, a General Counsel was found to have caused a record-keeping violation by failing to provide information to the Audit Committee after the CFO objected to his doing so. The General Counsel failed to inform the Committee that the CFO had misrepresented to it a point of Japanese law that impacted the company's liabilities. The SEC held that Isselmann, in

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> The SEC has taken a dramatically different approach to inside lawyers than it has to outside counsel. Since the early 1980's, the SEC has declined to initiate enforcement action against outside counsel unless the lawyer has either been held civilly or criminally liable, or has been disciplined by the bar. The SEC, however, pursues inside counsel without regard to whether there has been an independent finding of misconduct. (Villa Report at 2)

See n. 114, below.

44 The SEC has proceeded only very rarely against a major outside law firm or its partners for conduct in connection with its representation of a public company. For an analysis of some factors explaining this record, see Michael A. Perino, SEC Enforcement of Attorney Up-the-Ladder Reporting Rules: An Analysis of Institutional Constraints, Norms and Biases, 49 Vill. L. Rev. 851 (2004).

45 In re Isselman, SEC Rel. No. 34-50428 (Sept. 23, 2004).

46 In re Google, Inc., and Drummond, SEC Rel. No. 33-8523 (Jan. 13, 2005).

allowing the CFO to block his communication with the Audit Committee, had failed to fulfill his "gatekeeper role."

In Drummond, Google's General Counsel was found to have caused a violation of the registration requirements of the 1933 Act. Drummond, in advising Google's Board regarding a stock-option grant, had failed to report that issuing the grant might cause the company to exceed a disclosure threshold, that the company would need to rely on other exemptions to avoid registration requirements, and that such reliance would be doubtful. In other words, Drummond did not properly advise the Board of the legal risk it was taking by issuing the stock options.[47]

Also of significance, though applying the negligence standard applicable under Section 17 of the 1933 Act, is a 2005 SEC decision in a litigated proceeding involving an outside lawyer. In re Weiss, SEC Rel. No. 33-8641 (Dec. 2, 2005). Weiss, as bond counsel to a school district, was found to have violated the 1933 Act, §§17(a)(2) and (3), by issuing an unqualified opinion that the district's bonds were tax-exempt, without making a reasonable inquiry into the relevant facts and circumstances or advising the school board about the relevant criteria for tax-exempt status. Reversing an administrative judge's decision, the Commission held that this conduct "departed from the standard of reasonable prudence and was at least negligent." (Id. at 23). The

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[47] For a useful discussion of the Drummond decision and its historical context, see Stanley Keller, Searching Google for Meaning: Equity Compensation Pitfalls and a Changed Climate for Lawyer Responsibility, 10 Sec. Law Reporter 34 (Fall 2005).

Giovanni P. Prezioso, the SEC's then General Counsel, referred to Isselmann and Drummond as involving "lawyers who failed to advise key decision-makers within their organization." The decisions, he stated, "do not impose sanctions for lawyers for the *advice* they gave – but for their actions in situations where they in fact *failed to advise* their clients and became participants in the prohibited conduct." Remarks Before the Spring Meeting of the Ass'n of General Counsel, April 28, 2005, available at www.sec.gov/news/speech/spch042805gpp.htm ("Prezioso AGC Remarks") (emphasis in original).

Commission stated that Weiss's liability stemmed from his failure to conduct an adequate inquiry, and not from breach of any duty to discover a fraud. (Id. at 23 n.38). Thus Weiss suggests that, under Section 17 of the 1933 Act, lawyers issuing opinions can be held as primary violators under a negligence standard, even assuming they lacked actual knowledge, due to their own negligence, of any client wrongdoing.[48]

In the aftermath of the Enron and WorldCom scandals there were suggestions from SEC personnel of an increased scrutiny of lawyer conduct. For example, in September 2004 the SEC's then Director of Enforcement, Stephen M. Cutler, stated:

> Consistent with Sarbanes-Oxley's focus on the important role of lawyers as gatekeepers, we have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate. Stephen M. Cutler, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, Speech before UCLA School of Law, Sept. 20, 2004, available at www.sec.gov/news/speech/spch0920045mc.htm) ("Cutler UCLA Speech").

Drummond, Isselman and Weiss may reflect such a heightened scrutiny. Some recent reports from practitioners also suggest an active SEC focus on lawyer conduct. As of yet, such scrutiny and focus have not resulted in any major enforcement actions against lawyers. Nor, to date, has the SEC initiated any proceedings for violations of its 2003 lawyer conduct rules. The Commission's current approach to lawyer conduct, under Chairman Cox (who did concur in Weiss), remains to be seen.

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48 See also SEC v. Integrated Services Group Inc., James L. Rowton and David M. Loev, SEC Litig. Rel. No. 33-19476 (Nov. 29, 2005) (lawyer charged as primary violator of Section 5 of the 1933 Act for issuing opinion letters to transfer agent stating, wrongly, that SEC registration not required for issuance of stock, some of which the lawyer received and sold; no allegation lawyer acted fraudulently or with knowledge of client fraud).

4. Conclusion: no clear rules

The learning from all of the above cases and proceedings is surprisingly limited. The SEC has not provided a definitive pronouncement on the scope of a lawyer's duties in representing a public company, or when a given action or inaction by a lawyer, falling short of active participation in a fraud, will give rise to liability. The Carter & Johnson interpretation of "improper or unethical professional conduct" seldom has been cited by the SEC or the courts. Though the SEC now does have clear authority to promulgate "minimum standards of professional conduct", under SOX § 307, it has not sought to do so beyond adopting its "reporting up"(and permissive "reporting out") regulations. Such cases as Isselmann, Drummond, and Weiss may represent the wave of the future (or a return to the National Student Marketing approach), viewing lawyers as "gatekeepers", a word used expressly only in Isselmann. Or they may represent only aberrations caused by the uniquely charged atmosphere created by the Enron, WorldCom and other recent scandals.

Nor have the courts clarified these issues. The state of the law on aiding and abetting liability was confused before the concept was removed from civil litigation by Central Bank (see pp. 42-43, above). The state of the law is no less confused with respect to current primary liability theories pleaded against lawyers (see pp. 43-45, above).[49]

In sum, there remains "controversy, confusion and uncertainty concerning a lawyer's duties" in the contexts relevant to this report. Cramton, 58 Bus. Law. at 173.

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49 It is possible that some clarification may be forthcoming in the pending class actions against law firms arising out of the Enron and Adelphia scandals (see p. 43 and n.39, above).

B. Task Force recommendations concerning a lawyer's duties

Before we consider whether any changes in a lawyer's ethical duties are advisable, in the public company context, a brief restatement of those duties is in order.

1. Duties are owed solely to the client and its confidences must be protected

As framed by the existing ethical rules of almost all states, a lawyer advising a public company client (or any client) owes his duties of loyalty solely to that client. The duty is to render independent, candid, competent and conflict-free advice, solely with the interests of the client in mind. (See, e.g., ABA Model Rules 1.1, 1.7 and 2.1). The lawyer must preserve inviolate all confidences of the client learned in the course of the representation (ABA Model Rule 1.6), a category of information much broader than that protected by the attorney-client privilege.[50] The lawyer also is obligated to respect the decision-making authority of the client (ABA Model Rule 1.2(a)), the highest authority of which is the Board of Directors in the case of a public company.

This required single-minded loyalty to the client, and protection of the client's confidences, are justified principally by the belief that these ethical duties foster a relationship of trust between client and lawyer that is essential to the rendition of well-informed legal advice. ABA Model Rule 1.6, Comment 2 (see pp. 61-65, below).

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50 The attorney-client privilege protects against disclosure in litigation only confidential attorney-client communications in connection with the seeking or rendition of legal advice. The ethical duty to preserve client confidences, or "secrets," sweeps more broadly, encompassing "all information relating to the representation, whatever its source." ABA Model Rule 1.6, Comment [3]. See New York Code of Professional Responsibility ("NYCPR"), DR4-101A (limiting secrets to such information the client has requested "be held inviolate" or the disclosure of which would be embarrassing or "likely to be detrimental to the client").

2. The limit of loyalty: do not counsel or assist a crime or fraud

An important limit to a lawyer's duties of client loyalty and confidentiality is that the lawyer cannot advise or knowingly assist a client in committing a crime or a fraud. In New York the rule is stated thusly:

> In the representation of a client, a lawyer shall not: *** [c]ounsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent.

DR 7-102A.7.[51] See Norman Redlich, Lawyers, the Temple and the Market Place, 30 Bus. Law. 65, 67 (1974):

> . . .[I]f there is anything which is clear, it is our professional duty to refuse to approve of, or participate in, a transaction which we believe to be unlawful, even if it means that we have to delay or thwart a major program of a client, or cause a considerable loss of money, or embarrass management — or even cause us to lose a major client.

Here the rules of civil liability and the ethical rules are in harmony.[52] If a lawyer learns of an impending or ongoing client fraud, withdrawal may be required ethically to avoid

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51 The similar ABA Model Rule 1.2(d) uses "criminal or fraudulent," rather than "illegal or fraudulent", and the NYSBA House of Delegates, at its June 24, 2006 meeting, voted to conform New York's rule to the ABA rule. See COSAC Report, Vol. 1 at 21.

The reason for this change and its likely impact are not clear. Violations of the securities laws with the requisite intent generally will be criminal. See 15 U.S.C. § 77x (1933 Act); 15 U.S.C. § 78ff (1934 Act).

52 The interplay between ethical rules and rules of liability is beyond the scope of this report, but receives considerable focus in the decision denying Vinson & Elkins' motion to dismiss in the Enron securities class action. Enron, 235 F. Supp. 2d at 598-601, 704-05. The court concludes that while ethical rules do not create "standards for imposition of civil liability on lawyers", they do "reflect public policy concerns." (235 F. Supp. 2d at 598-99).

active participation in the ongoing wrongdoing, and also to avoid liability for such participation.[53] This generally will be the case when the lawyer is called upon to perform any service advancing the client's course of action once the lawyer knows the action is criminal or fraudulent. Model Rule 1.2, Comment [10] (lawyer may not "continue assisting a client in conduct the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent"). For example, an attorney who has drafted or reviewed a securities prospectus, and then becomes aware it contains material misrepresentations, violates both this rule and likely the securities laws as well if she proceeds to file the prospectus with the SEC.[54]

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53 See, e.g., In re American Continental Corp./Lincoln Savings & Loan Secur. Litig., 794 F. Supp. 1424, 1452 (D. Ariz. 1992) (denying Jones Day motion for summary judgment due to fact questions concerning its knowledge of client fraud in continuing its representation):

> Attorneys must inform a client in a clear and direct manner when its conduct violates the law. If the client continues the objectionable activity, the lawyer must withdraw "if the representation will result in violation of the rules of professional conduct or other law." Ethical Rule 1.16 . . . . Under such circumstances, an attorney's ethical responsibilities do not conflict with the securities laws. An attorney may not continue to provide services to corporate clients when the attorney knows the client is engaged in a course of conduct designed to deceive others [in violation of the securities laws], and where it is obvious that the attorney's compliant legal services may be a substantial factor in permitting the deceit to continue.

54 "Such acts as preparing documents or engaging in their transmission constitute substantial assistance to a fraudulent scheme," subjecting the lawyer to possible civil or criminal liability. Geoffrey C. Hazard, Jr., Rectification of Client Fraud: Death and Revival of a Professional Norm, 33 Emory L.J. 271, 276-77 (1984). See, e.g., SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1996) (lawyer violated Rule 10b-5 as aider and abettor in reviewing and filing disclosure statements, despite knowing of material omissions); SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968):

> A lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him.

See also ABA Model Rule 1.2 Comment [10]: lawyer may not assist client fraud "by drafting or delivering documents that the lawyer knows are fraudulent". Compare the

(footnote continued)

The knowledge required to invoke this exception includes knowledge inferred from obvious facts. A lawyer cannot be willfully blind to facts indicating client wrongdoing.[55] Cf. Frank, 388 F.2d at 489 (a "lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand").[56]

Short of such knowledge, or "red flags" providing equivalent notice, lawyers appear to have no ethical duty of inquiry even if there is some reason to suspect possible wrongdoing by clients. That is, if an attorney becomes aware of facts that **might** suggest corporate wrongdoing, depending on whether other facts exist, there generally is no duty under prevailing ethical standards for the attorney to inquire concerning whether those other facts do exist.[57] As an illustration,

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conduct of the law firm representing Spiegel, Inc., in continuing to draft and file with the SEC Forms 12b-25, purporting to explain Spiegel's continuing failure to file the required 10-K and 8-K reports, but omitting, according to the Independent Examiner's Report, the "real reason" for Spiegel's default, i.e., an impending going concern opinion by its auditors. Stephen J. Crimmins, Independent Examiner's Report concerning Spiegel, Inc., Sept. 5, 2003, available at www.secinfo.com/dsTKg.222n.c.htm.

A more difficult issue, in terms of liability, is presented when the client, rather than the lawyer, files a misleading document that the lawyer has reviewed. Plainly the lawyer now has a duty to report this violation of law to the Board, under the SEC's lawyer conduct rules. Beyond this, the lawyer's ethical and legal responsibilities are unclear. (See p. 42, above).

55 ABA Model Rule 1.13(b), comment 3 (knowledge inferred from circumstances; lawyer cannot ignore the obvious).

56 One experienced practitioner finds this a frequent tendency: "Lawyers often adopt a head-in-the-sand approach to avoid the difficulty of saying 'no'." Longstreth Speech, n. 17 above, at 11.

57 In the context of advising clients on unasserted claims, ABA Committees have stressed that a lawyer is not obligated to "carry on an investigation by searching out or developing facts or information beyond such as already available to him from the assigned legal work in which he is engaged." ABA Committee on Audit Inquiry Responses, Second Report Regarding Initial Implementation, 32 Bus. Law. 177, 180 (1976) (relying on 1975 ABA Committee report).

(footnote continued)

consider a lawyer asked to form a series of limited liability companies under circumstances suggesting that such entities could be used either for a legitimate purpose, or for the improper purpose of reducing the liabilities appearing in the company's public financial reports. Such may have happened in the case of Enron. Whether Enron's inside or outside counsel who set up those corporate entities had any knowledge of their actual intended use we do not know. The point is that under current ethical rules they had no duty of inquiry, assuming that the client's intention to pursue an improper use was only possible but not obvious.[58]

3. The client is the company

It is a matter of critical importance to the proper application of the above rules to a public company that the client be identified as the company itself, and not its individual officers or directors. ABA Model Rule 1.13(b). The lawyer for the client company must be alert to conduct by

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The ABA Committee on Legal Opinions states that a lawyer issuing an opinion letter is entitled to rely on factual information provided by others unless the information "appears irregular on its face or has been provided by an inappropriate source." Legal Opinion Principles, III.A, 53 Bus. Law. 831, 833 (1998).

The ABA Task Force in its 2003 report opposed imposing any duty of inquiry on lawyers, though also stating that "the lawyer may not simply accept . . . [client provided] information at face value if to do so would be unreasonable under the circumstances." (Report, 59 Bus. Law. at 167). See also ABA, Annotated Rules of Professional Conduct 40 (5th Ed. 2003) (collecting cases on "when lawyer should inquire into client's conduct").

Of course, the line separating the reasonable from the unreasonable may not always be clear, and there is always the risk, if a client fraud later surfaces, that a lawyer will be second-guessed by a regulator or jury having the benefit of 20-20 hindsight. Malpractice claims, sounding in negligence, have sometimes been based on a finding that a lawyer failed to make a reasonable inquiry when confronted with suspicious circumstances suggesting fraud. See cases discussed at Cramton, 58 Bus. Law. at 152-53.

58 While there appears to be no such duty of inquiry, we recommend below as a best practice that a lawyer make inquiry if in fact concerned about client conduct (see p. 115-16, below).

management that is in conflict with the best interests of the company. Such conduct or conflicts, when perceived, may require a report to the Board. See ABA Model Rule 1.13(b).

This essential ethical orientation is in tension with the practical reality that a lawyer's contacts will be with management (see pp. 57-58, 113-14 below). In the opinion of the court-appointed examiner of Enron, one explanation for the alleged failure of Enron's attorneys to alert its Board to management misconduct "may be that they lost sight of the fact that the corporation was their client. It appears that some of these attorneys considered the officers to be their clients when, in fact, the attorneys owed duties to Enron." Neal Batson, Court-Appointed Examiner, Final Report Nov. 4, 2003 ("Batson Report") at 115. [59]

One subject that dramatizes this tension is executive compensation. A lawyer representing a public company is put in an awkward position, at best, if asked to review the company's proposed compensation arrangements with the executive who retained the lawyer for the company, or who is in a position to determine whether the lawyer continues to represent the company. A lawyer asked to render such advice, and the Board receiving it, should reflect on whether the interests of both the company and the lawyer would best be served by having the Compensation Committee retain separate counsel free of any such possible conflict.

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[59] See also remarks of Senator Edwards during the floor debate over SOX:

> We have seen corporate lawyers sometimes forget who their client is. What happens is their day-to-day contact is with the CEO or the chief financial officer because those are the individuals responsible for hiring them.
>
> 148 Cong. Rec. S6524-02, S6551-52 (daily ed. July 10, 2002). (Statement of Sen. Edwards).

Bevis Longstreth also identifies "the corporate lawyer's apparent confusion as to who his client is" as explaining "most of the failings in recent years" (Longstreth Speech, n. 17 above, at 12).

4. A lawyer's duties should not extend to the investing public

a. The arguments in favor of a duty to the public

There has been a lively debate for many years concerning whether lawyers representing public companies should have duties broader than solely to advance their client's interests as articulated by its management and Board of Directors. One view advocates lawyers having duties to the investing public, or duties to uphold the rule of law, that should leaven the duties owed to the client.

The argument in favor of recognizing a duty to the public, though fundamentally advanced on moral grounds, is also premised on two practical observations: the strategic importance of lawyers in corporate governance, and the perceived need to counteract pressures on lawyers to acquiesce in client wrongdoing. The first premise is that lawyers are often in a position to know of impending or ongoing client wrongdoing, and thus are able to "blow the whistle," such as by reporting to the SEC, if they are unable to convince the client to abandon the wrongful course of conduct. There is some support for this premise based on our review, summarized above, of the public record concerning a number of recent corporate scandals (see pp. 24-30, above).

We also agree that there are pressures on lawyers to acquiesce in wrongful client conduct, reflecting in part the increased competitiveness of the profession (see pp. 113-14, below).[60] Outside lawyers are pressed to attract and retain clients. A law firm partner's compensation – or even a small law firm's survival – may depend on the business referred by the CEO of a major client. The mobility of clients insures a heightened sensitivity to client satisfaction. Fisch & Rosen, 48 Vill. L. Rev. at 1123 ("in an era in which major public companies routinely retain a number of

[60] See Bainbridge & Johnson, 2004 Mich. St. L. Rev. at 306 ("The nature of the legal market gives lawyers – both in-house and outside counsel – strong incentives to overlook management wrongdoing").

outside firms, no lawyer's position is secure.") The "client", for this purpose, is logically perceived as the corporate manager who has retained the lawyer to represent the company, making problematic the willingness of the lawyer to advise against or report misconduct by that same manager, or a law firm's willingness to monitor its leading rainmakers who have "portable" business. See Coffee, 84 B.U.L. Rev. at 361 ("A professional with a single dominating client has an incentive to subordinate his own firm's interest in preserving its reputation to his client's demands for acquiescence"). These pressures have increased over the past three decades. Many firms, in order to retain "star" partners, have adjusted their compensation systems away from "lock-step" seniority models to performance-based models that reward business generation and client retention. See Coffee, Gatekeepers at 196-97; cf. Cramton, 58 Bus. Law. at 175 (today's "bottom line" orientation risks "a race to the bottom" from the vantage point of respect for law and the public responsibilities of lawyers").[61]

For in-house lawyers, the obvious pressure is to retain their compensation and their jobs, and their role as a valued member of the management "team," rather than incur the wrath of a CEO or other high-ranking officer. See, e.g., ABA Task Force Report, 59 Bus. Law. at 152 (such pressures "may induce lawyers to seek to please the corporate officials with whom they deal rather than focus on the long-term interest of their client, the corporation"); Cramton, 58 Bus. Law. at 156

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61 Opinions are sharply divided as to whether corporate lawyers, in earlier, less competitive times, in fact tended to render more forthright and independent advice to clients, urging their recognition of the public interest and functioning as "wise counselors" or even "lawyer-statesmen". Compare R. Gordon, 35 Conn. L. Rev. at 1208-09 (finding that such a wise-counselor model did obtain in the Post World War II era), Erwin O. Smigel, The Wall Street Lawyer: Professional Organization Man? 6, 341-54 (1969) (similar), and Coffee, Gatekeepers at 233 n.3 (similar, citing own experience as associate in 1970s), with Stuart Speiser, Sarbanes-Oxley and the Myth of the Lawyer – Statesman, 32 Litigation 5 (2005) (finding no evidence of such a model, or advice based on the public interest, but rather advice designed to avoid litigation).

("The practical problem, especially for inside counsel, is that of angering the person within the organization with the power to fire the lawyer").[62]

It is difficult to assess the degree to which such pressures in fact influence lawyer conduct. The large law firms that provide securities representation for most major public companies are themselves significant institutions.[63] Few if any are dependent on one or two clients (or rainmakers) for their profitability, which should enable them to resist inappropriate client pressures. See Coffee, Gatekeepers at 195. Likewise, the General Counsel of most major corporations are people of stature and independence, unlikely to be drawn into a web of fraud. Nonetheless some of the recent scandals do suggest that occasionally lawyers have bent to management pressures, and failed to ask the questions or take the actions that might have prevented or mitigated corporate misconduct.[64]

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[62] It should not be assumed, however, that such pressures are greater on in-house rather than outside counsel. Much depends on the standing of the lawyer. Albert W. Driver, Jr., The Inside General Counsel's Response to Auditors' Inquiries, 30 Bus. Law 217, 220 (1974-75):

> In some respects an opinion [letter to auditors] of inside general counsel may be preferable to an opinion of outside counsel in that inside general counsel may in fact be less subject to corporate pressures. Slight displeasure of the company with outside counsel can lead to instant termination of the relationship, whereas the relationship between the company and the inside general counsel may be more stable due to his significant and accepted role within the organization.

[63] America's 100 largest law firms in 2005 reportedly realized in the aggregate gross revenues of $51 billion. The Am Law 100 2006, The American Lawyer (May 2006) at 126. See also n.163, below.

[64] The supposed force of these pressures is sometimes cited as rendering likely futile any requirement, such as embodied in the SEC's lawyer conduct rules under SOX, that lawyers report wrongdoing by management. Fisch & Rosen, 48 Vill. L. Rev. at 1117, 1123-27; Bainbridge & Johnson, 2004 Mich. St. L. Rev. at 320-21. For a more optimistic view on the utility of the SEC's rules, see Peter C. Konstant, Sarbanes-Oxley and Changing Norms of Corporate Lawyering, 2004 Mich. St. L. Rev. 541, 551-58.

Given that there is some foundation for the above two premises, the argument for a broader duty urges that the public interest requires that lawyers be held responsible for protecting shareholders and the investing public from client wrongdoing. On this view, they are "guardians of the public trust," responsible for "channeling conduct along lawful paths rather than looking the other way as their clients violate the law." Cramton, 58 Bus. Law. at 176. As one proponent has phrased it: "Lawyers for public corporations must act as counselors for law compliance, not as advocates". Konstant, 2004 Mich. St. L. Rev. at 553. See Gordon, 35 Conn. L. Rev. at 1200 (lawyers are "licensed fiduciaries of the legal system") and 1207 (lawyer "a public agent of the legal system" who may not act in furtherance of his client's interest "in ways that ultimately frustrate, sabotage, or nullify the public purposes of the laws"); cf. William H. Simon, The Practice of Justice: A Theory of Lawyers' Ethics 9 (1998) (lawyer should take such actions as, under the circumstances, "seem likely to promote justice").[65]

Such a revised definition of the lawyers' role would make them quite analogous to auditors, owing duties directly to the public to protect it from client fraud. SEC Chairman Harvey L. Pitt, Remarks before the Annual Meeting of the ABA's Business Law Section, Aug. 12, 2002 (available at www.sec.gov/news/speech/spch579.htm) ("Pitt Speech"):

> Although some lawyers believe the roles of outside auditors and corporate lawyers are vastly different, lawyers representing public companies have responsibilities quite similar to those of outside auditors. Outside auditors owe a duty to shareholders and the investing public – to assure that a company's financial reports are

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65 The profession has long paid a penalty in public esteem for resisting any recognition of a duty to act in the public interest and aligning itself solely with client interests. For example, over 70 years ago lawyers were accused of an "almost perverted singleness of purpose with which they have championed the cause of their clients" in corporate transactions. William O. Douglas, Directors Who Do Not Direct, 47 Harv. L. Rev. 1305, 1329 (1934).

> reliable and truthfully prepared. Similarly, lawyers who represent corporations serve shareholders, not corporate management.[66]

See also p. 32 above (quoting Sommer remarks); Coffee, 84 B.U.L. Rev. at 360-61.

b. Reasons for rejecting a public duty

We have actively considered the arguments in favor of this reorientation of a public company lawyer's duties. We do not favor it for several reasons. Recognition of a duty to the investing public would represent a sea change in the ethical duties of lawyers and potentially in their relationships with clients. All of the consequences of such a fundamental change cannot be predicted. But one likely consequence would be a chilling of communications between lawyers and clients, degrading the quality of legal advice by limiting the information provided by client to lawyer.

"The quality of the attorney's counsel is a function of the quality of information he receives from the client." Fisch & Rosen, 48 Vill. L. Rev. at 1128. We accept the traditional wisdom, based on common sense supported by our own experience, that clients would be more guarded in sharing information with their lawyers, and less inclined to include lawyers in meetings to discuss sensitive issues, if lawyers were viewed as having whistle-blowing duties to the investing

66 Chairman Pitt's implication that company counsel owe duties directly to company shareholders is controversial. The predominant view is that duties are owed to the company as represented by its Board. See generally ALI, Restatement (Third), The Law Governing Lawyers § 96 comment b. (2000) (lawyer representing organization does not form client-lawyer relationship with, or owe duties to, holders of interests in organization such as its shareholders). See, e.g., Pelletter v. Zweifel, 921 F.2d 1465, 1492 (11th Cir. 1991) (lawyer owes fiduciary duty to entity, not to its shareholders).

public.[67] Excluded from at least some meetings and denied access to some information, lawyers would be less able to influence client conduct, and to render fully informed legal advice.

> Instead of being viewed as a trusted advisor and confidant, the attorney will be viewed by the client as a potential adversary—one to be given as little information as possible. As clients become less likely to entrust important information to their counsel and less likely to seek legal advice for fear their lawyers will raise concerns regarding potential material violations, the ability of attorneys to provide the type of fully-informed guidance issuers need to comply with the law will be undermined.

Association letter to SEC objecting to proposed "noisy withdrawal" proposed rules, Apr. 7, 2003, at 3. See, e.g., Fisch & Rosen, 48 Vill. L. Rev. at 1127-29; cf. Upjohn Co. v. United States, 449 U.S.

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67 Harris Weinstein, a vigorous adversary of many law firms during the savings and loan scandals when Chief Counsel of the OTS (see n.33, above), strongly supports the traditional wisdom that confidentiality encourages client candor:

> To me, client confidentiality is a principle of utmost importance. In the end, we can do our job as lawyers only if we can have fully candid and open discussions with our clients about their circumstances and their plans. I have great concern about a client's willingness to be open and to consult if he or she cannot be certain that the lawyer will preserve the confidence.
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> Weinstein, 1993 U. Ill. L. Rev. at 68.

The proposition that confidentiality encourages client candor has its skeptics. See, e.g., William H. Simon, The Practice of Justice at 54-62. We know of no empirically valid evidence supporting *or* refuting the proposition. See Fred C. Zacharias, Rethinking Confidentiality, 74 Iowa L. Rev. 351, 376-82 (1989) (reviewing limited evidence available). However, we note that a recent ACC survey does suggest that most in-house counsel *believe* that the attorney-client privilege facilitates legal advice. Ass'n of Corporate Counsel, Ass'n of Corporate Counsel Survey: Is the Attorney-Client Privilege Under Attack?, at 1-2 (Apr. 6, 2005), available at www.acca.com /Surveys/attyclient.pdf ("ACC Survey") (over 90% of 363 in-house counsel responding to ACC survey sent to 3,000 ACC members believe privilege encourages employee candor and thus facilitates legal advice).

383, 389-91 (1981) (discussing similar rationale for attorney-client privilege as encouraging client candor).[68]

Another consequence of dual loyalty might be an unhealthy increase in defensive lawyering. Lawyers under a duty to the investing public would be concerned about their liability in the event they fail to fulfill that duty. Fisch & Rosen, 48 Vill. L. Rev. at 1125. To minimize the risk of liability, the tendency might be to err on the side of overly conservative advice to clients – advice too conscious of the lawyer's personal interests in avoiding liability and not sufficiently focused on the client's own interests. The SEC itself has recognized this danger.[69]

Recognition of a duty to investors would also place lawyers in a position rife with potential conflict because a large public company has many classes of investors – bondholders, shareholders, short sellers, etc. – the interests of whom may be in conflict, or at least divergent. All such investors might not have the same interest in the timing or content of public disclosures concerning the company, the merits of particular corporate transactions or other operational decisions on which legal advice might be sought.

Arguments conflating the duties of auditors with those of lawyers are not persuasive in our view. Their roles are fundamentally different, the auditor reporting to the public and the

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68 We note that these risks are already posed to some degree by the legal and ethical requirements that lawyers report up to the Board evidence of illegal conduct by corporate managers (see pp. 70-72, below). Managers may be wary of fully confiding in lawyers given this reporting up duty if they are concerned about their Board's reaction to some planned course of action.

69 See Carter & Johnson, 1981 SEC Lexis 1940 at *81:

> Concern about his own liability may alter the balance of his judgment in one direction as surely as unseemly obeisance to the wishes of his client can do in the other. While one imbalance results in disclosure rather than concealment, neither is, in the end, truly in the public interest.

lawyer advising his client in confidence. This Supreme Court summary of the auditor's duties to the public, contrasting them with the lawyer's role "as the client's confidential adviser and advocate," dramatizes the distinction:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (emphasis in original).

Thus we do not favor recognition of a duty to the investing public by lawyers representing public companies. As a basic rule, it is sound to view lawyers as having duties solely to their public company clients, with an obligation to preserve client confidences and abide by the decision-making authority of the Board of Directors.[70]

c. Confidentiality as a means to an end

The profession does need to recognize that the client-centric view of a public company lawyer's duties, which in protecting confidentiality serves the interests of the profession as well as the public interest,[71] is not written in stone. Its justification is as a means to an end,

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70 This does not imply that a lawyer may disseminate to investors or file with the SEC statements by her client that she knows are false. Such affirmative conduct likely both violates the ethical rule barring conduct that facilitates a client fraud and the securities laws (see pp. 52-54, above).

71 The interests of the profession are served by limiting the lawyers' duties as owing solely to their clients, and by giving their legal advice the protections of confidentiality and privilege, because inter alia, this tends to limit the risk of lawyers being subjected to liability or question. See Daniel R. Fischel, Lawyers and Confidentiality, 65 U. Chi. L. Rev. 1, 8-9 (1998). It also simplifies a lawyer's role when he can clearly identify his client as the only party to whom any duties are owed.

namely facilitating the compliance of public companies with the law. Coffee, 84 B.U.L. Rev. at 361:

> . . . the ultimate goal of the law is to achieve law compliance, not to maximize uninhibited communications between the attorney and the client. The norm of client confidentiality is a means to an end, not the end in itself.

The premise of the confidentiality norm is that most clients wish to comply with the law, and that lawyers, advising them in a trusting and confidential relationship, will be able to help guide and convince them to do so. Every time a major scandal impacts a public company, under circumstances in which lawyers were in a position to advise against the conduct, this premise becomes subject to question.[72] Thus the rule of client primacy does not provide an excuse for acquiescing in wrongful client conduct, but rather a platform from which to render forceful advice to prevent client wrongdoing.

5. The lawyer's need to take account of the client's duties to the investing public

The fact that, in our view, lawyers have no duty to the investing public does not mean that they can prudently ignore the interests of the investing public in advising their clients.

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[72] See Redlich, 30 Bus. Law. at 72:

> . . . I am certain that unless the public, the regulatory bodies and the courts are convinced that communication between lawyers and clients is in fact having a positive effect on compliance with the law, the legal profession has little hope in persuading the courts that imposing on lawyers a limited duty to divulge is harmful, even if such compulsory disclosure does result in some restrictions on the willingness of clients to consult with lawyers.

See also Konstant, 36 Wake Forest L. Rev. at 84 (questioning "[c]onclusory statements that confidentiality is successful in causing clients to comply with the law," and citing to article suggesting that lawyers involved in savings and loan scandals made no effort to deter client misconduct); Gordon, 35 Conn. L. Rev. at 1202-03 (questioning confidentiality as facilitating informed legal advice if lawyers are unwilling to press clients to reveal all facts relevant to the advice.)

The lawyer must consider only the client's interests, as ultimately decided by the Board of Directors. But in rendering advice, the lawyer must be conscious of the client's own duties to the investing public and the consequences to the client of violating those duties. Cf. ABA Comm. on Ethics and Profess. Responsibility, Formal Opin. 335 (1974):

> While the responsibility of the lawyer is to his client, he must not be oblivious of the extent to which others may be affected if he is derelict in fulfilling that responsibility.

There should seldom be a conflict between the public interest in preventing corporate fraud and a lawyer's duties to his public company client, if the identity of the client and its interests are properly understood. Lawyers take their directions from corporate officers or directors, but their client is, and they owe their duties of care and of loyalty to, the corporate entity (see pp. 55-56, above). The corporation is obligated to comply with the law. Failure to comply may cause liability and reputational damage, and regulatory actions, resulting in serious harm to the company. If it sometimes might be in the company's economic interest to violate the law, that interest is not one the lawyer can recognize or encourage. ABA Task Force Report, 59 Bus. Law. at 177 (duty of lawyers to advise corporate officers that actions violating the law "are always contrary to the legitimate interests of the corporation").[73] Thus advice leading to compliance with the law protects both the investing public and the legitimate interests of the client.

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[73] See ALI, Principles of Corporate Governance: Analysis and Recommendations § 2.01(b)(1) (1994):

> (b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:
>
> > (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law. . .

More generally, if the profession loses sight of the impact on the public of its private legal advice, the vacuum of moral responsibility thus created risks being filled by public regulation. The SOX reporting up requirements enacted in 2002, it can reasonably be argued, resulted in part from the retrenchment in the profession's ethical rules as articulated by the ABA in the years from 1974 until the 2003 ABA Model Rule amendments (see pp. 75-78, below), coupled with the failure of state ethical bodies to address corporate practice (see pp.184-85, below). Should the profession retrench once again, failing to embrace the governance responsibilities recognized by the ABA's 2003 amendments, and a new outburst of corporate scandals create a climate for expanded regulation, the imposition of mandatory whistle-blowing duties or enhanced liability standards would not be surprising, however counterproductive to the cause of good corporate governance. See Fisch & Rosen, 48 Vill. L. Rev. at 1137 ("if attorneys do not act, more draconian measures may follow, including requirements that require direct reporting to the governmental authorities"); Longstreth Speech, n. 17 above, at 14-19 (pointing to risk that the bar may be subjected to stringent regulation analogous to PCAOB regulation of accounting profession); Coffee, Gatekeepers at 351 (SEC, given its authority under SOX to establish lawyer conduct rules, could require lawyers "to take reasonable steps to investigate the accuracy of statements made in documents they prepare").

6. Advice beyond narrow legal questions

While not an ethical obligation, lawyers should counsel their clients on more than the outer bounds of the law. Conduct technically legal can harm the corporation in ways beyond the reach of courts or regulators, such as by damaging its reputation, community goodwill, or its relationships with employees.

A good lawyer gives the client advice on such issues, going beyond narrow legal analysis. Ignoring these issues ill-serves the client. Action complying with today's legal requirements may create reputational risks which decision-makers have not considered, or may later require expensive alterations because of foreseeable changes in the law. ABA Model Rule 2.1 expressly encourages lawyers, in rendering advice, to "refer not only to the law but also to other considerations such as moral, economic, social and political factors" relevant to the client's situation. See ABA Task Force Report, 59 Bus. Law. at 177.

A good illustration of this point is presented by executive compensation. Allegedly excessive executive compensation, insufficiently monitored by Boards of Directors, and inadequately disclosed to the public, is said to evidence a glaring failure of corporate governance.[74] Plainly, lawyers must advise their public companies on the legal requirements applicable to executive compensation, such as compliance with the SEC's new disclosure rules,[75] and the requirements of several exchanges that members of the Board Compensation Committees be independent of management.[76] Lawyers can also render important advice in setting up appropriate

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74 See generally Lucian Bebchuk & Jesse Freed, Pay Without Performance (2004) (discussing, inter alia, actions by Boards of public companies decoupling executive pay from performance, and failing to negotiate at arms' length with the executives); William B. Chandler, III & Leo Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. Pa. L. Rev. 953, 1001 (2003) (the two resident authors, Chancellor and Vice Chancellor of the Delaware Chancery Court, suggest need for "reinvigorated application of the concept of waste" to respond to "Argentine-like inflation in executive compensation"); Glass Lewis & Co., Pay Dirt: A Review of 2005 Executive Compensation Practices, Sept. 17, 2006 ("Hundreds of U.S. companies continue to pay their senior executive teams millions – and often, tens of millions of dollars of annual pay for performances ranging from mediocre to abysmal").

75 SEC Securities Rel. No. 33-8732A, Aug. 29, 2006, Executive Compensation and Related Person Disclosure (adopting rule requiring added disclosure requirements for, *inter alia*, executive compensation).

76 E.g., NYSE Listed Company Manual, Corporate Governance Standards § 303A.05(a) (2004):

> Listed companies must have a compensation committee composed entirely of independent directors.

policies and procedures with respect to Committee and Board review of compensation decisions. Although the lawyer's role surely also includes counseling against illegal compensation practices, such as the undisclosed backdating of stock options (see pp. 111-12, below), restricting advice to specific legal questions might not sufficiently serve the client's interests. An award of "excessive" executive compensation, even if entirely legal, can have detrimental impacts on a company in terms of its public image, investor relationships, and dealings with other constituents, such as creditors and employees.[77] Effective lawyering should include advice on these non-legal, but still important consequences of corporate decisionmaking.

The decision-making authority on all such issues, of course, resides with the client. The degree to which such non-legal advice is welcomed or influential may depend on the client's view of the lawyer. Our point is that while, as outlined above, we would limit a lawyer's "duties" in representing a public company, a good lawyer will often go beyond those duties (respecting applicable ethical rules) to serve the interests of the client, and on occasion, also to reflect his own sense of justice.[78] A lawyer "has at least an aspirational obligation to counsel clients – beyond law

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[77] Cf. Glass Lewis, Pay Dirt at 2:

> For all the recriminations sparked by this year's wave of stock-option-backdating probes, the scandal over executive compensation isn't just about violations of the law. Often the scandal is what's legal.

[78] When issues speak strongly to the lawyer's own sense of right or wrong, to ignore them does a disservice to the lawyer's own conscience as a moral professional. See The Corporate Conscience and the Corporate Bar, 26 Bus. Law. 959, 967 (1971) (remarks of Frederic L. Ballard):

> Possibly the lawyer has no duty to tell the corporation what it ought to do or what it ought not to do, but he does have sooner or later a duty to himself.

The lawyer can withdraw if she truly finds the client's conduct, though legal, to be "repugnant." ABA Model Rule 1.16(b)(4).

– about practical considerations, likely public perceptions and reactions, and generally about doing the right thing." Harvey H. Goldschmid, A Lawyer's Role in Corporate Governance: The Myth of Absolute Confidentiality and the Complexity of the Counseling Task at 7 (Orison S. Marden Lecture at the Association, Nov. 17, 2003), available at www.sec.gov/news/speech/spch111703hjg.htm ("Goldschmid Speech").

C. Reporting up: now a legal duty and ethical imperative

1. The SEC's regulations under SOX

In the public company context, a lawyer's duties to the client have been defined by regulations and ethical rules to include an obligation, under prescribed circumstances, to "report up" the corporate hierarchy evidence of wrongdoing by the company's officers, employees or other agents.

The SEC's "reporting up" regulations, adopted in 2003 pursuant to SOX § 307, obligate a lawyer to report to the client "evidence" that a "material" violation of the securities laws or fiduciary duties is "reasonably likely." The triggering "evidence" is defined as

> . . . credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur. 17 C.F.R. § 205.2(e).

The initial report is made to the company's chief legal officer or CEO, 17 C.F.R § 205(3)(b)(1). If no "appropriate response" is received, the lawyer is obligated to report up the evidence to the Board of Directors or Audit Committee, 17 C.F.R § 205.3(b)(3).

This reporting up duty is entirely consistent with the lawyer's duties of client loyalty and confidentiality, since the client is the company and no client confidences are disclosed outside the company. Nonetheless, a decision to report up will not be an easy one for a lawyer. Where the conduct to be reported is that of a business executive who has retained the lawyer, or who is in a position to prejudice the lawyer's employment in the case of in-house counsel, the disincentive to report up is palpable. See Fisch & Rosen, 48 Vill. L. Rev. at 1123-26. But the faithful observance of such a duty appears critical to minimizing corporate scandals, since we believe that almost all Boards of Directors of public companies, if informed of wrongdoing by corporate managers, will take action in response to such reports (see p. 74, below).[79]

In that context, the triggering definition in the SEC regulations quoted above may not be sufficiently clear to encourage reporting up when it is appropriate. Some have contended that the "reasonably likely" phrase in the trigger requires that the lawyer conclude it is more likely than not, i.e., more than 50% likely, that a material violation is threatened, and that no "prudent and competent" lawyer could conclude otherwise.[80] Such a reading seems mistaken and, if widely followed, may deter reporting up even when objectively warranted, given the disincentives noted above for lawyers to report on the managers with whom they deal.[81] Accordingly, it would be helpful if the SEC made clear, consistent with its release adopting the rules, that the trigger requires a report whenever a lawyer concludes, based on credible evidence, that a material violation is "more

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79 The facts of Carter & Johnson present a clear instance of where reporting up likely would have aborted illegal conduct by management. The company's independent directors were actively concerned about its public disclosures, but were never advised by counsel that counsel had pressed management to supplement those disclosures (see pp. 34-35, above).

80 See Statement of Prof. Richard W. Painter before U.S. House of Rep. Committee on Financial Services, Hearing before Subc. on Capital Market, Insurance and Govt. Sponsored Enterprises, The Role of Attorneys in Corporate Governance, Feb. 4, 2004, at 3-4, available at http://financialservices.housegov/media/pdf/020404rp.pdf ("Painter Statement"); George M. Cohen, Roger C. Cramton & Susan P. Koniak, The Defective Trigger of the SEC's Rule Implementing SOXA's Duty to Report, 37 Sec. Reg. & Law 108, Jan. 17, 2005; Gordon, 35 Conn. L. Rev. at 1189.

81 There seems little danger, at present, that the SEC rules will lead to "over-reporting" by lawyers to boards of "all possible information related to . . . actual, likely or even improbable wrongdoing . . . ." Fisch & Rosen, 48 Vill. L. Rev. at 1126.

than a mere possibility," even if not "more likely than not." See SEC Rel. No. 33-8185, Implementation of Standards of Professional Conduct for Attorneys, Jan. 29, 2003, at n.50.

2. ABA Model Rule 1.13(b): New York should adopt its presumption in favor of reporting up

Largely consistent with these SOX regulations, in 2003 the ABA amended Rule 1.13 of its Model Rules. Model Rule 1.13(b) as amended requires a lawyer to report certain law violations up the ladder unless the lawyer reasonably believes it is not in the best interest of the client to do so.

Before its amendment, Model Rule 1.13(b) provided that where a lawyer knows that an officer's conduct in a matter related to the representation involves a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization, and that violation is likely to result in substantial injury to the organization, the lawyer "must proceed as is reasonably necessary in the best interest of the organization." The corresponding New York Disciplinary Rule, DR 5-109, is similar.

The 2003 amendment to Model Rule 1.13(b) requires the lawyer in such circumstances to refer the matter to a "higher authority" in the organization, including the Board of Directors if warranted, "[u]nless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so." In effect, the 2003 amendment creates a presumption in favor of reporting up the ladder.

New York should adopt this amendment to ABA Model Rule 1.13(b).[82] Model Rule 1.13(b) as amended provides, consistent with the mandate of the SOX rules, positive

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[82] The NYSBA COSAC Report recommends that New York adopt (i) the change in the presumption, i.e., the language in the second sentence of 1.13(b), and (ii) the rest of the other changes to 1.13(b) with some minor differences. COSAC Report, Vol. 1 at 191.

encouragement for the lawyer to report up knowledge of material violations of law. That is the appropriate default position, unless the lawyer has specific reasons for believing such reporting "is not necessary in the best interest" of the corporation.[83]

3. New York should adopt ABA Model Rule 1.13(e), requiring Board notification of a lawyer's discharge for reporting up, or related withdrawal

Rule 1.13(e) applies when a lawyer reasonably believes that the lawyer has been discharged because of reporting up pursuant to Rule 1.13, or when the lawyer withdraws in circumstances that would have permitted such reporting. In such circumstances, the lawyer must proceed as he "reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal."

It seems clear that a board of directors would want to know, and should know, if a lawyer is discharged for actions taken under this rule or withdraws in circumstances that would require or permit such action (see ABA Task Force Report, 59 Bus. Law. at 169). We recommend that this provision be adopted in New York.[84]

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83 The relevant factors a lawyer may consider in determining the company's "best interest" -- identical to the factors contained in New York's current DR 5-109 -- are set forth in Comment [4] to Rule 1.13. Comment [4] states that "[o]rdinarily, referral to a higher authority will be necessary," the only exception mentioned being when "it may be appropriate for the lawyer to ask the [wrongdoing] constituent to reconsider the matter."

84 The NYSBA COSAC Report omits 1.13(e) from the text of its proposed Rule 1.13. However, some of the content of 1.13(e) is reflected in Comment [8] to proposed Rule 1.13, which states that under "some circumstances" Rule 1.4 (duty of communication to client) and Rule 1.16(d) (duty to protect client's interests upon termination of representation) "may require" the lawyer to inform the board of the lawyer's discharge or withdrawal and the basis for same. COSAC Report, Vol. 1 at 191, 196.

We believe the clarity of Model Rule 1.13(e) is preferable to this uncertain guidance in COSAC Comment [8].

D. Reporting "out": a narrow but necessary permissive right

For responsible public companies, particularly in today's scandal-sensitive climate, it would be surprising if senior managers and an independent Board of Directors all took no action in response to a lawyer's report of an impending or ongoing securities fraud or other serious corporate misconduct.

> These decision-makers will be in a position where it would be foolhardy, in light of the significant personal and corporate consequences arising from a failure to act, not to address appropriately any evidence of a material violation reported to them. (Association letter to SEC, Apr. 7, 2003, p. 62 above, at 3.)[85]

At the very least, one would expect a Board to consider the report to determine, in good faith, whether it agreed or disagreed with the lawyer or deemed further inquiry necessary. But where a Board fails to consider or act on the report, or is disabled from acting (for example, by conflict of interest), and permits the illegal course of conduct to continue, or fails to remediate it, it is appropriate to recognize a limited discretion to "report out" the wrongdoing beyond the client, such as to the SEC. Such permissive reporting out of client confidences in these rare circumstances is provided by ABA Model Rules 1.6(b)(2) and (3) and 1.13(c), as amended in 2003, [86] the ethical

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85 One view of the Enron facts is that its Board had ample knowledge of the risks of management's conduct yet took no action, a passivity that "reporting up would not have changed." See Fisch & Rosen, 48 Vill. L. Rev. at 1122.

Even if this view of the facts is correct, however, given the current climate produced in large measure by Enron itself, a Board in a comparable position today would not likely display such somnolence.

86 Model Rules 1.6(b)(2) and (3) require that the lawyer's services have been used in the client wrongdoing, while Rule 1.13(c) does not. However, Rule ¶ 1.13(c) applies only when the client company itself is threatened with "substantial injury", while Rules 1.6(b)(2) and (3) are not so limited. See n. 93, below.

rules of most states, the ALI's Restatement of the Law Governing Lawyers, and the SEC's lawyer conduct rules. New York should join this consensus by adopting the amended ABA Model Rules.[87]

1. New York should adopt the ABA Model Rule 1.6(b)(2) and (3) amendments

a. Background and context

The duty of a lawyer to preserve client confidences has been termed "a sacred trust," yet the duty has never been absolute. Cramton, 58 Bus. Law. at 186. There always has been a need to consider other interests and values that also should inform a lawyer's conduct. See ABA Task Force Report, 59 Bus. Law. at 170 (some commentators emphasizing importance of client confidentiality "have ignored exceptions to confidentiality that have developed to serve other policy purposes").

There have been exceptions that speak to a lawyer's self-interest in making use of client confidences when necessary "to establish or collect the lawyer's fee or to defend the lawyer...against an accusation of wrongful conduct." DR 4-101C.4. See Meyerhofer v. Empire Fire & Marine Ins. Co., 497 F. 2d 1190, 1194-95 (2d Cir. 1974) (applying the rule as justifying lawyer's disclosure of confidences to defend himself against a 10b-5 claim).

More pertinent to our topic is the traditionally recognized exception, varying in scope among the states, permitting (or requiring) lawyers to disclose client confidences when confronted with certain kinds of threatened or actual client wrongdoing. At this point a review of some ABA history is in order to place the 2003 Model Rule amendments in context.

The ABA's ethical rules have evolved over three generations: the Canons of Professional Ethics adopted in 1908 (the "Canons"); the Model Code of Professional Responsibility

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87 The COSAC Report does not recommend that New York adopt the Rule 1.6(b)(2) and (3) or Rule ¶ 1.13(c) permissive reporting out provisions. COSAC Report, Vol. 1 at 52-67, 191.

adopted in 1969 (the "Code"); and the Model Rules of Professional Conduct adopted in 1983 (the "Model Rules").

Under both the Canons and the Code, lawyers were under a mandatory duty to disclose any client fraud to the victims of the fraud. Canon 41 required a lawyer to "promptly inform the injured party" of a client fraud, if the client refused to rectify it. Similarly, DR 7-102(B)(1) of the Code required a lawyer, upon learning that a client "in the course of the representation [had] perpetrated a fraud upon a person or tribunal" to "reveal the fraud to the affected person or tribunal" if the client failed to rectify it.

Given these ethical rules, it was confidently asserted by commentators in the early 1970s, when a lawyer's responsibilities under the securities laws became the subject of controversy, that there was an affirmative ethical obligation to report a client's securities fraud notwithstanding the generally applicable duty to preserve client confidences. Panel Discussion, Responsibility of Lawyers Advising Management, 30 Bus. Law. 13, 17 (remarks of Lewis H. Van Dusen, Jr.), 24-25 (remarks of Kenneth J. Bialkin), and 30 (remarks of J. Gordon Cooney) (1974).[88]

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[88] Mr. Cooney's remarks are illustrative:

> [T]he lawyer violates the standards of his own profession, as laid down by the Code of Professional Responsibility, if the lawyer, after he learns that a fraud or crime is about to be committed, fails to inform the proper authorities. 30 Bus. Law. at 30.

This duty to report out under DR 7-102(B)(1) was clouded by a 1974 amendment to the rule, apparently adopted in response to the SEC's National Student Marketing complaint, limiting the reporting out obligation to information not "protected as a privileged communication". See Geoffrey C. Hazard, Jr., Susan P. Koniak & Roger C. Cramton, The Law and Ethics of Lawyering 283-85 (3d ed. 1999). Opinions varied as to whether this amendment had vitiated the reporting out duty, or had left it largely unaffected given the crime-fraud exception to the attorney-client privilege. A 1975 ABA ethics opinion tended toward vitiation by construing "privileged communication" to embrace all client confidences, reflecting the view that the "tradition" of protecting client confidences "is so important that it should take precedence, in all but the most serious cases, over the duty imposed by DR 7-

(footnote continued)

In adopting the Model Rules in 1983, the ABA House of Delegates deleted any such mandatory reporting out requirement. Further, even a permissive right to report out client confidences was limited to when reasonably believed necessary

> to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm.

Model Rule 1.6(b) (1983).

The proposal by the Kutak Commission, which drafted the Model Rules, that the permissive right to report out extend to an actual or impending client crime or fraud that threatened financial damage had been rejected by the ABA's House of Delegates in 1982. Similar proposals were rejected by the House in 1991 and again, when proposed by the ABA's Ethics 2000 Commission, in 2001. Stephen Gillers & Roy D. Simon, Regulation of Lawyers: Statutes and Standards 69-71 (2005 ed.).

Thus the ABA's ethical rules on disclosing a client financial fraud had turned around 180 degrees from 1969 to 1983: a requirement to disclose the fraud in the Code had become a prohibition against disclosing it in the Model Rules.[89] The only remedy available under the Model

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102(B)". ABA Committee on Ethics and Professional Responsibility, Formal Opin. 341 (Sept. 30, 1975). See Theodore Sonde, "Up the Ladder" and Over: Regulating Securities Lawyers – Past, Present & Future, Wash. & Lee L. Rev. 331 (2003) (terming above developments as "the functional evisceration" of DR7-102(B)(1)). See generally Stephen Gillers, Regulation of Lawyers: Problems of Law and Ethics 337-38 (7th ed. 2005) (discussing the history of DR 7-102(B), ABA Opinion 341 and related developments).

[89] The reporting out provisions of the Canons and the Code presumably had in mind face-to-face frauds, and not the widespread securities frauds pursued under Rule 10b-5. However, it would seem the case for reporting out is all the stronger as the number of victims of the fraud increases.

Rules to a lawyer learning of a client financial crime or fraud was to withdraw from the representation. Model Rule 1.16(b)(2).[90]

Soon after the Enron and WorldCom scandals were exposed, in 2002 the ABA appointed its Task Force on Corporate Responsibility (the "ABA Task Force"). That Task Force recommended, once again, that the permissive reporting out provisions in Model Rule 1.6(b) be expanded to encompass financial frauds. Those recommendations were narrowly adopted by the House of Delegates in 2003.

The 2003 amendment to Model Rule 1.6 in fact brought the ABA into conformity with the trend in ethics codes elsewhere. Most states, when they adopted their versions of ABA Model Rule 1.6 after 1983, had granted attorneys the right to disclose client confidences -- and a few required such disclosures -- if necessary to prevent financial damage resulting from a client crime or fraud in which the lawyer's services have been used.[91] ABA Task Force Report, 59 Bus. Law. at 171 & n.89 (citing 41 such state ethics codes); Cramton, 58 Bus. Law. at 157.

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[90] The withdrawal might not be entirely silent in some circumstances. See nn.91 and 95, below.

[91] New York's Disciplinary Rule does not go so far, but does permit disclosure of client confidences to reveal "[t]he intention of a client to commit a crime and the information necessary to prevent the crime." DR 4-101C.3.

New York also permits disclosure of client confidences to the extent implicit in withdrawing a written or oral opinion or representation previously given by the lawyer, and believed still to be relied upon by others, if the lawyer discovers that the representation or opinion "was based on materially inaccurate information or is being used to further a crime or fraud." (DR4-101.C.5, sometimes termed the "noisy withdrawal" rule). Comment [3] to ABA Model Rule 4.1 is similar, recognizing that "[s]ometimes it may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm an opinion, document, affirmation or the like."

This report does not focus on the duties or responsibilities of a lawyer in issuing an opinion letter. The relevant literature is extensive. An ABA website, the Legal Opinion Resource Center, collects relevant ABA reports: www.abanet.org/buslaw/tribar/home/shtml.

In 2000, the American Law Institute had adopted the Restatement of the Law Governing Lawyers. Section 67 (1) permits the use or disclosure of client confidences to the extent the lawyer "reasonably believes" necessary to prevent a crime or fraud, threatening "substantial financial loss," in which the lawyer's services have been used. Section 67(2) permits disclosure if such a crime or fraud has already occurred and the lawyer reasonably believes such use or disclosure "is necessary to prevent, rectify, or mitigate the loss."

Consistent with these ethical rules, the SEC's SOX lawyer conduct rules adopted in 2003 permit a lawyer to disclose client confidences to the SEC to the extent reasonably believed necessary, inter alia, "to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors," or "to rectify" the consequences of such a material violation, "in furtherance of which the attorney's services were used." 17 C.F.R. § 205.3(d).[92]

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[92] In adopting its lawyer conduct rules, the SEC retreated from its original "noisy withdrawal" proposal. This proposal would have required a lawyer to withdraw from representing an issuer, inform the SEC of that withdrawal, and disaffirm any prior SEC filing believed to be materially false, if the lawyer had reported up a material violation of law and received no "appropriate response" within a reasonable time. Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. No. 33-8150, 67 Fed. Reg. 71670 (Dec. 2, 2002) (proposed to be codified at 17 C.F.R. § 205.3(d)). This proposal evoked vehement opposition from the bar, including from this Association. Association letters to SEC, Dec. 16, 2002, and Apr. 7, 2003.

The SEC dropped the proposal from its rules as adopted, while retaining the permissive reporting provision cited in the text. There is controversy concerning whether even this permissive reporting rule is authorized by SOX § 307. There is also dispute as to whether this SEC rule preempts a state ethics code that prohibits such reporting out. The SEC's position is that it does. 17 C.F.R. § 205.1 ("where the standards of a state . . . where an attorney is admitted or practices conflict with this part, this part shall govern"). See also Goldschmid Speech, p. 70 above, at 6-7; Washington State Bar Ass'n, Interim Formal Ethics Opin., The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations Under the RPCs (July 26, 2003); John K. Villa, Hidden Storms for Those in Safe Harbors: The SEC's Professional Conduct Rules and the Federal Preemption Doctrine, ACC Docket (Feb. 2004); E. Norman Veasey, Issues of Federalism in Light of the SEC
(footnote continued)

b. The 2003 ABA Model Rule amendments

The ABA Model Rule amendments adopted in 2003 permit the disclosure of client confidences reasonably believed necessary "to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another" – or "to prevent, mitigate or rectify substantial injury" resulting from such a crime or fraud – "in furtherance of which the client has used the lawyer's services" (Model Rules 1.6(b)(2) and (3)). While controversial, these amendments still stop well short of the mandatory reporting out requirement in effect under the former Canons and Code (see pp. 75-77, above).

As stated, Model Rules 1.6(b)(2) and (b)(3) were part of a package of recommendations made by the ABA Task Force. In support of both sections, the ABA Task Force Report stated the following, with which we agree:

> The Task Force believes that the interest of society, and the bar, in assuring that a lawyer's services are not used by a client in the furtherance of a crime or a fraud justifies an exception to the important principle of confidentiality, as most states have recognized. The importance of protecting both society and the bar from the consequences of a client's misuse of the lawyer's services in furtherance of a serious crime or fraud must be balanced against the importance to the client-lawyer relationship of the principle of confidentiality.

Report, 59 Bus. Law. at 172-73. New York should adopt the broader permissive disclosure provisions of ABA Model Rules 1.6(b)(2) and (3).[93] Under the extreme circumstances posited by

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Final Rules Under Section 307 of the Sarbanes-Oxley Act, Professional Lawyer (Fall 2002). We take no position on these questions of law.

93 Model Rule 1.6(b)(2) reads:

> A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime or fraud that is reasonably certain to result in

(footnote continued)

these Model Rules, a lawyer should have the discretion to make limited disclosures, to regulators or others, when reasonably necessary to prevent or mitigate a substantial financial fraud.

Model Rule 1.6(b)(2) permits a lawyer to disclose limited confidential information to prevent a client from committing an ongoing or threatened crime or fraud as defined, when the client has used or is using the lawyer's services in furtherance of the fraud. Comment [7] to Rule 1.6 gives two good reasons for this rule. First, "[s]uch a serious abuse of the client-lawyer relationship by the client forfeits the protection of [the confidentiality rule]." Corporate managers engaged in such wrongdoing, and directors condoning it, forfeit any right to demand that the company's lawyers, whose services have been used to further the wrongdoing, keep such wrongdoing secret.[94] Second, says Comment [7], "[t]he client can, of course, prevent such disclosure by refraining from the wrongful conduct."

> substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.

Model Rule 1.6(b)(3) reads:

> A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent, mitigate or rectify substantial injury to the financial interest or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services.

94 See Cramton, 58 Bus. Law. at 175:

> The professional duty of confidentiality should include the same policy that the law has always applied to the attorney-client privilege. Confidentiality evaporates when a client attempts to use the privilege to further a crime or fraud.

See also ABA Task Force Report, 59 Bus. Law. at 170-72; ACCA Statement to ABA Task Force, July 29, 2003, in support of its the proposed amendments to Model Rule 1.6(b)(2) and (3) ("ACCA Statement"), at 1:

(footnote continued)

Model Rule 1.6(b)(3) speaks to crimes or frauds already committed using the lawyer's services. It permits the lawyer to disclose limited confidential information when necessary to "mitigate or rectify substantial injury to the financial interests or property of another" resulting from the wrongdoing. Again, disclosure is justified, in part, because the client has abused the client-lawyer relationship. While "the client no longer has the option of preventing disclosure by refraining from the wrongful conduct," disclosure is permitted "to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses." Comment [8] to Model Rule 1.6. A 1993 Association report, with which we agree, supported such a disclosure provision in these words:

> [D]isclosure of client confidences and secrets to rectify a crime or fraud in the commission of which the lawyer's services have been used, whether permissive or mandatory, is necessary to protect important rights of third persons.
>
> * * *
>
> [D]isclosure maintains the proper balance between, on the one hand, the competing interests of client confidentiality and attorney loyalty to client interests and, on the other hand, the interests of society and third persons in avoiding harm resulting from illegal and/or fraudulent acts.

Association Professional Responsibility Committee, <u>Report on the Debate Over Whether There should be an Exception to Confidentiality for Rectifying a Crime or Fraud</u> at 26-27 (Feb. 1993).

We recommend that New York adopt Model Rules 1.6(b)(2) and (b)(3).[95]

> ... clients, whether corporations or individuals, should not be able to abuse a lawyer's services under the cloak of the duty of confidentiality.

[95] The version of Model Rules 1.6(b)(2) and (3) under consideration by the NYSBA House of Delegates does not include the reporting out provisions in the 2003 ABA amendments, but rather would permit disclosure of client confidences only (in pertinent part) "to prevent the client from committing a crime". COSAC Report, Vol. 1 at 62-67. Thus it would reach

(footnote continued)

2. New York should adopt the ABA Model Rule 1.13(c) amendments

The 2003 amendment to Model Rule 1.13(c) permits reporting outside the company when the Board "insists upon or fails to address in a timely or appropriate manner" conduct that is "clearly a violation of law" which the lawyer "reasonably believes . . . is reasonably certain to result in substantial injury" to the company. In these circumstances, "information relating to the representation" may be disclosed, though "only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury" to the company.

Rule 1.13(c) differs from Rule 1.6(b) in that it enables a lawyer to protect the client company (not a third party) from harm, and regardless of whether the misconduct has utilized the lawyer's services. The lawyer has a special need to act in such circumstances and should have the discretion to do so since the client is the company, not the management or other agents who are themselves breaching their fiduciary obligations to the company.

Given our study of recent corporate scandals, we believe that a lawyer ought to have the discretion to protect the corporate client against its agents who are harming it. The lawyer should have to go up the ladder first, which the proposed rule requires. In the overwhelming number of cases that will be sufficient to protect the company. In the rare event that such efforts to

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ongoing or impending criminal (but not civil) frauds, whether or not the lawyer's services were used, and would not reach any past crimes or frauds.

New York's current "noisy withdrawal" rule (DR 4-101(C.5)), which the COSAC proposal would continue as Rule 1.6(b)(3), is not an adequate substitute for amended ABA Model Rules 1.6(b)(2) and (b)(3) because its reach is limited to where the lawyer has made or issued a representation or opinion (see n. 91, above). Further, the rule permits only notice of the withdrawal, which may not adequately inform those who would be harmed by the threatened or ongoing fraud. Cf. Hazard, 33 Emory L.J. at 299-301 (withdrawal ineffective, in protecting innocent lawyer or third parties, when fraud has already occurred or when third party does not understand cautionary signal implied by withdrawal).

rectify the situation internally fail, however, the lawyer should have the authority to reveal limited confidential information of the corporate client to protect that client. We thus recommend that New York adopt Model Rule 1.13(c). See ABA Task Force Report, 59 Bus. Law. at 175-76.[96]

3. The distinction, concerning reporting out, between the roles of advisor and advocate

Both Model Rule 1.6(b)(3) and Rule 1.13(c) distinguish between the roles of corporate advisor and the role of litigator or investigator. The permission to disclose client confidences authorized by Model Rule 1.6(b)(3) "does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense." Model Rule 1.6(b)(3), Comment [8]. Likewise, Model Rule 1.13(d) provides that the permission to disclose authorized by Model Rule 1.13(c)

> shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against the claim arising out of an alleged violation of law.

The comment explains that this provision "is necessary in order to enable organizational clients to enjoy the full benefits of legal counsel in conducting an investigation or defending against the claim." Comment [7].

Thus it is only the corporate advisor who, under the limited circumstances described in Model Rules 1.6(b)(3) and 1.13, may disclose client confidences. Such a permissive right of

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[96] The COSAC Report does not recommend adoption of this permissive reporting out provision of Model Rule 1.13(c). COSAC Report, Vol. 1 at 191. Instead, if faced with such Board intransigence, COSAC's proposed Rule 1.13(c) only provides that "the lawyer may resign in accordance with Rule 1.16." Such a step clearly provides no benefit for the company's shareholders or any third parties injured by the ongoing illegal conduct.

disclosure is not available to investigating or defense counsel.[97] Some of the resistance to these exceptions, in our view, stems from a failure to recognize the distinct roles of advisor and litigator, the former obliged to facilitate only lawful transactions, and exercising "independent professional judgment" (ABA Model Rule 2.1), and the latter obliged to provide "zealous advocacy" to defend the client's past conduct. See, e.g., Cramton, 58 Bus. Law. at 173, 176; Coffee, Gatekeepers at 192-93, 204-05; Gordon, 35 Conn. L. Rev. at 1204-07.[98]

To be sure, both the advisor and the litigator have an ethical duty to preserve and protect client confidences. But this need is near absolute and indispensable to the litigator's role: the adversary system could not function if a client could not confide in its litigator without fear of disclosure to the adverse party. (See ABA Task Force Report, 59 Bus. Law. at 176).[99] In contrast,

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97 A similar distinction is drawn in the SEC's lawyer conduct rules. Lawyers need not report up evidence of material violations if they have either been retained to conduct an investigation of such evidence, or to defend the company (or some agent), provided that the company's Board is given periodic reports on the results of the investigation or the progress and outcome of the proceeding in which the defense has been asserted. 17 C.F.R. § 205.3(b)(6).

98 See Richard W. Jennings, The Corporate Lawyer's Responsibilities and Liabilities in Preparing Legal Opinions, 30 Bus. Law. 73, 75 (1974-75):

> In asserting a position on behalf of his client, an advocate, for the most part, deals with past conduct and must take the facts as he finds them. By contrast, however, a lawyer serving as an adviser primarily assists his client in determining the course of future conduct and relationships. The lawyer serving as an advocate should resolve in favor of his client any doubts as to the bounds of the law. In serving a client as adviser, however, a lawyer in appropriate circumstances should give his professional opinion as to what the ultimate decisions of the court would be as to the applicable law. The thrust here seems to me to carry the implication that the lawyer as legal adviser should assume an objective and independent role which would be incompatible with his role when serving as advocate.

99 Even in the litigation context there are exceptions, such as the litigator's obligation to take reasonable remedial measures in the event a client commits perjury or engages in "criminal or fraudulent conduct related to the proceeding. . . ." Model Rule 3.3.

encouraging law-abiding executives to confide in their corporate advisors requires a less absolutist view of client confidences. In this context, countervailing interests -- in preventing misuse of the lawyer's services, aborting serious violations of law, and avoiding or minimizing the damage to third parties or the corporation itself -- justify limited exceptions to the rules protecting client confidences.

4. The arguments against the ABA Model Rule reporting out amendments

a. The risk of chilling client communications: minimal

The combined effect of Model Rules 1.6(b)(2) and (3) and 1.13(c) is to permit (but not require) disclosure of client confidences, in the limited circumstances described, when client wrongdoing either i) has utilized the lawyer's services, or ii) threatens substantial injury to the client company itself. The principal argument against even such narrow and permissive reporting out provisions is a concern that they will undermine the trust essential for an effective attorney-client relationship and deter the client's willingness to confide in its attorney. We have agreed above with the general need for confidentiality, and with the proposition that recognizing a mandatory duty by lawyers to the investing public would unacceptably undermine the attorney-client relationship. However, we believe that the ABA's permissive reporting out provisions will not pose a risk to the attorney-client relationship or reduce client candor.

In the corporate context, no assurance of absolute confidentiality, or anything close to it, can be given by the company's lawyer to corporate managers. Any well informed corporate manager should understand that communications with corporate counsel are always potentially subject to disclosure, including by reason of the following:

> the corporate entity can waive confidentiality at any time (including as directed by new management or a new board or, in bankruptcy, by a court-appointed trustee); it is only the corporation's privilege and its secrets that are

protected – the manager has no personal right to assert the confidentiality of communications with company counsel;[100]

SEC's lawyer conduct rules under SOX have created an affirmative duty to report up the corporate chain, as high as the Board of Directors, credible evidence of a likely material violation of law by the managers;

an attorney has the right to disclose client confidences when necessary to defend against an accusation concerning the attorney's own conduct, by the client or by any third party, or to prosecute a fee claim against the client (ABA Model Rule 1.6(b)(5));

in the event of later litigation, there is a well recognized exception to the attorney-client privilege for communications that appear prima facie to have been in furtherance of a crime or a fraud; e.g., In re Grand Jury Investigation, 445 F.3d 266, 274-75 (3d Cir. 2006); John Doe, Inc. v. United States, 13 F.3d 633, 636 (2d Cir. 1994);

the facts communicated to the attorney, though not the communication itself, are subject to disclosure in civil litigation, for facts are not privileged. Upjohn Co. v. United States, 449 U.S. at 395 ("The privilege only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorney.").

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100 See, e.g., William W. Horton, A Transactional Lawyer's Perspective on the Attorney-Client Privilege: A Jeremiad for Upjohn, 61 Bus. Law. 95, 126 (2005):

> [I]t must be acknowledged that any reliance on the attorney-client privilege as a factor encouraging open communications between corporate agents and corporate lawyers inherently rests on a fragile framework, in that the privilege belongs to the corporation as an entity and may be waived by the corporation without consultation with such agents, irrespective of any pressure imposed by the government.

There is some evidence that managers fail to understand that they have no individual right to confidentiality, and that this misunderstanding encourages them "to communicate openly with corporate lawyers". Id., 61 Bus. Law. at 111, 125 n.76.

There is much controversy over the allegedly increasing practice of federal prosecutors and regulators of encouraging corporate waivers of the privilege as an aspect of "cooperation" that may avoid or reduce any sanctions against the corporate entity for misconduct by its managers. See generally, ABA Task Force on the Attorney-Client Privilege, Report, 60 Bus. Law. 1029 (2005); see pp. 172-75, below. But even absent any government request, the corporation, for any reason it deems in its interest, can waive its privilege at any time.

The Supreme Court has opined that "an uncertain privilege . . . is little better than no privilege at all" because it cannot be relied on to preserve confidentiality. Id., 449 U.S. at 393. Be that as it may, the reality is that well informed corporate managers know they have no privilege, and cannot rely on the company's privilege or right to confidentiality to provide any certain or permanent shield for their own communications with the company's lawyers, especially given the lawyers' mandatory reporting up obligations under the SEC's lawyer conduct rules. The permissive reporting out provisions of the ABA Model Rules do not materially add to this unavoidable uncertainty.[101]

Nor do we believe that the narrow reporting out permission granted by Model Rules 1.6(b) and 1.13(c) will deter law-abiding corporate managers from seeking legal advice and candidly disclosing to company lawyers the facts necessary for such advice to be fully informed. Those managers determined to violate the law surely have not in the past confided with lawyers concerning their improper objectives, except any lawyers they have actively recruited to conspire with them. Any confidentiality protections are beside the point in this situation. See Horton, 61 Bus. Law. at 125.

Law-abiding corporate managers generally will have no such reluctance, and usually will require legal advice as to how to comply with complicated statutes and regulations. They will

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[101] The enactment of the SEC's reporting up rules under SOX is among the significant developments since the Association expressed opposition to the permissive reporting out concept in comments that did not focus on the context of public companies. Association Ethics 2000 Committee, Comments submitted to ABA Ethics 2000 Commission, March 1, 2000, and Feb. 2001. The principal ground of that opposition, the risk that such a permissive reporting out rule would chill attorney-client communications, in our view has been largely muted by the SEC's mandatory reporting up rules.

We also note that our support for permissive reporting out is consistent with an earlier 1993 Association report by its Committee on Professional Responsibility, which favored either a permissive or a mandatory reporting out ethical rule. (See p. 82, above)

not view a lawyer's ultimate right to report out a major fraud, if the fraud is condoned by the Board of Directors, as a likely scenario affecting them. Further, they will recognize that lawyers will continue to have a strong interest in retaining clients or, in the case of in-house lawyers, in being perceived as valued members of the management "team" (and retaining their jobs). These strong economic and professional pressures should assure managers and directors that a lawyer -- having no ethical obligation to disclose -- will not seriously consider voluntarily disclosing client confidences, risking the severance of the client (or employment) relationship in the process, except in extreme circumstances. For example, it seems almost inconceivable, in the disclosure context, that a lawyer would consider reporting out a Board's refusal to make a disclosure unless strongly of the view that the failure to disclose would constitute securities fraud. That judgment will not readily be reached, especially given the room usually existing for divergent reasonable views on the materiality of a given fact, as the SEC recognized in Carter & Johnson (see p. 36, above).[102]

Accordingly, we believe that the risk is minimal that these narrow permissive reporting out provisions will chill client communications or undermine the attorney-client relationship. There is no evidence that such provisions, in force in varying forms in most states for many years, have had any such impact.[103] Even where ethical rules require a lawyer to report client

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102 A practitioner's comment from 1974 still rings true today, for the law has not changed to any great degree:

> The great refuge of clients and lawyers in this area is the elasticity of the concept of materiality.

Panel Discussion, p. 76 above, 30 Bus. Law. at 27 (remarks of Kenneth J. Bialkin).

103 See ACCA Statement in support of the amendments to Model Rule 1.6(b)(2) and (3), n. 94 above:

> Indeed, the experience of ACCA members practicing in these 42 States [permitting reporting out] indicates that the adoption of this rule

(footnote continued)

wrongdoing -- such as New Jersey and Florida,[104] and in the many states that adopted the ABA's ethical rules in the Code era (see p. 78, above) -- there seems to be no indication of any resulting chill in lawyer-client communications. Nor, indeed, is there any indication that reporting out has taken place to any degree. The greater likelihood is that lawyers almost never will exercise such a permissive reporting right, save in extreme circumstances, given the practical pressures that deter them from doing so (see pp. 55-56 and 70-71 above, and 113-14 below).[105]

Adoption in New York of these permissive reporting out rules thus will not result in the frequent disclosure of client confidences, which will remain a very rare event. Is such an option so rarely to be available, and even more rarely to be exercised, worth recognizing? We

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> nationwide will do no damage to the preservation of an appropriate and trusting relationship between a lawyer and her client, and will not result in any increased liability concerns for lawyers, either.

Id. at 2.

104 N.J. Rules of Professional Conduct, Rule 1.6(b) (2000), provides that a lawyer "shall reveal", inter alia, confidential information "to the proper authorities" to prevent client "from committing a criminal, illegal or fraudulent act" likely to result in "death or substantial bodily harm or substantial injury to the financial interest or property of another. . . ."

Florida Rules of Professional Conduct, Rule 1.6(b) (2002), provides that a lawyer "must reveal" confidential information, inter alia, when necessary "to prevent a client from committing a crime."

105 On point is this observation by then SEC Commissioner Harvey Goldschmid:

> [W]hat are the odds of permissive 'reporting out' taking place for even hard-core financial wrongdoing? At least 40 states have long allowed some kind of permissive reporting out, but there is almost no empirical or anecdotal evidence to suggest that lawyers have acted on the invitation in the financial fraud area.

Goldschmid Speech, p. 70 above, at 6.

believe so. It is realistic to expect that recognition of the possibility of disclosure will have a prophylactic impact on some potential corporate misconduct. See ABA Task Force Report, 59 Bus. Law. at 174 (even if permissive reporting out not often used, "the existence of such authority gives lawyers the opportunity to use that power to encourage the client to remediate or refrain from unlawful conduct"). It is the utility of this incentive, as well as the far more likely chilling effect of a mandatory reporting obligation, that argues in favor of the permissive nature of any reporting out rule. ABA Governmental Affairs Office, Letter of Robert D. Evans to Hon. Richard Baker, Chair, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, Feb. 4, 2004, pp. 5-7.

Further, while instances justifying reporting out will be infrequent, such situations can have vast consequence. Consider WorldCom, a Fortune 500 company advised by an eminent law firm. If that firm had learned of the clear and massive fraud being orchestrated by WorldCom's financial officers, and been unable to convince its Board to put a halt to it, reporting out might have avoided at least some of the financial damage inflicted on so many when the fraud ultimately was exposed. In such an extraordinary circumstance, refusing to permit lawyers an option to report out because such would be inconsistent with the lawyer's general duty to preserve client confidences fairly invokes Ralph Waldo Emerson's credo: "A foolish consistency is the hobgoblin of little minds. . . ." (Self-Reliance, in Essays: First Series (1841)).

b. The relevance of Board independence; the limits of business judgment

It is urged that, regardless of confidentiality concerns, as a matter of corporate governance a lawyer should be obligated to accept the decision by an independent Board of Directors, the authorized corporate decision-maker. See ABA Model Rule 1.2(a) (lawyer "shall abide by a client's decisions concerning the objectives of the representation"). In this view, if a

Board decides as a matter of business judgment to run the risk of proceeding with a clear and material violation of law, the lawyer should be prohibited from going outside the corporate client to report it.

We agree that the presence of such an independent Board will be a powerful factor arguing against exercising any permissive reporting out option. Indeed, if the question of legality is subject to reasonable doubt, in our view it is best practice not to report out an action (or inaction) by a truly independent Board, even though the lawyer disagrees with it.[106]

But we do not favor an absolutist bar precluding such reporting in the face of clear illegality. Such a bar would be against the trend established by the Restatement, the SOX rules, the ABA Model Rules, and the ethical rules of most states. Directors can be independent, as non-management outsiders free from disabling conflicts of interest, and yet be effectively under the sway of a dominant CEO. In the view of the ABA Task Force, "many corporate boards have developed a culture of passivity with respect to senior executive officers, in which those officers are not subject to meaningful director oversight." (ABA Task Force Report, 59 Bus. Law. at 159).

As for business judgment, we submit it is not a permissible business judgment for a Board, no matter how independent, knowingly and materially to violate the securities laws (see

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106 Some nominally independent Boards, on closer inspection, are not truly independent. See, e.g., Jill E. Fisch & Caroline M. Gentile, The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors, 53 Duke L.J. 517, 558-65 (2003) (citing studies questioning whether nominally independent directors exercise independent judgment or meaningful oversight of management).

The Enron debacle itself involved a nominally independent Board which, however, was subject to a number of apparent conflicts and incentives that, it has been argued, made it extremely reluctant to interfere with management, and explain its failure to act even when in possession of considerable information on the risks posed by management's conduct. See Fisch & Rosen, 48 Vill. L. Rev. at 1114-22.

p. 66, above). If the lawyer confronts such a brazen decision by a Board, even one clearly independent, the discretion to report out is needed.

5. The alternatives to reporting out: withdrawal or acquiescence

Under both the SEC's lawyer conduct rules and the Model Rules reporting out is permissive, leaving the decision of whether to disclose client confidences in this context to the lawyer's own judgment. Disclosure surely would not be undertaken lightly given the consequences, especially if the company's directors appear to be independent of management.

Withdrawal from representation usually will be available as an alternative course of action to reporting out. Model Rule 1.16(b) permits a lawyer to withdraw from a representation if, inter alia:

> (2) The client persists in a course of action involving the lawyers' services that the lawyer reasonably believes is criminal or fraudulent;
>
> (3) The client has used the lawyers' services to perpetrate a crime or fraud; [or][107]
>
> (4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement. . . .

Thus under the ABA Model Rules a lawyer confronted by a client determined to commit a securities fraud generally will have a choice of (i) withdrawing, (ii) disclosing client confidences by reporting out, to the extent reasonably necessary to prevent the violation, or

[107] Withdrawal is mandatory, under Rule 1.16(a)(1), if "the representation will result in a violation of the rules of professional conduct or other law ." As explained in comment [2], this provision covers the situation in which a client "demands the lawyer engage in illegal conduct."

The NYSBA COSAC Report recommends that New York adopt these provisions of the Model Rule 1.16, with some minor changes. COSAC Report, Vol. 1 at 219-20. The Task Force supports this recommendation.

(iii) doing nothing, the latter permissible only if the lawyer can avoid any affirmative participation in the fraud.[108]

What can be said about the choice among these alternative permissible courses of action? Inaction, even if ethically permitted, will likely be morally objectionable to many lawyers and perhaps foolish as well. A client with a Board of Directors determined to proceed with a clearly fraudulent course of conduct is not a client (or employer) with which a prudent lawyer would wish to remain associated. Withdrawal, the second option, would remove the lawyer from the scene of the crime and, if effected promptly, hopefully avoid factual disputes as to whether she had any culpable involvement in the client's fraud.[109] But a silent withdrawal might not protect the corporation (or the public) from the substantial injuries threatened by the misconduct.[110] Accordingly, if the fraud is clear and the damage threatened great, the interests of the company, as

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108 In New York, under the COSAC proposed version of the Model Rules the option to report out would be available only if the client's conduct constituted a "crime." (see n.95, above).

109 The withdrawal option can present some subtle questions. May a lawyer or law firm engaged in providing a range of services to a corporate client withdraw from only a part of the representation, i.e., from the particular matter that has caused the concern about fraudulent conduct? May an in-house lawyer withdraw from participating in a particular assignment, while remaining otherwise occupied in the employer's legal affairs? We know of no clear answer. One relevant factor might be the degree to which the offending conduct is central to the overall client or employment relationship.

110 The notorious OPM scandal, exposed in 1981, highlights the limited utility, in terms of averting client fraud, of a silent withdrawal. See In re O.P.M. Leasing Services, Inc., 13 B.R. 64 (Bankr. S.D.N.Y. 1981), aff'd, 670 F.2d 383 (2d Cir. 1982). The firm of Singer Hutner represented OPM, by far its largest client, in connection with a series of leasing transactions which turned out to be fraudulent. Once the firm discovered OPM's fraud, it received "ethical" advice from two purported experts that it could continue to represent OPM in new lease transactions if OPM represented that they were fraud free. However, these transactions proved equally fraudulent. Singer Hutner then withdrew from its representation, without explanation (again based on ethical advice). This enabled OPM to ensnare its in-house lawyers and the firm of Kaye Scholer, which unwittingly closed additional OPM fraudulent financings before the fraud was finally exposed. See Hazard, Koniak & Cramton, The Law & Ethics of Lawyering at 304-08.

well as the public interest, often will be well served by timely disclosure to the SEC or other appropriate body.

These situations will be few and far between. Each will present decisions of unusual difficulty for the lawyer involved. No general recommendation as to a course of action is therefore feasible, save perhaps for one: the need to consult with another experienced lawyer before taking any particular course of action. In such circumstances, emotions tend to run high, and dispassionate advice will be particularly useful.

E. Professional courage: the indispensable element

Rarely if ever will any lawyer for a major corporation be faced with a reporting-out or withdrawal decision. Firm advice to clients, including directly to the Board when necessary, should be sufficient to address and redress nearly every instance of actual or potential wrongdoing. The essential need is for lawyers to give that advice clearly, after consultation with other experienced lawyers when necessary, and not waver when the advice is unwelcome, no matter how important the client or how powerful the officer or director resisting the advice. The facts of Enron, set out in the Batson Report, present stark examples of lawyers who correctly identified problematic conduct by company officers, indicated their concerns about its illegality, but then did not follow through with forthright advice to the Board or other senior officers. Batson Report, Appendix C ("Role of Enron Attorneys") at 126-34.

Not to waver or equivocate is no easy challenge for lawyers in some circumstances because of the economic and professional pressures already noted, and because the answers to legal issues are seldom completely free of doubt. It may take genuine professional courage to provide unwelcome advice and stick to it. See Matthew J. Barrett, Enron Accounting and Lawyers, The Notre Dame Lawyer 14, 20 (Winter 2002) ("Standing up takes courage"). Absent sound judgment and this professional courage, regulations and ethical rules may have little ability to inspire a lawyer to provide the clear and unvarnished advice a client needs and deserves.

The remainder of our recommendations below take the form of suggestions as to how lawyers can best discharge their responsibilities, i.e., best practices exceeding any requirements of law or ethical mandates. The uncertain and confusing status of the caselaw pertaining to the liability of lawyers (see pp. 42-45, 50, above) make it a matter of compelling self-interest for lawyers to adhere to professional standards higher than the "minimum level of conduct" prescribed by the ethical codes. Proposed preamble to New York Model Rules [6], COSAC, Vol. 1, p. 2. However, our purpose in making these suggestions is not to serve the self-interest of the bar, but rather to enhance the role of lawyers in corporate governance, ultimately for the benefit of company clients and their investors.

III. The Role of General Counsel and Other Internal Lawyers

A. Background and context

The General Counsel for a public company has a critical role in promoting compliance with securities laws.[111] In SOX, Congress emphasized the central role of the General Counsel, requiring that "up the ladder" reporting of material violations of the securities laws in the first instance be either to the CEO or the Chief Legal Officer ("CLO"). The SEC rules further amplify the General Counsel's obligation, imposing an affirmative duty on the CLO to "cause such inquiry" into the evidence of a material violation as he or she "reasonably believes is appropriate"

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[111] The Committee adopts the definition of General Counsel used by the ABA Task Force, i.e., the term "General Counsel" refers to the lawyer having general supervisory responsibility for the legal affairs of the corporation. ABA Task Force Report, 59 Bus. Law. at 155 n.43. If a public corporation has no General Counsel, it should identify and designate a lawyer or law firm to act as General Counsel. Id., 59 Bus. Law. at 161 n.63. Like the ABA Task Force, we recognize that a General Counsel may delegate certain of his responsibilities to subordinate lawyers. Id.

and, except where the General Counsel reasonably determines there is no material violation, to "take all reasonable steps to cause the issuer to adopt an appropriate response" and to advise the reporting attorney thereof.[112]

The position of General Counsel and in-house legal departments has been significantly strengthened over recent decades as corporations have moved much of their general legal business in-house, and used a variety of outside firms, usually selected by and reporting to the General Counsel, for matter-specific work. As a result of these trends, today at most major companies "general counsels have assumed the role of senior advisor to CEOs and boards once held by senior partners." Benjamin W. Heineman, Jr., The Ideal of the Lawyer-Statesman, 22 No. 5 ACC Docket 59, 62 (May 2004) ("Heineman, The Lawyer-Statesman").

The General Counsel's role can be difficult. General Counsels are far more likely than outside counsel to be the target of SEC enforcement proceedings or even DOJ criminal prosecutions (see pp. 46-47, above).[113] The General Counsel's integration into the senior management of the corporation, and the resulting likelihood that his job responsibilities will involve a mixture of executive conduct and legal advice, may contribute to this outcome. See Prezioso AGC Remarks, n.47 above.[114]

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112 17 C.F.R. § 205.3(b)(2). See also Prezioso AGC Remarks, n. 47 above.

113 Villa Report, n. 42 above, at 2.

114 Factors that seem to increase the likelihood the SEC will bring an enforcement action against a General Counsel include, among other things, (i) whether the General Counsel also held other management roles or titles, (ii) whether the General Counsel's activities were strictly limited to giving legal advice to management or the Board or whether he was an actual decisionmaker, and (iii) whether actions by the General Counsel facilitated the violation of the law. In many cases, the General Counsel's involvement in preparation of SEC filings or transaction documents that he knew or should have known were materially misleading was sufficient to establish facilitation. See Villa Report, n.42 above, at 13-17.

(footnote continued)

A strong General Counsel is an important participant in a good corporate governance process. He is a key advisor to senior management. He is uniquely positioned to bring relevant matters to the Board of Directors. He often participates in the negotiation, structuring and documentation of significant business transactions, as well as in the preparation of SEC disclosure and other regulatory filings. He is expected to bring to the table a broad view in his role as a counselor, giving advice based not only on the letter of the law, but also on broad ethical considerations and a "public" perspective,[115] including how a particular action might be viewed by third parties, such as potential investors, shareholders, government officials and the public in general.

As a result, the General Counsel has been described as the "guardian of the corporate reputation."[116] The SEC has made clear its expectations that the General Counsel play an essential leadership role in promoting an appropriate "tone at the top" or corporate culture to support rigorous compliance with the law.[117] The SEC views General Counsel as generally better able than other employees to "push back" on senior management when difficult legal issues arise and to assure an appropriate level of protection for whistleblowers and others who identify potential legal problems

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We hasten to note, however, that these enforcement actions have involved only a tiny fraction of the in-house bar. The greater frequency of SEC proceedings against General Counsel appears to reflect in part the SEC's view that General Counsel act more frequently than outside counsel as company decisionmakers, not just advisers. Kern is one of the few proceedings against an outside counsel alleged to have decisionmaking power (see n.30, above).

115 ABA Task Force Report at 61.

116 Benjamin W. Heineman, Jr., Imagination at Work, The American Lawyer (April 2006) ("Heineman, Imagination at Work") at 73.

117 Prezioso AGC Remarks, n.47 above; cf. Redlich, 30 Bus. Law. at 65 ("if the legal arm of a corporate enterprise loses its moral strength, that decline will be reflected throughout the enterprise").

at a company.[118] However, the General Counsel cannot single-handedly instill a culture of compliance and integrity in an organization. These values must be embraced and communicated by corporate management at all levels, especially the CEO and the Board of Directors. A lawyer would be well-advised to be sure that this is the case before accepting a position as General Counsel of a corporation.

There is an inherent tension in the role of the General Counsel and other internal lawyers that must be recognized and managed. To be effective, the General Counsel and his top lieutenants must maintain a close, open relationship with the CEO and other senior executives, and have a thorough understanding of the client's business and other objectives. To be "welcomed in," these high-ranking legal officers must be seen as trusted advisors, partners to the business and advocates for the corporation. If a culture is promoted in which they are seen only as the enforcers of the law, the General Counsel and other senior internal lawyers risk creating "an atmosphere of adversity, or at least arm's length dealing, between the lawyer and the corporate client's senior executive officers that is inimical to the lawyer's essential role as a counselor promoting the corporation's compliance with the law."[119] The tension, in short, is "between giving independent

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118 Prezioso AGC Remarks, n.47 above:

> The CLO generally can "push back" on senior management more forcefully than other employees when difficult legal issues arise, especially in light of the greatly heightened awareness among officers and directors today of the price of corporate malfeasance. Further, the CLO can serve as a bridge to the board on difficult legal matters. The CLO also can best assure an appropriate level of protection for the whistleblowers and others who identify potential legal problems at the company, especially given the sometimes difficult task of sorting out potential cases of whistleblower retaliation from ordinary personnel disputes.

119 ABA Task Force Report, 59 Bus. Law. at 156.

judgment and advice and securing the trust and confidence" of management and the Board. Heineman, The Lawyer-Statesman, p. 97 above, at 63.

In reconciling their potentially conflicting roles, the General Counsel and other internal lawyers must always keep in mind that their client is the corporation, not its directors, officers or other corporate agents (see pp. 55-56, above). They must be able to recognize, and have sufficient status and independence to deal with, situations in which the interests of the corporation may not align with the individual desires of senior management or even the Board of Directors. Such independence must include a willingness to speak privately to appropriate Board members about issues that trouble the General Counsel or even to resign when important interests of the corporation, the ultimate client, are not being served.[120]

The risks to the corporation inherent in the absence of a strong legal function has been noted in Congressional testimony, investigative reports and articles regarding several recent corporate scandals. According to the WorldCom investigative report, its legal department was "not structured to maximize its effectiveness as a control structure upon which the Board could depend."[121] The report states that "at [CEO Bernard] Ebbers' direction, the Company's lawyers were in fragmented groups, several of which had General Counsels who did not report to WorldCom's General Counsel for portions of the relevant period; they were not located geographically near senior management or involved in its inner workings and they had inadequate

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120 Heineman, The Lawyer-Statesman, p. 97 above, at 63.

121 Special Investigative Committee of the Board of Directors of Worldcom, Inc., Report of the Investigation, March 31, 2003 (the "Special Committee Report") at 31.

support from senior management."[122] Ebbers did not include the Company's lawyers in his "inner circle" and appeared to "have dealt with them only when he felt it was necessary"; he "let them know his displeasure with them personally when they gave advice – however justified – that he did not like", and generally "created a culture in which the legal function was less influential and less welcome than in a healthy corporate environment."[123]

Similarly, in HealthSouth, the General Counsel would appear at Board meetings only if the CEO, Richard Scrushy, invited him to discuss a particular issue.[124] Normally he did not even see the Board agendas.[125] There were no clearly established procedures to refer to the internal legal department allegations of criminal conduct.[126] It was clear that Scrushy (like Ebbers) created a culture of intimidation[127] and made it personally difficult for anyone, including the General Counsel, to give advice that Scrushy did not like.[128]

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122 Id.; see also Richard C. Breeden, Corporate Monitor, Restoring Trust, Report to the Hon. Jed S. Rakoff On Corporate Governance For the Future of MCI, Inc., August 2003, (the "Breeden Report") at 140.

123 Special Committee Report, n.121 above, at 277.

124 U.S. House of Representatives, Committee on Energy and Commerce, The Financial Collapse of HealthSouth, Hearing before the Subcommittee on Oversight and Investigations, 108th Cong., 1st Sess. (the "HealthSouth Committee Hearing"), Part 1, Oct. 16, 2003, at 82.

125 Id. at 104.

126 Id. at 80, 90, 92.

127 See, e.g., id. at 38, 84-88.

128 Id. at 104-05. William Horton, General Counsel of HealthSouth, responded to questions regarding his access to Scrushy as follows: "In general, I do not think I would characterize it as a problem of access, sir. But I would characterize it as a question of what was going to be needed to get his attention …. Mr. Scrushy was never—was never an easy man to discuss things with that were bad news or that would make him unhappy." Id. at 105.

Articles about Enron have noted that the Enron lawyers were insulated in "silos", with little contact or direction from the General Counsel.[129] A climate was created where the "worst thing you could do was be viewed as an obstructionist", a situation exacerbated by a structure that allowed business managers effectively to determine lawyers' compensation.[130] In his Final Report, the Court Appointed Examiner for Enron outlined numerous situations where Enron's General Counsel or other internal lawyers failed to analyze, elevate, or adequately advise Enron management or its Board of known issues, including significant conflicts of interest.[131] Among other things, he noted that it "appeared some of these attorneys considered officers to be their clients when, in fact, the attorneys owed duties to Enron."[132] In other cases, he noted this possible explanation for the attorney's behavior:

> [S]ome of these attorneys saw their role in very narrow terms, as an implementer, not a counselor. That is, rather than conscientiously raising known issues for further analysis by a more senior officer or the Enron Board or refusing to participate in transactions that raised such issues, these lawyers seemed to focus only on how to address a narrow question or simply to implement a decision (or document a transaction).[133]

Strengthening the role of the General Counsel should be a high priority in efforts to promote compliance with laws, including the securities laws. That being said, public companies come in all sizes and shapes. The following recommendations should be viewed as general

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129 David Hechler, Speak Truth to Power, The American Lawyer (Mar. 2006) ("Hechler, Speak Truth to Power") at 77-83.

130 Id. at 80.

131 Batson Report, p. 56 above, Appendix C at 126-34.

132 Batson Report, p. 56 above, at 115.

133 Id.

principles or guidelines, not rigid prescriptions applicable to all companies. The most important thing is that, whatever system a corporation adopts, it be effective.

B. Recommendations

1. Clear mandate and authority with Board support

The General Counsel should have a clear mandate and authority from the Board of Directors and the CEO to promote a culture of integrity and compliance with the law.[134] The Board should articulate its expectations of the General Counsel in this regard, and should ensure that his role includes alerting appropriate decision-makers of issues relating to potential violations of law and potential injury to the corporation (including damages to its reputation), as well as serving as a facilitator and counselor to senior management.

The General Counsel also should have a strong relationship and easy access to the chairman of the Board and, if there is one, the designated lead independent director. He should also have ready access to the COO, the CFO, the chair of the Audit Committee, the chair of the Governance Committee and any other senior executives responsible for compliance, governance or ethics issues, and any company ombudsman.

The General Counsel should meet regularly and in executive session with the lead independent director or a committee of independent directors, as distinguished from only ad hoc meetings initiated by the General Counsel when a special need arises. The regularity of such meetings would help build a relationship of trust with the independent directors and facilitate the

[134] In some corporate structures, the Compliance Department is organized separately from the General Counsel's office and may have separate responsibility for promoting and monitoring compliance with laws, corporate policies and ethical practices. This can work well with appropriate coordination between the two departments. However, the Task Force believes that in these structures the General Counsel still retains responsibility, shared with the CEO, other members of senior management and the Compliance Department, for generally promoting a culture of integrity and compliance with the law.

timely raising and discussion of important issues. See ABA Task Force Report, 59 Bus. Law. at 164-65; Breeden Report n.122 above, at 144 (recommending General Counsel meet at least annually with the full Board, independently of any officer or employee).

In most if not all companies, it also would be advisable for the General Counsel regularly to attend meetings of the full Board, the Audit Committee, the Compensation Committee and any Legal or Compliance or Governance Committee. This would help ensure that important issues involving legal, reputational or ethical concerns are appropriately raised and discussed in these meetings.

The selection, tenure and compensation of the General Counsel, including any decision to discharge him, should be approved by the Board or a committee composed of independent directors.

2. Stature and experience of General Counsel

The General Counsel, to be effective, must be seen as a senior, influential and respected officer of the corporation and member of the company's management, recognized as having strong qualities of independence, leadership, judgment and discretion. In hiring a General Counsel, corporate management would be wise to consider an experienced lawyer with independent stature. Such a person would be better positioned to assume a leadership role within the corporation. She also would be better positioned to give truly independent advice, not only because she would value her reputation for integrity, but also because presumably she would have more options if her independence were to be put to the ultimate test.[135]

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[135] Heinemann, The Lawyer-Statesman p. 97 above, at 62; see Breedon Report, n.122 above, at 142-43.

3. Reporting relationships and access

The General Counsel's reporting relationships and access to management and the Board need to be consistent with senior status in the corporation. We believe that the General Counsel should report to one of the highest ranking company executives, most often either the CEO or the officer carrying out the day-to-day duties of the CEO.[136]

The Task Force believes that the General Counsel should not report to the CFO due to their respective roles in financial reporting and disclosure. These two positions generally should be on the same reporting level within the corporation.

4. Departmental structure

Internal legal departments vary greatly in their degree of central control. It is not uncommon in major corporations for senior internal lawyers to be assigned to subsidiaries or discrete business units, and even to have their direct reporting relationship to a relevant business manager. Such decentralization can have advantages, as it enables the lawyers to get closer to their clients and their businesses.

However, Enron and Worldcom demonstrate the need for oversight by a strong General Counsel. The most senior lawyer for each division should have at least a strong "dotted line" reporting relationship to the General Counsel, who should have a significant voice in their hiring, firing and compensation.[137] There should be adequate communication between the most senior attorneys and the General Counsel to ensure consistency of approach and elevation of

136 For example, in some corporate structures the General Counsel reporting to the COO may prove more effective than reporting directly to the CEO as long as (i) the General Counsel has ready, unrestricted access to the CEO and (ii) the internal legal department is seen to be at an appropriately senior level in the corporate hierarchy.

137 See Heineman, Imagination at Work, n.116 above, at 74.

appropriate issues.[138] Further, these senior lawyers, and even the more junior lawyers, need to know that the General Counsel will support them if they are inappropriately threatened with discharge or other adverse action in response to rendering sound and forthright advice.[139]

The staffing of a strong legal function, in terms of numbers, ability and experience, should be such that lawyers can effectively fulfill the role of respected partners and counselors to the business and not just respond to the crisis of the moment or mechanically document transactions.

5. Processes and procedures

Many public companies are communicating their "up the ladder" reporting expectations to *all* attorneys, and are defining reportable allegations more broadly than SOX and the SEC lawyer conduct rules might require.[140] Stated reasons for extending the application and scope of such policies, even to attorneys in non-US locations,[141] include that (i) the rules are unclear as to which attorneys they cover, so it is safer to be over-inclusive, (ii) there is a desire for departmental consistency, and (iii) to the extent "reporting up" policies are designed to improve law department processes, such better practices should be the rule for everyone.[142]

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138 See Hechler, Speak Truth to Power, n.129 above, at 78-79.

139 Heineman, Imagination at Work, n.116 above, at 74.

140 Statement of the Ass'n of Corporate Counsel before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Services, Feb. 4, 2004 ("ACC Statement") at 6-7.

141 We note that companies with offices outside of the U.S. may encounter cultural or legal barriers in trying fully to implement the SOX "reporting up" requirements in other countries.

142 ACC Statement, n.140 above, at 6-8.

Such policies may vary in length, style and content, ranging from informal unwritten communications of expectations to detailed written policies, standards or guideline documents. The degree of formality often depends upon the size and complexity of the organization.[143] The key element, regardless of the approach an organization takes, is that the lawyers clearly understand their obligations, including what must be "reported up" and to whom they must report.

Robust processes and procedures also should be put into place to ensure that internal lawyers of appropriate seniority are involved in decisions on matters involving legal disclosure or risk. For example, a company should ensure that (i) internal lawyers are present at appropriate meetings or are non-voting members of relevant committees; and (ii) employees know where they can go within the internal legal or compliance department to raise concerns.

A corporation particularly should ensure that lawyers are appropriately involved in analyzing and resolving ethical or legal issues that arise. Many corporations are establishing employee hotlines or other mechanisms that enable employees to voice concerns. For these mechanisms to work, employees must be truthfully assured that they can report ethical or legal violations through such hotline or other channels without fear of retribution and that any concerns they raise will be independently and fairly investigated and appropriately resolved. See Heineman, The Lawyer-Statesman, p. 97 above, at 64 (stressing importance of corporations having "a robust ombuds system"). The presence of a strong internal legal function as part of the process can help provide that assurance.[144]

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143 Id.

144 At HealthSouth, a vice president in Finance reported to Compliance that she had concerns about certain accounting practices and entries that she felt were suspicious. HealthSouth Committee Hearings n.124 above, at 23. Her allegations apparently were never referred to the Legal Department or otherwise independently investigated. Id. at 81. Shortly thereafter she was passed over for a position, and was allegedly told that she did not get the position
(footnote continued)

6. Training

Properly structured training for internal lawyers can help reinforce that the primary client is the corporation and help establish an appropriate corporate culture within the legal department. It can also enable internal lawyers to better recognize and deal with difficult situations, including conflicts of interest.[145] Internal lawyers must know that they must elevate difficult situations, if problems persist, to the General Counsel or otherwise to senior management or the Board in accordance with the guidelines that the corporation has promulgated.

A very useful focus for training is a post-mortem on issues wrongly resolved or missed, focusing on how to avoid a repetition. Although first instincts often may be to "put the matter behind you," the lessons learned can be invaluable, not only for the legal department, but also for the corporation in assessing the adequacy of its controls.

The General Counsel and other senior legal department management should be sufficiently involved in such training to demonstrate its importance and to focus their own thinking about these problems.

On a day to day basis, more junior lawyers need to have access to sufficiently senior and experienced internal lawyers – if necessary, including the General Counsel – to obtain support and to discuss issues where required.

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because she would not "do what they wanted [her] to do." Id. at 23. A strong and credible in-house legal role perhaps could have resulted in different treatment of this situation and resulted in an earlier discovery of certain aspects of the fraud.

145 The conflicts facing internal lawyers are not all that different in nature from those facing external counsel. Among others, one's duty to the corporation may conflict either with satisfying the corporate officer with whom one works closely or with the lawyer's own personal economic incentives. Pressures, however, may be somewhat exacerbated in the in-house environment, given that there is only one client.

7. A culture of consultation

Internal legal departments would do well to foster a culture of collaboration and consultation. This is not only an issue of collegiality. It is good practice for all lawyers, particularly on difficult judgment calls.

The internal lawyers must also be able to recognize where they need outside expert advice to make an informed judgment. The SEC has rejected defenses asserted by internal counsel in enforcement actions that they were "generalists" or that they were not experts in a particular area.[146] It is also worthy of note that, in exercising its discretion, the SEC has been far less likely to bring actions against General Counsels who have sought external legal advice.[147]

8. Relationships with external counsel

The General Counsel should have ultimate authority over the selection of the principal external lawyers retained by the company[148] and should clearly define their roles. In communicating the corporation's expectations to external lawyers, the General Counsel (or his designee) should make clear that the corporation, not the individual officer retaining them, is the external lawyer's client. He also should ensure that external lawyers are aware that they must alert relevant internal legal staff of any significant concerns, including, but not limited to, those involving potential violations of the securities laws or ethical rules.

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146 Villa Report, n.42 above, at 3-4.

147 Id.

148 This authority can take many forms. Commonly used methods include actual selection of counsel for individual deals and the formulation of "approved lists of counsel" from which other corporate officers can choose. The key is that outside counsel understand that their client is the corporation, not the individual officer, and that the legal department exercises oversight of their work accordingly.

As a matter of procedure, it is good practice to provide external law firms with a copy of the corporation's Code of Conduct and its policy on "reporting up" pursuant to the SEC's lawyer conduct rules. External counsel also should have a designated contact in the legal department with whom they can speak, should the need arise. The General Counsel (or his designee) also may find it useful to review the external firm's own policy regarding compliance with the SEC's reporting up rules.

The General Counsel (or his designee) should consider meeting regularly, at least once a year or even more often, with any outside firm performing substantial ongoing work for the company.[149]

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149 A not inconsistent but contrasting procedure is suggested by Bevis Longstreth, former SEC Commissioner and retired corporate partner of Debevoise Plimpton, who proposes that outside counsel meet annually with independent directors:

> As a matter of best practice, require all outside lawyers who have significant representation of a corporation (say $50,000 or more of billings in the previous or current year), to meet at least twice during the year with a group of independent directors, composing what might be called the "Legal Committee of the Board." The meeting would be without the presence of management and would involve a frank dialogue over the legal issues the lawyers have been retained to address, the nature of unusual constraints imposed on their work, the nature of their relationship with management, the range of legal risks involved in each matter they have worked on, the advice given to management with respect to those risks and management's reaction, the nature of any red flag observed and other matters relating to their services that may be important to the Committee.

Longstreth Speech, n.17 above, at 24-25. Such meetings, we suggest, should not be in lieu of meetings between the General Counsel and outside counsel or between the General Counsel and the Board.

9. Compensation

Question has been raised as to whether certain types of compensation, such as equity interests or large bonuses (often linked to profits), can compromise the independence of the General Counsel or other internal lawyers.

We do not believe that the type or mix of compensation, such as whether a significant portion of an internal lawyer's consists of equity or bonuses, is significant in this context. At present, in fact, equity and bonuses are often a substantial element in the compensation of internal lawyers, as well as other officers in a corporation. Equity in particular has the effect of creating a long term economic stake in the company for the employee, thus aligning the interest of the individual lawyer with the interests of the corporation.

The question is one of process: by whom, and upon what criteria, is lawyer compensation determined? It should not be determined solely by any business manager to whom a lawyer reports. Rather, the Board should review compensation awards to the General Counsel to ensure that any potential conflicts are adequately managed. The General Counsel or his delegates should have appropriate input into the compensation of other in-house lawyers.

10. Back-dated stock options

In recent months there have been several instances in which General Counsels have been dismissed in connection with their receipt, and/or their failure to prevent the receipt by other corporate officers, of back-dated stock options.[150] The facts of these cases and the questions of law they raise are largely undeveloped to date. It is clear, of course, that if a lawyer participates in an

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150 See generally Linda Thomsen, Director, SEC Division of Enforcement, Testimony Concerning Executive Compensation and Options Backdating Practices Before U.S. Senate Committee on Finance, Sept. 6, 2006 (available at www.sec.gov/news/testimony/2006/ts090606lt.htm); see e.g., Justin Scheck, Preeminent Corporate Lawyers Didn't Stop Shady Options Deals, The Recorder, Aug. 28, 2006.

action that would constitute a violation of the securities laws if done by any other corporate officer, he will also he held liable.[151] Moreover, a General Counsel's ability to monitor executive compensation practices for legal compliance, and for more prudential concerns, may be compromised to the extent that General Counsel is a part of the same compensation system.

This issue again highlights the need for active Board oversight of the General Counsel's compensation, and perhaps of other senior lawyers, especially any who function with respect to the compensation of other corporate officers.

IV. The Role of External Counsel

A. Background and context

The ways in which large public companies use outside counsel have changed over the years. With the sprawling, multi-national operations of the Fortune 500, and increasingly specialized nature of corporate law practices, public companies tend to use a stable of experts from various firms for discrete projects, rather than, as in days past, rely on one firm. In-house General Counsel, often supported by large staffs, have taken on the general counseling role in many major corporations. See Developments, 107 Harv. L. Rev. at 1555.

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151 In October 2004, the former General Counsel of Symbol Technologies, Inc., pleaded guilty to criminal charges he had back-dated the exercise dates for stock options granted to himself and other executives. The details of the scheme are set forth in the SEC's parallel complaint: SEC v. Symbol Technologies, Inc., E.D.N.Y., 04 Civ. 2267 (LDW), complaint filed June 3, 2004.

In August 2006, the former General Counsel of Comverse Technologies, Inc., was indicted along with two other executives, and sued civilly by the SEC, in connection with an alleged scheme to back-date options issued to the three officers and other company employees. See SEC v. Alexander, SEC Litig. Rel. No. 19796, Aug. 9, 2006. He pled guilty to one count of conspiracy on November 2, 2006. Beth Bar, Ex-Comverse GC Pleads Guilty to Conspiracy, N.Y.L.J., Nov. 3, 2006.

This trend toward limited, piecemeal representations by outside firms comes at a price: any one outside counsel may have a limited understanding of a client's business and the general context of the transactions he or she is structuring or documenting. There is an increased risk, in this legal environment, that lawyers may unwittingly facilitate a client's misconduct, or lose the opportunity to counsel against it.[152]

The risk is magnified by another change in the legal profession: its increasingly competitive nature.[153] Both partners and clients are less tied to a given firm than was typical until roughly the 1980s. Today a partner's compensation may importantly depend on retaining a significant client, and a firm's profitability may depend on its ability to retain its partners with "portable business." At the same time, most public companies are no longer tied to a single law firm, a relationship that gave the firm a sturdy platform from which to render unwelcome advice. Today, public companies unhappy with the advice or service of one firm can and do readily switch their business to other firms. This competitive environment, as already noted (see pp. 57-58, above), creates pressures on outside counsel to avoid confronting clients about questionable

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152 See Gordon, 35 Conn. L. Rev. at 1193-94, 1201-02. There is a related risk with respect to a complicated transaction on which many lawyers are working. These lawyers "may obtain only fragmentary knowledge of the larger picture, and thus not be in a position to learn troublesome facts." Milton C. Regan, Jr., Teaching Enron, 74 Fordham L. Rev. 1139, 1246 (2005) (author suggests this factor as one possible explanation for failures by Enron's lawyers to detect wrongdoing).

The remedy for this problem is better coordination and synergy between the lawyers, and leadership of the team by a senior lawyer who does understand "the larger" picture.

153 For a brief review of the factors contributing to this trend, arguably commencing or accelerating with the launch of The American Lawyer in 1982, see Joel Henning, Bar Association, Law Firms, and Other Medieval Guilds, 32 Litigation 17 (2005).

transactions or accounting treatments in order to maintain the client relationship. (See ABA Task Force Report, 59 Bus. Law. at 152).[154]

What are the best practices for outside counsel in this challenging environment? In short, outside firms must consciously strive to avoid having these competitive pressures compromise their judgment, dilute their advice or limit their loyalty to their true client, the corporation.

B. Recommendations

1. Understand the context of assignments

Outside counsel, through dialogue with the company's General Counsel or management, should endeavor to be aware of the context in which and the purpose for which its services are being requested and used. In the example of LLCs cited above (see pp. 54-55), if counsel for a public company is asked to form a series of LLCs in circumstances that raise a concern that such LLCs may be used to remove improperly expenses or debt from the company's financial reports, counsel should ask questions to gain reasonable assurance that no such use is planned.

Counsel cannot guarantee that her services will not be put to some improper purpose, but she can reduce this risk through appropriate inquiries when circumstances suggest some reason

154 It is sometimes argued that the increasing incidence of law firms being paid for transactional work, including public offerings, only at the conclusion of the project -- approaching a contingent fee arrangement -- maximizes the economic pressure on firms to complete the deal, and may encourage acquiescence in problematic client conduct. (See Painter Statement, n. 80 above, at 6 n.20:

> A lawyer's job is sometimes to say "no" to a deal, and a contingent fee arrangement makes it very hard to say anything but "yes".

While the point has a certain logic to it, the Task Force has not found persuasive evidence that this factor is a significant influence on lawyer conduct.

for concern. Further, concerns about wrongdoing aside, understanding the context in which counsel is working may facilitate better or more efficient legal services.

2. Focus on risks to the client, <u>not mere implementation</u>

Once the context of the requested service is understood, a lawyer owes the client advice on the legal and other risks perceived by the lawyer to be posed by a proposed transaction or disclosure (<u>see</u> pp. 67-69, above). If a lawyer avoids giving counsel on these broader questions and implications, and instead confines her role solely to drafting the disclosure or structuring the deal, her services may fall short of what the client can reasonably expect from counsel. <u>See</u> p. 102, above (Enron Examiner criticizing its lawyers who "saw their role in very narrow terms, as an implementer, not a counselor").

3. <u>Inquire when a concern arises</u>

When in the course of the representation a lawyer becomes seriously concerned about the legality of the company's actual or intended conduct, the lawyer will need to consider whether his concern rises to the level of requiring a report up under the SEC's lawyer conduct rules, or applicable ethical rules (<u>see</u> pp. 70-73, above). But counsel should not limit his consideration to this narrow question for in fact he is concerned, regardless of whether he must report up. The best practice when the SEC's trigger point for reporting up has not been reached, but counsel nonetheless has a serious concern, is to make reasonable inquiry of the company, <u>i.e.</u> in essence to report up the concern. If such inquiries and consequent counseling do not allay the concern, counsel should seriously consider withdrawing from the representation.

Absent the pressing of such inquiries, both the existing ethical responsibility to avoid facilitating a fraud and the SOX and ethical duties to report up evidence of a likely fraud are deprived of much of their potential positive impact.[155] An attorney avoiding inquiry may well miss an opportunity to detect, or avoid unwitting involvement in, a fraud damaging to the client.

There is no way generally to define in words the circumstances that would create a level of concern warranting such an inquiry. An experienced lawyer – or a less experienced one consulting with more experienced colleagues – is likely to sense when questions need to be asked about the client's conduct. It is not a matter of seeing a "red flag" pointing to likely fraud. Rather, the impetus to inquire will arise at a lower threshold, when the client's conduct illuminates for the prudent lawyer a yellow light of caution: do not proceed without a better understanding of the client's plans and purposes.

4. Reporting out: a serious option

If a company's Board declines to consider or take action in response to counsel's report of a threatened or ongoing material violation of law by the company, counsel should seriously consider reporting such material violation to the appropriate regulatory or governmental authorities (as permitted under prescribed circumstances by the SEC's lawyer conduct rules, ABA Model Rules 1.6(b) and 1.13(c), and the ethics rules of most states). The argument for reporting out would be especially compelling if there is substantial reason to doubt the independence of the company's directors and the wrongdoing threatens to cause significant damage to the company. (see pp. 91-93, above).

5. Successor counsel: the need for disclosure

In the unusual situation in which outside counsel has withdrawn (or been discharged) from a representation because of a concern about the company's conduct (see pp. 93-94, above),

155 SOX §307, and the SEC's lawyer conduct rules, do not themselves appear to impose a duty of inquiry. See Fisch & Rosen, 48 Vill. L. Rev. at 1115.

there is a risk that successor counsel may take on the representation unaware of the concern, and unknowingly facilitate a continuation of corporate wrongdoing. The OPM scandal involved just such a scenario (<u>see</u> n. 110, above).[156]

We believe that withdrawing counsel will not be at liberty, absent the client's consent, to disclose to the successor firm the circumstances that caused its withdrawal. New York's "noisy withdrawal rule," DR4-101C.5, permits only limited disclosure. Withdrawing counsel, if inquiry is made, is obliged to refer successor counsel to the client.

It is successor counsel that can and should, before accepting the engagement, request that the company permit prior counsel to disclose the reasons for its withdrawal or discharge, if successor counsel senses that there may have been an issue concerning the client's conduct.[157] A

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156 There are suggestions that Enron may have gone to a supposedly more "flexible" firm, Andrews & Kurth, to obtain legal opinions on certain transactions with respect to which Vinson & Elkins proved reluctant to issue an opinion. Ellen Joan Pollock, <u>Enron's Lawyers Faulted Deals But Failed to Blow the Whistle</u>,W.S.J., May 22, 2002 (Andrews & Kurth, however, says it is unaware of working on any Enron transactions that another firm had declined to work on).

Another such instance may be presented by a 1992 decision concerning O'Melveny & Meyers. <u>FDIC v. O'Melveny & Meyers</u>, 969 F.2d 744 (9th Cir. 1992), <u>rev'd and remanded on other grounds</u>, 512 U.S. 79 (1994), <u>reaff'd on remand</u>, 61 F.3d 17 (9th Cir. 1995). According to the opinion, denying O'Melveny's motion for summary judgment, O'Melveny prepared for a new bank client private placement memoranda ("PPM") for two real estate syndications. The PPMs, it later developed, contained fraudulent financial statements for the bank. O'Melveny had never contacted Rogers & Wells, which had just represented the bank in another, never closed syndication, and which had learned of the bank's true financial condition from its prior accountants. <u>Id</u>., 969 F.2d at 746-47. <u>See</u> <u>also</u> Andrew Longstreth, <u>Nowhere to Hide</u>, American Lawyer 18-19 (Sept. 2006) (suggesting, based on Senate staff report, that tax shelter opinions may have been shopped among firms).

157 This recommendation is similar to a procedure made part of White & Case's 1978 settlement of the <u>National Student Marketing</u> case:

> Prior to the undertaking by the Firm of corporate representation as principal outside counsel of a prospective client having securities registered under the Federal Securities Laws, . . . if the Firm has ascertained that the representation of such prospective client by

(footnote continued)

refusal by the company to so permit should usually disincline proposed successor counsel from accepting the engagement.

C. Other proposals not recommended

We now discuss a number of thoughtful proposals that the Task Force does not recommend, after actively considering them.

1. Lawyer certification of client disclosures

It has been suggested that outside counsel should be required to certify the accuracy of a company's non-financial disclosures in any SEC filing. This proposal, as a means of reducing the incidence of corporate fraud, has been most carefully developed by Professor John Coffee of Columbia Law School, who discussed his proposal with the Task Force.[158] In essence, this proposal would require a public company, before filing a substantive document with the SEC, to retain independent counsel to review it and for such lawyer to certify, "after making such inquiry . . . reasonably believed appropriate in the circumstances," that she believed the non-financial disclosures to be true and correct and not to omit any material facts. As Professor Coffee further explains:

> By training and by professional orientation, the lawyer can be expected to insist upon accurate and full disclosure of material information. Based on this foundation, the independent lawyer could be asked to monitor the corporation's disclosures in a functionally similar fashion to the manner in which the independent auditor monitors the corporation's financial performance.

> its prior principal outside counsel was terminated by such counsel, due inquiry will be made of such prospective client as to the reasons for the change and the prospective client will be requested to release such prior counsel from any obligation of confidentiality for purposes of discussion with the Firm of the proposed representation. . . .White & Case letter to SEC, n. 23 above, ¶ 1.

158 See Coffee, Gatekeepers at 347-52; Coffee, 84 B.U.L. Rev. at 356-58.

Coffee, Gatekeepers at 198.

While intriguing, we believe adoption of this proposal would be a mistake. The potential benefits appear to be limited. Most recent corporate fraud has involved financial reporting, and thus would not likely have been aborted by this procedure.[159] Further, the cost to clients of implementing the proposal would be considerable. For an outside law firm to be in a position responsibly to certify a client's disclosures would require an enormous expenditure of time. It would appear necessary for a company to engage such certifying counsel on a continuing basis:

> Indeed, law firms would likely agree to provide such certification only if they could maintain a continuing oversight of the [company]; one-time-only certifications would be a service that few firms would dare, or be economically motivated, to provide. Coffee, 84 B.U.L. Rev. at 358.[160]

Such cost very likely would be out of all proportion to the advantage that might be achieved in the form of more accurate reporting.

2. Imposing liability on lawyers, under SEC regulations, for negligence in filing documents

Related to the certification proposal is Prof. Coffee's suggestion that the SEC, using its authority under SOX § 307 to set "minimum standards of professional conduct," adopt a rule permitting it to suspend or disbar an attorney from practicing before it for negligence in the preparation or review of SEC filings. Id., 84 B.U.L. Rev. at 359. By such a rule, the SEC would be

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159 An alternative proposal, worth considering but beyond the scope of this report, is to require an issuer to hire an investment bank to review and certify the company's annual report on Form 10K and other periodic filings under the 1934 Act, a context that would afford an opportunity for meaningful due diligence. See Merritt B. Fox, Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis, 70 Va L. Rev. 1005, 1034 (1984). Prof. Fox is working on an article expanding on this concept. Merritt B. Fox, Civil Liability and Mandatory Disclosure, Oct. 2, 2006, draft.

160 The obvious analogy is to the "continuous due diligence" sometimes utilized by underwriters with respect to frequent issuers of securities. See pp. 138-40, below.

mandating attorneys "both to conduct a minimal due diligence review before an attorney files a document or report with the SEC and to certify its good faith belief in the accuracy of the statements made therein." Id. See Coffee, Gatekeepers at 351-52.

Here, again, in our view the costs entailed by such a rule would likely exceed its benefits. SEC filings are made by companies, not their lawyers, and outside counsel at present usually are consulted only with respect to the adequacy of particular passages. They do not generally perform any due diligence with respect to such filings. We question whether lawyers would willingly undertake such assignments, thereby risking liability or SEC sanctions in the event of inaccuracies in a client's disclosures. Such a rule might only minimize the extent to which lawyers review client filings, or, in the alternative, vastly increase the client's legal bills if its lawyers accepted such an assignment. Further, undertaking such a review would slow down the filing process for all issuers, contrary to the appropriate desire of the SEC, and the public market, that information be released quickly.[161]

3. Prohibiting lawyers serving as directors of their clients

Service by a lawyer who renders legal services to a public company as a director of such company raises serious concerns. Such service can impair the lawyer's independent judgment and give rise to conflicts of interests, depending on the circumstances. See generally, ABA Section of Litigation, Report of the Task Force on the Independent Lawyer, The Lawyer-Director: Implications for Independence 36-62 (1998).

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161 We do not question, however, the SEC's authority under its Rule 102(e) to sanction a lawyer for gross or repeated negligence in SEC filings the lawyer actually does make. As noted above, a lawyer also can be liable for negligent conduct under Section 17 of the 1933 Act (see pp. 48-49, above).

Nonetheless, we do not recommend a total bar on such service. Some companies may strongly and appropriately desire to have outside (or inside) counsel serve as a director. Lawyers, given their experience and expertise, can provide valuable service as directors. Further, the risks created by such service can often be reduced through careful consultation between lawyer and client. Id. at 63-66; see also Panel Discussion, Lawyers as Directors, 30 Bus. Law. 41 (1974).

V. The Role of Law Firms

A. Background and context

1. The need for institutional supervision

The law firms advising public companies come in as many different sizes as the companies they advise, ranging from mega-firms international in scope to small, local firms. They have in common at least one thing: they are potentially exposed to financial and reputational loss for the wrongful acts or omissions of their partners or associates. Further, law firms and/or their partners owe ethical duties to provide appropriate supervision for their lawyers.[162]

This gives all firms an incentive to promote a culture of compliance with applicable regulations and ethical rules and to establish procedures to monitor and encourage such compliance. The need for larger firms consciously to focus on such matters seems especially critical since their sheer size may make more challenging the development and maintenance of a firm-wide standard of

[162] The ABA Model Rules place such responsibilities on the individual "partner in a law firm" or other lawyer with "direct supervising authority over another lawyer. . . ." Model Rules 5.1(a) and (b). New York's DR 4-104 extends such responsibilities directly to the "law firm" as an entity. We applaud New York's approach as encouraging heightened law firm focus on ethical issues. See Mark Hansen, Taking a Firm Hand in Discipline: New York Ethics Rules Pinpoint Firms – Some Say More States Should Follow, 84 A.B.A. J. 24 (Sept. 1998).

professionalism, as distinguished from variable standards applied by individual partners or practice groups.[163]

2. Firm responses to the SEC's reporting up regulations

The SEC's lawyer conduct rules under SOX, adapted in 2003, resulted in many firms adopting implementing procedures. The Task Force asked nearly 100 law firms to answer ten questions related to the SEC's lawyer conduct rules. A copy of the survey is attached as Appendix E to this report. Nineteen firms responded. A summary of their responses -- not all firms answered each question -- follows:

> *Written Procedures*. All nineteen firms have written procedures for implementing the SOX reporting up obligations.[164]
>
> *Responsibility for Implementation*. The principal responsibility for implementing the procedures resides with (i) a firm-wide committee for sixteen of the firms, (ii) a small group of individuals for three of the firms, and (iii) a general counsel (one of the firm's partners) of one of the firms.
>
> *Informing Lawyers within the Firm*. Seventeen of the firms conducted seminars and other training to inform their lawyers of the firm's procedures. Thirteen issued firm-wide memos and conducted seminars. Two, in addition to the memo and the seminars, informed their lawyers with notices or statements on their intranet and/or in their risk management handbook. One, in addition to the memo and seminars, notified lawyers of

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163 The increase in the size of "large" law firms in recent decades has been dramatic. In 1960 the largest law firms did not exceed 100 lawyers. Chambliss & Wilkins, 16 Geo. J. Legal Ethics at 342. In 2005, at least 66 American firms had over 500 lawyers, and 13 had over 1000. The American Lawyer, n.63 above, at 145-46.

164 Firms with written procedures in place may have been more likely to respond to the survey.

their policies and procedures with periodic email reminders. Two only used a firm-wide memo. One only used training sessions and a video. One only used the firm's employee handbook.

Certifications. Seven firms require lawyers to sign statements certifying that they understand the firm's procedures and promise to comply with them. Twelve do not require lawyers to sign such statements.

Protecting Subordinates. The written policies of nine firms expressly protect subordinate attorneys from retaliation by senior attorneys for reporting up. Ten firms do not have such provisions in their written policies.

Reporting to the Client. Nine of the firms have policies providing that a lawyer should not make a SOX report to the client, requiring that the decision whether to report be made by the firm. Ten of the firms have policies that do not include this provision.

Internal and Client Reports. Since the development of the written procedures, initial reports have come from seven partners and three associates. In three of these instances, the initial report resulted in a report to a client.

Impact of the SEC Lawyer Conduct Rules

> *On Corporate Wrongdoing*. Six firms believe the rules have had a positive impact in reducing the risk of corporate wrongdoing. Twelve do not believe the rules have had any impact in reducing such risk.
>
> *On Lawyer Client Relationships*. Two firms believe the rules have had a positive impact on lawyer-client relationships. Two firms believe they have had a negative impact on lawyer-client relationships. Fifteen firms

believe they have had no significant impact on lawyer-client relationships.

Possible Changes to the SEC Lawyer Conduct Rules. Seven firms believe the rules should be continued as is. Four firms believe they should be revoked. Four firms believe they should be modified, one stating that the rules should be made clearer while three did not specify how the rules should be modified.

B. Recommendations

1. Written "reporting up" procedures

Every firm with significant public company representations should adopt written procedures for implementing the "up-the-ladder" obligations imposed by the New York Code of Professional Responsibility and the SEC's lawyer conduct rules under SOX. The SEC's rules require supervisory attorneys to make reasonable efforts to ensure that subordinate attorneys conform to the rules, which necessarily requires a training program to stress compliance as an obligation of employment.

Firm procedures should include, among other things, mechanisms within the firm to report possible violations, education and training sessions, and the establishment of designated senior lawyers or committees to facilitate compliance. One example of such procedures, drawn from the procedures that several individual firms shared with the Task Force, is set forth in Appendix F.

2. No retaliation

Among the more important aspects of a reporting up procedure is a clear assurance that lawyers – especially junior attorneys – will be protected against any retaliatory action by reason of reporting a perceived problem to the firm. Absent such assurance, an associate reasonably may view such a report as a career-threatening move, especially when it focuses on some perceived misconduct or failure to act by a more senior lawyer.

3. A statement of best practices

Law firm culture has a significant impact on how ethics rules are interpreted and enforced within a firm. Law firms also should adopt for the guidance of their attorneys a statement of best practices in advising public companies. One example of such a statement of best practices is set forth in Appendix G. Adopting and publicizing a statement of best practices, and implementing them, establishes a set of shared values and encourages a tone at the top that promotes compliance. The peer pressure that comes from the adoption of best practices by a critical mass of New York firms can have a salutary effect on all firms, and encourage lawyers in them to raise concerns.

4. Protecting the attorney-client privilege for communications between lawyers and their law firm's in-house counsel on matters of professional ethics involving clients of the firm

Our review of the role of the lawyer in corporate governance convinces us that the attorney-client privilege should protect consultations between lawyers and their law firm's in-house counsel (or specially retained outside counsel) on matters of professional conduct, including issues pertaining to clients. We strongly believe this protection will facilitate compliance with applicable rules and statutes, and better enable the firm to enforce its ethical standards internally, thereby strengthening the lawyer's role in corporate governance. We recommend that the courts review such matters in light of this strong public interest.

In recent years, a few courts have concluded that the attorney-client privilege will not protect a lawyer's consultation with in-house counsel when the courts find a conflict of interest between the interests of the firm and the interests of the firm's client in the matter. See VersusLaw Inc. v. Stoel Rives, LLP, 111 P.3d 866 (Wash. Ct. App. 2005) (malpractice claim); Koen Book Distrib. v. Powell, Trachman, Logan, Carrle, Bowman & Lombardo P.C., 212 F.R.D. 283 (E.D. Pa.

2002) (same); Bank Brussels Lambert v. Credit Lyonnais (Suisse) S.A., 220 F. Supp. 2d 283 (S.D.N.Y. 2002) (same). We believe that such a result often is not necessary in situations where a lawyer consults the firm's in-house counsel about conduct involving matters of professional obligations. Our view is supported by NYSBA Committee of Profess. Ethics, Eth. Opin. 789, 2005 WL 3046319 (Oct. 26, 2005), which concluded that such a consultation does not necessarily create a conflict of interest with the affected client, as prohibited by DR5-105A and 105B: "seeking advice on how best to accommodate a lawyer's multi-faceted obligations in service of one or more clients does not, without more, entail the kind of 'differing interest' that DR 5-105(A) and (B) regulates." Id. 2005 WL 3046319, at *5.

We also believe that there is great value to the profession in the development of in-house ethics advisers, a growing area of law practice. See Elizabeth Chambliss and David B. Wilkins, The Emerging Role of Ethics Advisors, General Counsel, and Other Compliance Specialists in Large Law Firms, 44 Ariz. L. Rev. 559 (2002) ("[a]necdotal evidence suggests that large law firms increasingly are turning to in-house counsel ethics advisors, firm general counsel, and other specialists to manage the firm's compliance with professional regulation"). The courts should recognize this positive development in the profession by protecting the consultations that result.

Most importantly, the use of in-house ethics advisers and in-house counsel to advise on professional obligations is supported – if not required – by the NYCPR. DR 1- 104A says, "[a] law firm shall make reasonable efforts to ensure that all lawyers in the firm conform to the disciplinary rules." Ethical Consideration ("EC") 1-8 says "[a] law firm should adopt measures giving reasonable assurance that all lawyers in the firm conform to the Disciplinary Rules . . . . Such measures may include . . . a procedure whereby junior lawyers can make confidential referral of ethical problems directly to a designated senior lawyer or special committee . . . ."

As discussed above, we have made a variety of recommendations with regard to law firms, e.g., that firms should (i) develop written policies for up-the-ladder reporting, (ii) establish professional responsibility committees, and (iii) have general counsel or other advisers to guide the lawyers in the firm on their ethical and legal obligations. Consultation is long recognized as the key to the effectiveness of such committees. The enforcement of such policies, and the increasing complexity of lawyer regulation – in the area of corporate governance as well as in the area of lawyer-client relations generally – requires consultation on often difficult and overlapping obligations. Thus we agree with NYSBA Eth. Opin. 789 when it states:

> The Code explicitly imposes obligations on a law firm as an institution – a departure from the traditional confinement of ethical codes to regulation of individual lawyers . . . . These rules necessarily create an obligation to establish protocols, appropriate for the size and practice of the firm, to enable the firm to enforce these standards internally. To envision such a system without access to confidential advice on legal ethical issues affecting the firm's obligations is difficult.

Id. 2005 WL 3046319, at *2 (emphasis added)

Accordingly, we urge the courts to protect consultations between a lawyer and a firm's in-house counsel on matters of professional conduct.

VI. The Lawyer-Auditor Relationship and Financial Disclosures

A. Background and context

Because so many of the recent financial frauds have concerned manipulations of financial statements, it is important to focus on the role of lawyers in dealing with their clients' financial disclosures and their clients' auditors. There is heightened recognition of the need for corporate and securities lawyers to be knowledgeable about the accounting concepts relevant to their clients. Absent such knowledge, a gap between the roles of auditors and lawyers permits corporate fraud:

> . . .[A] lawyer remotely interested in corporate governance and accounting must be able to appreciate that lawyers play a significant role when accounting fraud occurs and should consider the nature of that role and duties attendant to it. This appreciation shows that an important lesson from Enron is the danger that prevailing professional cultures create a crack between law and accounting that resolute fraud artists exploit, not cultures that emphasize the intersection of law and accounting that should foil would-be fraudsters.

Lawrence A. Cunningham, Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows, 57 Bus. Law. 1421, 1422-23 (2002). Cf. Regan, 74 Fordham L. Rev. at 1247 (suggesting that Enron's lawyers, in some instances, may have avoided "confronting unpleasant issues" by treating them as "requiring an accounting rather than a legal judgment").

Ideally, to protect a company and its investors the company's Audit Committee, its lawyers and its auditors would work together in a coordinated fashion to achieve a common objective: accurate reporting and appropriate corporate conduct. In particular, given the risk of financial fraud, a closer working relationship between the lawyers and accountants would be desirable.

However, lawyers and auditors do have differing roles, the auditors being independent outsiders directly reporting to the public and the lawyers principally functioning as confidential advisors. (see pp. 63-64, above). Those contrasting roles, and the present climate surrounding the auditing of public companies, with litigation and regulatory risk ever present, make the realization of this idealized coordination unlikely. It appears that, as a predicate for this coordination, the SEC and the Public Company Accounting Oversight Board would have to articulate a need for it. Absent such regulatory encouragement, it will be difficult for lawyers and accountants to alter significantly their traditional arm's length relationship sua sponte.

Nonetheless, lawyers do have an important role to play in connection with their clients' financial disclosures, and we now offer suggested best practices with respect to the fulfillment of that role.

B. Recommendations

1. Understanding accounting concepts

Because accounting concepts are so frequently central to issues on which companies require legal advice – e.g., the adequacy of disclosures, choice of structure for transactions, revenue and expense recognition practices – a basic familiarity with the accounting concepts relevant to a client is essential for a lawyer advising a public company on financial disclosure and financial structuring. Law firms should provide adequate training programs for their attorneys in these areas. In-house lawyers with financial, transactional or public disclosure responsibilities should be similarly trained.

2. Lawyer consultation on financial disclosure

It is vital that lawyers be actively consulted on matters of financial disclosure, as many accounting issues have taken on legal overtones. One lesson from the recent corporate accounting scandals is the need to avoid any rigid separation between a company's legal and accounting functions. Lawyers functioning in the disclosure area, albeit not primarily responsible for a company's financial disclosures, should not distance themselves from the process used to prepare such disclosures.

One sound way to involve lawyers in mitigating the risk of accounting misdeeds, and thus to improve the mechanisms of corporate governance, focuses on the internal control provisions of Section 404 of SOX. That provision directed the SEC to adopt rules requiring each reporting company (other than registered investment companies) to include in its annual report a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, as well as an assessment of the effectiveness of those internal controls. Section 404, and the implementing rules and standards, also require each registered public accounting firm that prepares or issues an audit report on a company's annual financial statements to attest to, and report on, management's assessment of internal control over financial reporting. Internal control over financial reporting has been defined by the SEC as "[a] process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. . . ." 17 C.F.R. § 240.13a-15(f). In our view, a system of internal controls that does not require the financial staff to consult with the in-house lawyers (and outside lawyers when there is no appropriate in-house counsel) most familiar with a particular subject or account is not a robust system of internal controls. Thus an effective system of controls meeting the requirements of SOX 404 should involve active consultation with counsel.

There are numerous areas in which counsel's knowledge and experience will be essential to the accurate preparation of the financial statements. Perhaps the most familiar area has to do with litigation reserves. A company cannot accurately determine its liabilities under FASB SFAS No. 5 without consulting counsel about what is reasonably probable. Other areas suggest themselves. An in-house lawyer, for example, may have knowledge concerning whether a patent accounted for as an asset on the balance sheet has a defect that would require that it be written off or written down. Likewise, counsel involved in distribution or collections might know of an account that has determined to stop paying or of a defect in the company's ability to collect, information indispensable in accounting for the company's receivables and reserves. Counsel may also be familiar with the terms of distribution agreements, which may impact when a company may recognize revenue. Countless other examples could be cited.

In instances such as these, counsel is not responsible for determining the proper accounting treatment of the information in counsel's possession, and, indeed, may not even be aware of its accounting significance. For example, it is the accountant's job to determine whether a contract is one that permits immediate revenue recognition. But, in each of these instances, counsel may be in possession of information that would be relevant to that ultimate accounting judgment. An optimal system of internal controls, accordingly, should require the financial personnel responsible for public accounting to consult with a lawyer when it is reasonably foreseeable that the lawyer is knowledgeable about these kinds of facts regarding material transactions.

Moreover, establishing consultation with counsel as a best practice would achieve many of the objectives set forth above without the attendant costs. If financial personnel are required to check with the lawyers, they can no longer shut out the lawyers – the lawyers would become an essential part of internal controls. Nor could the lawyer disclaim responsibility if consulted: while the lawyer may not know all of the intricacies regarding public accounting, the lawyer would be held responsible for what he does know and for ensuring that the appropriate accounting personnel know the essential facts in his possession concerning each material transaction.

We have given some thought to the form that consultation with counsel could take. One possibility would be to require some form of written certification or confirmation by the lawyers to the responsible financial personnel of the facts within personal knowledge relevant to a proposed disclosure.[165] Such certifications, and the lawyer consultation they require, might also be an appropriate part of a company's process to support the CEO and CFO certifications of financial statements mandated by SOX § 302, another context in which consultation with the company's internal and external lawyers is essential.

Other, less formal methods of consultation could be appropriate. We are not prepared to recommend a particular form of consultation for all companies, regardless of their size and nature. However, the essential thrust of this recommendation – that there be best practices that actively involve lawyers in the system of internal controls, and in the process supporting the required SOX § 302 certifications – should fit every company.

3. The 1975 ABA-AICPA "Treaty": a new context

The Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, 31 Bus. Law. 1709 (1976), developed in 1975 by the ABA in consultation with the American Institute of Certified Public Accountants (the "Treaty"), recommends how lawyers should respond to auditors' inquiries concerning asserted and unasserted claims (loss contingencies). The Task Force has considered whether the Treaty should be modified in light of such developments since 1975 as adoption of the SEC's lawyer conduct reporting up rules and the recent amendments to the ABA Model Rules. It appears that no such modification of the Treaty is necessary. What is necessary is an awareness of how the new rules can impact lawyer conduct consistent with the Treaty.

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165 Such lawyer certifications, limited to matters on which they have been engaged, are to be distinguished from a requirement for lawyer certifications concerning matters on which they have not been engaged -- necessarily requiring as a predicate extensive due diligence -- which we oppose (see pp. 118-19, above).

For example, if a lawyer advises a client that an unasserted claim should be disclosed to its auditors and in its financial statements, but management resists this advice, then, depending on the particular circumstances, this may trigger a reporting up obligation under the SEC's lawyer conduct rules. Such a client position might also disable the lawyer from responding to an auditor's inquiry letter if such a response, omitting the lawyer's prior confidential advice to the client, would mislead the auditor and hence violate SEC Rule 13b2-2(b). Such withholding by the lawyer of a response letter would be highly likely to trigger a dialogue between the client and its auditor that would surface the disclosure issue.

4. Report on claims directly to Audit Committee

External counsel, as recommended in the Treaty, confirm in their responses to auditors' letters that it is their practice to consult with clients when, in the course of performing legal services, they learn of unasserted claims that may require financial statement disclosure. These consultations typically occur only with company management, protected by the attorney-client privilege, with any disclosure of a particular unasserted claim to the auditors being left to the client.

This practice should be modified in one respect, consistent with the spirit if not the literal requirements of the SEC's lawyer conduct rules: the Audit Committee should be made aware of such possible claims, as well as any advice, if rendered to management, that such unasserted claim should be disclosed to the company's auditors or in the company's financial statements.

5. Do not recognize an attorney-auditor privilege

The Task Force has considered whether to recommend that a privilege be recognized with respect to communications between a company's lawyers and its auditors. Relationships between auditors and companies, and the companies' lawyers, have become more difficult in recent years. Auditors are under pressure to obtain information in auditing a company's financials.

Lawyers are reluctant to engage in non-privileged communications with auditors or to recommend that their clients waive the privilege with respect to attorney-client communications, given the risk of later third party litigation. See Thomas W. White, The Growing Tension Between Auditors & Lawyers, Directors Monthly, Oct. 2004, at p. 8. Open, less guarded and less adversarial communications would be helpful in achieving the common interest of the auditors and their clients of ensuring the accuracy and completeness of financial disclosures. See Merrill Lynch & Co. v. Allegheny Energy, Inc., 229 F.R.D. 441, 448 (S.D.N.Y. 2004) (finding no waiver of attorney work product privilege by a company's provision of internal investigation documents to its auditor, since the interests of a company and its auditor are aligned "insofar as they both seek to prevent, detect and root out corporate fraud"); International Design Concepts, Inc. v. Saks Inc., S.D.N.Y., 05 Civ. 4754 (PKC), Mem. Opin., June 5, 2006, at 4-5 (similar, citing other cases). A limited privilege covering attorney-auditor communications could facilitate such communications and enable better evaluation of issues that might affect a corporation's financial position.

Nonetheless, the Task Force does not recommend the recognition of such a privilege. Treating communications with an auditor as privileged is inconsistent with the nature of the auditor's public certification of a company's financials and the relevance, in the event of later litigation or regulatory scrutiny, of all facts and procedures on which the certification was based. See United States v. Arthur Young & Co., 465 U.S. at 818 (to insulate accountant's workpapers from disclosure would be "to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations").

Information material to a company's financial condition must be disclosed to the auditor, including facts known to counsel. The privilege applying to attorney-client communications does not render facts privileged. Thus the Audit Committee and the General

Counsel should ensure that the auditors are being provided with all facts recognized as material that are in the possession of inside and outside counsel. This does not mean that the auditors need be given access to privileged attorney-client communications. The material facts known to counsel can be shared with the auditors either by counsel -- recognizing that such counsel-to-auditor communications are not privileged -- or by the company.

6. Due diligence: a need to reexamine and educate

Due diligence, as used in modern corporate practice, means more than the processes and procedures necessary to create a defense for underwriters and others under the 1933 Act, although that aspect is a vital part of the concept. Without being exhaustive, due diligence also includes work done to evaluate the accuracy and completeness of non-financial sections of disclosure documents and to test the representations and warranties made in corporate acquisitions, privately placed securities offerings and other transactions. Much of this work, especially outside the financial statements, is, and historically has been, done by lawyers. Unless the context indicates otherwise, "due diligence" is used in this report with the broader meaning.

The Task Force views due diligence in this broader meaning, and the lawyers' role in it, as an important component of effective corporate control and governance processes. Our focus is not primarily on the content of the "reasonable investigation" needed to sustain a signing officer's or director's or an underwriter's affirmative defense in litigation under Section 11 of the 1933 Act.[166] Rather our concern is more on whether due diligence, as now practiced, meets the reasonable expectations of, and is properly understood by, independent directors and corporate

166 See generally Donald C. Langevoort, Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment, 63 Law & Contemp. Prob. 45, 63 (2000) (questioning justification for strict underwriter liability, and need for traditional due diligence, in accelerated offerings by "large capitalization issuers," who have "substantial reputational incentives to be candid in their capital raising").

executives who necessarily rely in part on lawyers' participation in (1) the preparation and review of, and sometimes their sub-certifications or alternative assurances regarding, the company's public disclosure documents, and (2) the testing of representations and warranties in corporate transactions.

Underlying this discussion is a sense of unease that due diligence may not be receiving sufficient attention from issuers, underwriters, their respective lawyers and the SEC. Anecdotal evidence, by its nature noncomprehensive and selective, drawn from the experience of some Task Force members and our interviews with some other lawyers, supports this sense of unease. Due diligence for both issuers and underwriters, we believe, is often performed in a highly competent and professional manner. But there appears to be a lack of consistency, and especially difficult challenges in the context of accelerated public offers. No one can say with any assurance that more effective or thorough due diligence would have led to earlier discovery of the accounting and other misstatements and outright corporate frauds that have plagued recent years. But the sheer frequency of these unhappy events and their size certainly raises the question.[167]

Effective ongoing review of company disclosure documents by inside and (where involved) outside counsel to ensure proper disclosure is an important element of control. Oversight of these practices by Audit Committees and other independent directors is an aspect of sound corporate governance.

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[167] As is true with respect to effective lawyering in general, there is no empirical data indicating with what frequency due diligence procedures have averted misleading or fraudulent securities offerings. One well known such instance concerns Penn Central. Persistent inquiries by underwriter's counsel (Sullivan & Cromwell) concerning management representations resulted in aborting a planned (and fraudulent) offering. See Theodore Sonde, The Responsibility of Professionals Under the Federal Securities Laws – Some Observations, 68 Nw. U.L. Rev. 1, 14 (1973); Coffee, Gatekeepers at 235 n.27. See also n. 173, below.

Directors and officers of public companies can be liable for material errors and omissions in disclosure documents, but may establish a defense, or show an absence of scienter, through their own due diligence. Likewise, under state corporate law directors have a duty of care (from which they may be substantially absolved from liability by statute and corporate charters and by-laws) in the discharge of which they are entitled, for certain purposes, to rely on the expertise of others. In some instances, especially before WorldCom and Enron, directors and officers may have been too content to rely on indemnification and insurance as insulators from personal financial liability and may not have inquired sufficiently into the scope of the due diligence work being done by others, especially (for present purposes) by the corporation's inside and outside counsel. Perhaps officers and directors have not, in some instances, paid enough attention to the personal reputational damage they can suffer as the consequence of ineffective due diligence. Perhaps, in some instances, the lawyers, not facing inquires into the scope of their own investigations, have not taken care to disclose the scope of their work or have done less work or less careful work than they might otherwise have done.

There is a perception that many aspects of due diligence work tend to be dull and unglamorous and, unless a material problem is discovered, unappreciated. While as a result a tendency to skimp on due diligence may be understandable, such skimping is unacceptable. Law firms should review the adequacy of their due diligence training programs and practices, including the need to assign qualified personnel to lead due diligence teams.

Issuer's inside counsel and (where involved) outside counsel should advise client boards and management on the extent of due diligence work done in connection with the client's public disclosure documents and its material corporate transactions. They should emphasize the need for senior management to support adequate due diligence processes and procedures and to make themselves and staff members meaningfully available for due diligence interviews.

Effective ongoing due diligence by companies and their counsel can also provide an improved baseline for due diligence by underwriters and their counsel, particularly for companies that access the public securities market with some frequency. Seasoned issuers have been able to use shelf registration to access the capital markets rapidly since the early 1980s, with the adoption in 1983 of SEC Rule 415 under the 1933 Act. 17 C.F.R. § 230.415 (1984). See generally Fox, 70 Va. L. Rev. 1005. Well-known seasoned issuers have had even more assured rapid access to the markets since 2005. As former SEC Chairman William Donaldson noted, in an April 2005 speech to the Bond Market Association: "A transaction twenty years ago might have taken six months, and five years ago it might have taken two weeks. Today it can be done overnight, and next year it might take even less time..." (www.sec.govinews/speech/spch042005whd.htm).[168]

In these accelerated offerings, the time for traditional due diligence is severely truncated.[169] See generally, ABA Committee on Federal Regulation of Securities, Report of Task Force on Sellers' Due Diligence and Similar Defenses under the Federal Securities Laws, 48 Bus. Law. 1185 (1993) ("Due Diligence Task Force Report").[170] The SEC's original concept, in

168 These accelerated procedures are not available to new issuers, and thus the time available for due diligence is not constrained for these issuers.

169 This impact on due diligence was stressed by Commissioner Barbara Thomas in her dissent from the SEC's adoption of Rule 415. Delayed or Continuous Offering and Sale of Securities, SEC Rel. 33-6423, 1982 SEC LEXIS 979 at *45 (Sept. 2, 1982) (Comm'r. Thomas, dissenting). See generally Fox, 70 Va. L. Rev. at 1006 n.5.

170 See SEC Advisory Committee on the Capital Formation and Regulatory Process, Report, July 24, 1996 at 13, available at www.sec.gov/news/studies/capform/capffull.txt ("Wallman Committee Report") (shelf registration and other SEC rules changes "to facilitate issuer access to the markets... may be impairing the ability of issuers' boards of directors,
(footnote continued)

authorizing these accelerated procedures, was that due diligence would be performed on a "continuous" basis by an issuer's chosen underwriters and their lawyers, who would thereby acquire a "reservoir of knowledge" concerning the issuer. Shelf Registration, SEC Release No. 33-6499, 1983 WL 408321, at *6; Due Diligence Task Force Report, 48 Bus. Law. at 1207-08. In theory, such continuous due diligence would make feasible, when an offering is launched on short notice, brief updating of the due diligence in the limited time available.

Some frequent issuers, working with their customary underwriter or underwriters, have instituted such "continuous due diligence" programs. These programs sometimes include the use of designated "underwriters' counsel," who are expected to develop a meaningful level of familiarity with the issuer. See generally Robert J. Haft & Arthur F. Haft, Due Diligence – Periodic Reports and Securities Offerings, § 5.4 (2005) (descriptions by practitioners Robert M. Thomas, Jr., and Joseph McLaughlin of continuous due diligence methods and their limitations). Opinions vary on the effectiveness of these programs, very likely based on one's own experience.[171] Lawyers and their clients, both issuers and underwriters, should consider how such continuous due diligence

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underwriters and independent accounting firms to perform their traditional Securities Act 'due diligence'").

The underwriter-defendants in the WorldCom case stressed "the difficulty of meeting the traditional standard for due diligence in the context of integrated disclosure and shelf registrations." In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 684-85 (2004) ("WorldCom"). See Due Diligence Task Force Report, 48 Bus. Law. at 1240-41 (urging courts to take time available for due diligence into account, among other factors, in assessing reasonableness of due diligence performed). However, it has been urged that the circumstances of WorldCom's offers in 2000 and 2001 provided ample time for traditional due diligence. See Coffee, Gatekeepers at 44-46.

171 Continuous due diligence was in use by WorldCom, according to the contentions of the underwriter-defendants in the WorldCom class action securities litigation. That litigation was settled before judge or jury had occasion to rule on the underwriters' argument that their "continuous due diligence" met the standard of "reasonable investigation" required to establish a defense under the 1933 Act. See WorldCom, 346 F. Supp. 2d at 684-85.

programs can be implemented by a wider range of companies and how the programs can be made more effective.[172]

Traditional underwriters' due diligence provided an important and useful "watch-dog" pressure on an issuer's disclosure documents. See Coffee, Gatekeepers at 203-04.[173] As traditional due diligence by underwriters has receded with respect to well seasoned issuers, this pressure has diminished. In such circumstance, internal due diligence should play a greater role. The use of internal "disclosure committees" by many issuers, as recommended by the SEC, has responded to this need in part.[174]

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172 See Coffee, Gatekeepers at 236 n.32 ("few, if any, issuers have attempted this theoretically available technique").

173 Commissioner Thomas, in dissenting from the SEC's adoption of Rule 415, offered this personal observation:

> [I]n my experience as a securities lawyer representing both issuers and underwriters, I viewed first hand the importance of an underwriter's counsel in the disclosure process. The give and take among the underwriters and their counsel, and the issuer and its counsel, increased the likelihood of complete and accurate disclosure, and many times during the process discoveries were made which kept troubled companies from coming to market, or at least fully informed the public as to the risks inherent in a proposed transaction. Thomas dissent, n. 170 above, at *45.

See Fox, 70 Va. L. Rev. at 1026 (1984):

> The universal view of those who have commented on this [traditional due diligence] process [in connection with 1933 Act registration statements] is that it frequently resulted in significant additional disclosure [beyond a company's prior 1934 Act filings].

174 The SEC, in response to SOX §302, recommended in 2003 that companies create a "committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis". Certification of Disclosure in Companies' Quarterly and Annual Reports, SEC Rel. No. 33-8124 (Aug. 28, 2002) at 8, available at www.sec.gov/rules/final/33-8124.htm. This recommendation was similar to a "best practices" proposal made by the Wallman Committee in 1996. Wallman Committee
(footnote continued)

The SEC has not formally updated its views on what constitutes adequate due diligence for an underwriter (Rule 176) for over twenty years. In its 1998 Aircraft Carrier release, the SEC showed an interest in giving greater guidance in determining whether a "reasonable investigation" was conducted or "reasonable care" was used under Sections 11 and 12, respectively, of the 1933 Act. SEC Release No. 33-7606A (Nov. 13, 1998), available at www.sec.gov/rules/proposed/337606a1.txt [175]. But it did not carry this interest forward to the promulgation of final regulations, despite support from this Association (see letter from the Association's Committee on Securities Regulation to the SEC, Apr. 5, 1999, at 20-21). One consequence is continued and meaningful uncertainty in this core area of due diligence about the scope of the investigation required to establish a defense. Another is a lack of express focus on mechanisms, such as continuous due diligence techniques, to provide investors with protection against misleading disclosures to the extent that traditional due diligence no longer fulfills this role.

Report, n. 170 above, at 44-48. These disclosure committees are today used by many public companies.

175 The Commission's proposed expansion of Rule 176 would have listed six due diligence practices that "the courts should consider as positive factors in expedited offerings," two of which expressly invoke the lawyers' role:

> Whether the underwriter received a favorable opinion from issuer's counsel opining that nothing has come to its attention that has caused it to believe that the registration statement contains an unfair or untrue statement or omits to state a material fact;
>
> Whether the underwriter employed counsel that, after reviewing the issuer's registration statement, . . . [1934] Act filings and other information, opined that nothing came to its attention that would lead it to believe that the registration statement contains an untrue statement or omits to state a material fact . . .

Id. at nn. 460-61.

In sum, in the Task Force's view the subject of due diligence (e.g., standards, procedures and training for those performing due diligence and the education of and disclosures to interested parties) is in need of serious professional attention, particularly because of changes wrought by integrated disclosure, the ever-accelerated pace of business transactions (including securities offerings) and the effect of SOX requirements.

Improved issuer due diligence practices would better ensure proper information for investors, provide a defense to a company's officers and directors in return for sound governance, and provide a better baseline for underwriters' due diligence, especially in rapidly executed transactions.

In the latter context, we urge the bar, working with the underwriting community, to focus on the development of new techniques better suited than traditional due diligence to the current realities of the marketplace. The private development of such techniques is preferable to asking the SEC to take the initiative in this area – given, inter alia, the SEC's disinclination to do so to date – but, if successful, may serve as a sound basis for SEC rulemaking in the future. Any such rulemaking should pay particular attention to issues of independent verification, areas of specialized expertise, and distinctions between issuer's counsel and underwriters' counsel. Most importantly, it should also take into account any effect on the appropriate scope of due diligence of the CEO and CFO certifications and improved internal controls, as mandated by SOX, and the widespread use of disclosure committees.

VII. **The Role of Lawyers in Conducting Internal Investigations**

A. Background and Context

1. Introduction

When conducting an internal investigation on behalf of a company, investigative and company counsel face many challenges, from determining the proper scope of the inquiry, to making findings of fact and recommending remedial action, to addressing the expectations and demands of regulators and prosecutors. Some commentators have suggested that good corporate governance dictates that counsel must follow all leads of possible unlawful conduct, address every instance of wrongdoing and cooperate fully with the authorities. Others take as their starting point the interests of the corporation's shareholders, as determined by their appointed representatives (the Board of Directors or a committee of the Board), and use as their guiding principle the obligation to maintain shareholder value.

Often these two approaches will not be in conflict. An independent, comprehensive investigation, coupled with full cooperation with government authorities, will be consistent with, and indeed mandated by, the need to preserve shareholder value. There are other circumstances, however, where a company may properly determine that, on balance, an investigation that has no limitations will result in a waste of assets, or that compliance with certain government demands will have such negative collateral consequences as not to be in the best interest of the corporation's shareholders.

We believe that the second approach is more consistent with the proper role of a lawyer to a client, and in the end is the best prescription for good corporate governance. The determination of the scope and timing of an investigation, the remedial actions taken, and the level of cooperation are choices for the client, advised by counsel, subject to the duties and constraints imposed by state or federal law. The responsibility for establishing the client's own standards of corporate governance resides with the corporation's directors and managers.

But the fact that the ultimate decision-making responsibility rests with the client does not provide an excuse for the lawyer to acquiesce passively in client decisions the lawyer believes are contrary to the client's interests. The lawyer has an obligation in an internal investigation, as in other areas of practice, to analyze and understand the facts with impartiality and to provide impartial, sometimes tough advice. A legal regime that preserves the ability of counsel to provide such advice is necessary to assist directors and managers in discharging their duties.

2. Internal investigations in today's enforcement environment

In today's regulatory enforcement environment, internal investigations are a fact of life for corporations. The federal government and market regulators are aggressively investigating, prosecuting, and seeking severe penalties for wrongdoing. And because prosecutors and regulators now place unprecedented emphasis on and have, in fact, come to expect companies' full cooperation with investigations, companies tap lawyers with ever-increasing frequency to conduct internal inquiries. As then General Counsel of the SEC, Giovanni P. Prezioso, recently commented, "The strong incentives for cooperation, in both criminal and Commission investigations, appear to have greatly increased the number of independent investigations undertaken by companies presented with evidence of potential misconduct."[176] In order to effectively guide clients through government and internal investigations, lawyers must understand this enforcement landscape.

The proliferation of internal investigations has largely tracked the government's evolving enforcement strategies and priorities. Historically, the Department of Justice (the "DOJ"

176 Giovanni P. Prezioso, Remarks Before the Vanderbilt Director's College (Sept. 23, 2004) ("Vanderbilt Remarks"), available at http://www.sec.gov/news/speech/spch092304gpp.htm.

or "Justice Department") and the SEC pursued a reactive approach to business-crime and regulatory actions.[177] When wrongdoing was exposed, law enforcement and regulators typically addressed it by conducting extensive inquiries and meting out appropriate sanctions. As such, lawyers and clients responded to government inquiries from a more defensive posture.

However, in recent years the government has become more proactive in its enforcement activities and has encouraged companies also to be proactive in reporting problems. Cooperation with government investigators has always been a way potentially to mitigate charges or penalties or avoid them altogether. But in 2001 and 2003, respectively, the SEC, in its "Seaboard Report",[178] and the DOJ, in its "Thompson Memo,"[179] formally set forth their expectations in memos detailing the factors their staffs would take into account in charging companies. While the nature and seriousness of the underlying conduct and its pervasiveness within a corporation will always be the dominant consideration, cooperation with investigatory proceedings stands out as the next most important factor affecting the outcome. Both agencies underscore that working with the government, voluntary disclosure of wrongdoing, and internal investigations are strongly encouraged and will be substantially credited; but these efforts must be authentic and effective in

177 See, e.g., Stephen M. Cutler, Remarks Before the District of Columbia Bar Association (Feb. 11, 2004) ("Remarks Before D.C. Bar"), available at http://www.sec.gov/news/speech/spch021104smc.htm.

178 On October 23, 2001, using its authority under Section 21(a) of the 1934 Act, the SEC issued its Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions. SEC Rel. No. 34-44969, 76 SEC Docket 220 (Oct. 23, 2001) ("Seabroad Report"). Section 21(a) of the 1934 Act authorizes the Commission to issue a report of investigative findings if it determines that an enforcement action is not warranted.

179 Memorandum from Larry Thompson, Deputy Att'y Gen., to Heads of Dep't Components & U.S. Atty's (Jan. 20, 2003) ("Thompson Memo"), available at http://www.usdoj.gov/dag/cftf/business_organizations.pdf.

getting the facts out. The government is more than willing to pursue perjury and obstruction-of-justice charges when it believes the evidence is sufficient to support them. Coupled with this cooperation bias is an increased emphasis on, and rewarding of, effective compliance and ethics programs, both as prophylactic and remedial measures.

To further these enforcement goals, the government has allocated enormous resources to prosecuting corporate wrongdoing and is actively pursuing harsh penalties against companies and individuals. In addition, parallel criminal and civil proceedings have become increasingly common, with the Justice Department and the SEC coordinating investigations and prosecutions, and sharing information. The stakes and risks that companies face are extremely high.

Now, more than ever, cooperation is key. Although the 2001 SEC and 2003 Justice Department corporate charging statements remain their official policies, these agencies' expectations and aspirations have since shifted and been heightened further.[180] Stephen Cutler, the former Director of the SEC's Division of Enforcement, committed to, and the current Director Linda Thomsen has continued, a "forward looking-approach," which involves "seeing around the corner," "identifying trends, practices, and risks within our capital markets," and nipping problems in the bud.[181] Similarly, the Justice Department now pursues "real-time enforcement," a strategy that depends upon swift investigations and indictments, and "stresses rooting out corporate fraud and restoring public confidence in the integrity of our markets."[182] Long and comprehensive

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180 Cutler, Remarks Before D.C. Bar, n. 177 above.

181 Id.; Linda Thomsen, SEC Enforcement Director Responds to Questions About Program's Direction, SEC Today, at 1 (Nov. 16, 2005).

182 Christopher Wray, then Assistant Att'y Gen., Crim. Div., Remarks to the ABA White Collar Crime Luncheon (Feb. 25, 2005) ("ABA Remarks"), available at http://www.usdoj.gov/criminal/press_room/speeches/2005_3853_rmrkCrimLuncheon030205.pdf.

investigations and indictments have largely been replaced by "segmented" and prompt ones, often for less complex violations.

Today, full cooperation is essentially expected. Although the SEC and Justice Department statements may stress that self-policing and self-reporting are encouraged and will be credited, in practice a company may now be punished for failing to cooperate adequately with government investigations, judged from the perspective of the investigators. Indeed, Cutler has explained that cooperation is currently assessed using a "more graduated scale" and that the Commission takes into account both cooperation, and "lack thereof," in making charging decisions.[183] Similarly, federal prosecutors "now take a harder look at whether the company is really [fully] cooperating" in deciding whether to bring charges.[184] Moreover, the government often expects companies to waive the attorney-client privilege and work-product protection as part of a company's full cooperation.[185] Evidence of these enhanced overall expectations can also be found in the New York Stock Exchange's ("NYSE" or "Exchange") recent pronouncement that members will be charged if they do not comply with their twin affirmative duties to (1) cooperate with Exchange reviews and investigations, and (2) fully disclose violations of Exchange rules and the securities laws. NYSE Information Memo No. 05-77: Factors Considered in Determining Sanctions (Oct. 7, 2005).

Appendix H to this report reviews in detail the DOJ, SEC, and the NYSE corporate-prosecution policies, the recently revised U.S. Sentencing Guidelines for Organizations, as well as Section 10A of the 1934 Act, which imposes reporting obligations on outside auditors. The NASD

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183 Cutler, Remarks Before D.C. Bar, n. 177 above.

184 Wray, ABA Remarks, n. 182 above.

185 See Marcia Coyle, Waiving Privilege a Crucial Sentencing Issue, Nat'l L.J., Aug. 29, 2005, at 6 ("In practice, companies are finding that they have no choice but to waive these privileges whenever the government demands it.").

and the Commodity Futures Trading Commission (CFTC) and others also have similar guidelines.[186] Together these complimentary and competing forces shape today's enforcement climate. But in conducting internal reviews, lawyers and clients should also appreciate that government expectations have clearly risen since their issuance.

In sum, today public companies and their lawyers face a demanding regulatory and enforcement environment. Government and market regulators are serious about rooting out corporate wrongdoing, and restoring and maintaining trust in our markets. In aggressively investigating, charging, and sanctioning misconduct, they have come to expect that companies will fully cooperate with them and self-report problems. Recent enforcement trends and government statements, in fact, indicate that companies will be punished if they impede governmental investigations or otherwise do not provide the level of cooperation expected by prosecutors and regulators. Similarly, corporations are both encouraged and rewarded for installing strong corporate governance and ethics programs that can help deter and identify violations. In this climate of compliance, internal investigations are more prevalent and important than ever.

3. The ethical and legal framework

The lawyer has an obligation, incident to his or her membership in the Bar, to provide unflinching legal advice, even in those circumstances where the client does not want to hear it. Under our system of justice, that function of the private bar is integral to ensuring compliance with the law. If the lawyer fails in the satisfaction of that obligation, it is not only the client who suffers, but – in many cases – the investing public as well. See pp. 65-66, above.

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186 See, e.g., NASD, Sanction Guidelines, available at http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf; CFTC, Enforcement Advisory: Cooperation Factors in Enforcement Division Sanction Recommendations, available at http://www.cftc.gov/files/enf/enfcooperation-advisory.pdf ("CFTC Cooperation Factors").

As set forth below, counsel conducting an investigation, and a company subject to an investigation, must seriously consider the degree to which it should cooperate with prosecutors and regulators. The wrong decision on this issue may, in certain circumstances and depending on the gravity of the underlying conduct, sound the death knell for the corporation. But, while this is an important question, we do not believe it is the proper starting point for the inquiry. Nor do we believe that this starting point is helpful either in resolving the practical problems that arise in investigations or, ultimately, in assisting corporations to abide by the best principles of corporate governance. By highlighting a number of the practical issues that arise in internal investigations other than cooperation, and by providing some of the considerations that counsel must consider in providing advice, we hope to enlist the Bar in providing advice to the client of not just what is strictly required by the law, but as to what actions are most conducive to an environment that fosters corporate compliance. That advice often will be that the client cooperate fully with governmental or regulatory investigations. Other times, however, it may not.

Counsel in conducting an internal investigation into allegations of illegal conduct must be guided by basic ethical duties, including: to represent the client competently and zealously within the bounds of the law; [187] to abide by client's decision-making authority,[188] after advising the

[187] NYCPR, Canon 7 ("The duty of a lawyer, both to the client and to the legal system, is to represent the client zealously within the bounds of the law . . . ."); DR 7-101 ("A lawyer shall not intentionally fail to seek the lawful objectives of the client through reasonably available means permitted by law and the Disciplinary Rules . . ."); DR 7-102 (requiring zealous advocacy within the bounds of the law).

[188] NYCPR EC 7-7 provides that the "authority to make decisions is exclusively that of the client and, if made within the framework of the law, such decisions are binding on the lawyer". <u>See also</u> p. 91, above (Model Rule 1.2(a)).

client as to the relevant considerations; [189]and to represent the interests of the public company, not any conflicting interest of individual officers or directors. See pp. 55-56, above. [190]

From these principles come certain practical considerations that should guide counsel conducting an investigation. Counsel must always consider the legal obligations that an officer or director owes to the corporation before providing the client advice. These obligations include duties imposed by federal and state law. For example, federal securities laws impose liability for misleading disclosures made by public companies, and such liability can extend to

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189 The lawyer should try to ensure that the client's decisions are made only after the client has been advised as to the potential ramifications of each legally permissible alternative course of action, including the possibility of harsh consequences that might result from the likely reactions of regulators.

EC 7-5 provides that a lawyer "furthers the interest of the client by giving a professional opinion as to what he or she believes would likely be the ultimate decision of the courts on the matter at hand and by informing the client of the practical effect of each decision." See also Canon 7. EC 7-8 allows a lawyer to "emphasize the possibility of harsh consequences that might result from assertion of legally permissible positions." However, "the lawyer should always remember that the decision whether to forego legally available objectives or methods because of non-legal factors is ultimately for the client and not for the lawyer." Id.

190 While "the decisions of constituents of the organization ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful" and "[d]ecisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province," the lawyer has no duty to obey an instruction of an officer or director that is in violation of that person's legal obligation to the organization and that would substantially injure it. Model Rule 1.13, cmt. [3]; see Sarah Helene Duggin, Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview, 2003 Colum. Bus. L. Rev. 859, 936 (2003):

> The client to whom [investigative counsel] owes undivided loyalty, fealty, and allegiance cannot speak to him except through voices that may have interests adverse to his client. He is hired and fired by people who may or may not have interests diametrically opposed to those of his client.

directors and officers who may be controlling persons of the corporation or be responsible for the statements under the group-published doctrine.[191]

Under state law, officers and directors have the familiar duties of due care, loyalty, and good faith. These duties encompass the obligations to consider and react with requisite process to reasonably available material information, to act in the best interests of the corporation and to prioritize the interests of the corporation, to act when there is a known duty to act, and not to act with intent to violate applicable positive law.[192] As a part of their fiduciary obligations, directors have the specific duty to investigate "red flags" indicative of wrongdoing by corporate agents.[193]

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191 As articulated by the Ninth Circuit:

> In cases of corporate fraud where the false or misleading information is conveyed in . . . annual reports . . . or other 'group published information,' it is reasonable to presume that there are the collective actions of the officers . . . Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading misrepresentations with particularity and where possible the role of individual defendants in the misrepresentations.

Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987) (citations omitted).

192 See In re Walt Disney Co. Derivative Litig., No. Civ. A. 15452, 2005 WL 1875804, at *35 (Del. Ch. Aug. 9, 2005) (describing fiduciary duties under Delaware law), aff'd, No. 411,2005, 2006 WL 1562466 (Del. June 8, 2006); see, e.g., Enron, 284 F. Supp. 2d at 657-58 (S.D. Tex. 2003) (finding that plaintiffs had stated a claim as to breach of fiduciary duty for directors' failure to act given their access to material information about the actual financial condition of Enron).

193 See In re Caremark Int'l, Inc Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."); see also In re Citigroup, Inc. S'holders Litig., Civ. A. No. 19827, 2003 Del. Ch. LEXIS 61, at *6-7 (June 5, 2003) (describing a failure to provide oversight claim under Caremark); In re Worldcom, Inc. Secs. Litig., No. 02 Civ 3288 (DLC), 2005 WL 638268, at *8 (S.D.N.Y. Mar. 21, 2005) ("[D]irectors . . . may not fend off liability by claiming reliance where 'red flags' regarding the reliability of an audited financial statement, or any other expertised statement, emerge."); cf. WorldCom, 346 F. Supp. 2d at 684 ("If red flags arise from a reasonable investigation, underwriters will have to make sufficient inquiry to satisfy themselves as to the accuracy of
(footnote continued)

Finally, corporate charters, bylaws and other internal policies and procedures can impose additional obligations on directors. They may require directors to receive reports of wrongdoing[194] and, where appropriate, to conduct investigations. They may also assign certain investigative obligations to committees of the Board of Directors such as the Audit Committee. Where a designated committee or director fails to fulfill its oversight responsibilities, it is possible that a violation of the duty of care has occurred.[195]

B. Recommendations

We now address several questions counsel typically confronts with respect to internal investigations.

1. Who should conduct the investigation and to whom does that counsel report?

After determining that an internal investigation is required, the first issue presented is who should direct the investigation. Typically, there are three alternatives: the Audit Committee or other committee of the Board composed of independent directors, the full Board of Directors, or management of the corporation (often the General Counsel or a lawyer in the office of the General Counsel). Various regulatory bodies have expressed their preferences with respect to how this issue is resolved. The Thompson Memo, for example, indicates that, in making the decision whether to criminally charge a corporation, the DOJ considers whether the corporation's directors "exercise[d] independent review over proposed corporate actions rather than unquestioningly ratifying officers'

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the financial statements, and if unsatisfied, they must demand disclosure, withdraw from the underwriting process, or bear the risk of liability.")

194 SOX §307 and various listing standards currently require audit committees of public companies regularly to receive reports of wrongdoing.

195 Cf. Walt Disney Derivative Litig., 2005 WL 1875804, at *35 (describing violation of fiduciary duty claim where directors fail to act in the face of a legal obligation to act).

recommendations." Similarly, the SEC's Seaboard Report suggests that one factor the SEC will consider in evaluating the level of the corporation's cooperation is whether the investigation was run by a committee consisting solely of independent, non-management directors. In assessing whether to recommend sanctions, the CFTC also looks at whether the company "use[d] an independent entity to investigate and report on the misconduct." CFTC Cooperation Factors, n. 186 above.

Those pronouncements do not and cannot relieve counsel from the duty to advise as to the best reporting line for an investigation in the particular case. There is no single "right" entity or person to supervise an investigation and, in most instances, corporations will have some discretion. However, in addition to the expressed regulatory preference for investigations run by Board committees, often it will be in the company's best interest to have non-management directors run an investigation. Such directors are independent from management and thus best able to judge the evidence with respect to management. In addition, an investigation run by independent directors, if properly performed, may have particular credibility with the government, regulators and the company's auditors, possibly eliminating the need for those entities to conduct their own parallel investigations. Moreover, investigations run by non-management directors, such as a company's Audit Committee, are often a sensible and cost-efficient path because it is frequently difficult to determine at the outset of the inquiry whether senior management had a role in alleged wrongdoing. Choosing the wrong person to run the investigation may result not only in a waste of that person's time, but also can lead to increased cost, delay and loss of credibility when it turns out that the alleged wrongdoing is more extensive. In those circumstances, a Board committee may be forced to redo the investigation, after hiring its own counsel.

However, in other instances, an investigation led by senior management may be more appropriate and efficient. The use of management and in-house counsel to lead an investigation offers premiums in terms of efficiency and cost-savings for the corporation and its directors. This seems particularly true where, for instance, misconduct seems safely localized. Thus, for example, where the wrongdoing occurred in a foreign affiliate of a United States-based corporation, or occurred in the past and under the watch of a different management team, current management or the chief legal officer may be the most appropriate choice to supervise the investigation. Likewise, where there is a premium on speed in conducting an investigation and high-level management does not appear to be involved, a corporation may well chose to have its in-house counsel conduct the investigation.

Counsel advising a corporation should inform the client of the impact of choosing one representative or entity to conduct the investigation, as, in all but the most unusual circumstances, the client will have a choice as to who is to conduct the investigation. Moreover, where senior management is chosen to supervise an investigation, counsel should regularly revisit that decision as the investigators learn more about the nature and scope of the conduct being investigated. The decision initially to launch an investigation led by management does not foreclose a later conclusion that the Board is the best body to supervise the investigation.

The extent of General Counsel's involvement in internal investigations must depend upon the facts (particularly the existence of conflicts) and the capabilities of the relevant in-house department. The General Counsel and/or internal lawyers can and often should be involved in many internal investigations. However, there are other circumstances, such as where a material allegation is made involving the CEO, or other senior management, when the Board might well desire that the General Counsel not be present. Such decisions should be made in consultation with the corporate body conducting the investigation.

Conflicts (or the appearance of conflicts) also should be taken into account in determining whether an internal lawyer should be in charge of an investigation of a peer or a major direct client or of a matter where the internal lawyer rendered significant legal advice. The client should be advised of such apparent conflicts and of the risk that the investigation will be compromised.

There is one circumstance where a lawyer's duty does not end with the advice that the company can chose who is to conduct the investigation from a range of options. In some circumstances, an officer or director's instruction that investigative counsel report to him or her may violate a fiduciary duty of that officer or director. For example, a director implicated in wrongdoing who insists that investigative counsel report to him or her alone, or retains as investigative counsel a personal friend, may be considered to have violated the fiduciary duty of loyalty by elevating personal interests above those of the corporation.

A decision with respect to the management of an internal investigation is no less subject to the laws of fiduciary duty than any other important decision. If made by officers in a self-interested fashion that causes harm to the corporation, the lawyer may need to bring it to the Board's attention, including pursuant to the SOX reporting up rules (<u>see</u> pp. 70-72, above). In those circumstances, counsel has no duty to obey the corporate officer or director and turn a blind eye to the breach of fiduciary duty. Counsel's duty is to the corporation – not to the particular director or officer – and, in those circumstances, should be unstinting in providing the corporation's Board his or her advice.

After the individuals who are directing the investigation are chosen, investigative counsel must be chosen. Again, this is a choice for the client. With few exceptions, the client has broad discretion over whom it may choose. The law does not dictate that a corporation must hire a particular lawyer or even a particular type of lawyer.

The more complicated question is whom it should choose. One factor in this decision is assessing how regulators will view the independence of prospective investigative counsel. In some circumstances, regulators have expressed skepticism regarding the independence of an investigation and the reliability of its results if the investigation has been conducted by counsel who has recently defended the corporation before a regulatory agency or as an advocate in litigation.[196] Likewise, regulators might well question the independence of an investigation conducted by a company's regular outside counsel, or by any counsel that does a significant amount of work for the client or its officers or directors. The retention of regular company outside counsel to conduct internal investigations undermined the credibility of investigations in two prominent scandals: Enron[197] and

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196 There has been such criticism of investigative counsel's role in the accounting scandal in the city government of San Diego, California. There counsel, also defending the City of San Diego before the SEC, led two internal investigations. The first investigation was characterized by an outside auditor as "insufficient." The SEC told city officials that the second internal investigation also lacked independence, since counsel had provided some information to employees in advance of their interviews. See Deborah Solomon, Lost City: After Pension-Fund Debacle, San Diego is Mired in Probes, Wall St. J., Oct. 10, 2005, at A1.

HealthSouth's retention of Fulbright & Jaworski both to conduct an internal investigation of inside trading allegations against CEO Richard Scrushy, and to represent the company in an SEC investigation concerning these allegations, received similar criticism. See HealthSouth Committee Hearings, n.124 above, Part 2, Nov. 5, 2003, at 55, 70-71, 77-78 (Board overruled recommendation of Audit Committee to appoint independent counsel to investigate).

197 See Enron, 235 F. Supp. 2d at 600-01, 657-58, 665-69, 705; Timothy E. Hoeffner & Susan M. Rabii, Maintaining the Integrity of Internal Probes, Nat'l L.J., June 23, 2003, at 19; Julie Mason, Houston Law Firm Probed for Role in Fall of Enron, Houston Chron., Mar. 14, 2002, at A13.

Global Crossing.[198]

Those concerns must be considered by counsel advising the corporation in every instance. There are costs to hiring counsel who is too close to current management. If true wrongdoing has occurred, counsel with ties to management might not be best suited to discovering it and rooting it out. If the company chooses wrong and there is wrongdoing where it was not believed to exist, the failure to act through independent counsel can be expensive.[199] Even where there is no true wrongdoing, the use of regular counsel to conduct the investigation can cause credibility problems, and possibly lead regulators or the Board to conclude that a new investigation must be conducted by independent counsel.

There are, however, some investigations where the benefit of hiring a law firm that is familiar with the company, or has prior experience in the subject matter of the investigation, will outweigh the disadvantages arising out of the prior relationship. Counsel knowledgeable of the company and its personnel, and familiar with the regulatory and factual framework, will have a shorter learning curve, will get up to speed more quickly and efficiently on a matter, and presumably will be better suited to evaluate evidence in context than counsel who lacks this background. This is a benefit both from the standpoint of shareholder value and from the standpoint of corporate governance.

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198 Christopher Stern, Report Criticizes Global Crossing's Outside Counsel, Wash. Post, Mar. 11, 2003, at E05. The criticism in Global Crossing in part focused on the fact that the Acting General Counsel supervising the investigation continued to be an active partner of the firm allegedly charged with investigating. See D-15, below.

199 See Report of Investigation in the Matter of Cooper Companies, Inc., SEC Rel. No. 34-35082, 58 S.E.C. 591, 594-96 (Dec. 12, 1994) (faulting internal investigation where co-chair and CFO of company had refused to cooperate with outside counsel's investigation, and the Board of Directors did not act).

Once again, counsel for the corporation should lay these choices out for those supervising the investigation and let them make their own choice. During the course of the investigative process, they should periodically assess whether outside counsel remains independent of the influence of interested directors and officers.

2. How should the scope of the investigation be determined?

After determining who should supervise an investigation and which counsel should be retained, the client must define the scope of the investigation. This issue usually is, and should be, resolved by the corporation in consultation with investigative counsel. It is an extremely important issue that can be addressed only with sensitivity to the facts giving rise to the investigation itself.

State and corporate fiduciary duty law and federal securities law and other federal obligations provide relevant guideposts. State corporate law requires directors to investigate red flags.[200] Under federal securities laws, a corporation is liable to investors if it intentionally or recklessly makes a false material statement. That liability may extend to all persons who make or participate in the making of the false statement.[201] Accordingly, officers and directors who are faced with red flags indicating that a material statement made by the issuer may be wrong, or that there may be material misconduct at the company, should conduct an inquiry that addresses those warning signs. While "[d]irectors are entitled to rely on the honesty and integrity of their

200 See, e.g., In re Chepak, SEC Rel. No. 34-42356, 2000 WL 49226 (SEC Jan. 24, 2000).

201 See Ernst & Ernst vs. Hochfelder, 425 U.S. 185, 211 (1976) (requiring allegations of more than negligence alone to sustain a 10b-5 action for failure to make proper inquiry); see also In re WorldCom. Inc. Sec. Litig., 2005 WL 638268 at *1 (describing the standards for imposing liability on directors of public companies under Section 11 of the 1933 Act and under the controlling person provisions in the 1933 and 1934 Acts).

subordinates until something occurs to put them on suspicion that something is wrong," if red flags go unheeded, "then liability of the directors might well follow."[202]

There are several factors that should be considered in determining the proper scope of an investigation. The guiding principle should be the need to uncover wrongdoing suggested by the allegations: at a minimum, the investigation must address those allegations. As the investigation proceeds, investigative counsel should continually reassess the breadth of the engagement, and recommend expanding (or contracting) the scope of the investigation as the circumstances warrant. If there is a reasonable likelihood that limitations in scope will lead regulators, auditors, lenders, or other important constituents to discount the findings and conclusions of the investigation, the company should consider expanding the scope of the investigation appropriately.

Nevertheless, directors have a fiduciary obligation to set appropriate limitations on investigative counsel and avoid wasting corporate assets. Internal investigations are often costly, and companies have an obligation to ensure that they are conducted efficiently. In addition to the cost of the investigation itself, extended investigations may have other negative collateral consequences for a company, such as delaying its submission of critical financial releases (which may cause the company's stock to be delisted from a stock exchange or constitute an event of default under loan agreements or significant contracts), depressing the price of the company's stock value, generating low employee morale, hampering employee recruitment or the company's ability to obtain new contracts, and protracting regulatory investigations. In addition, facts discovered through the investigation, even where there is no wrongdoing, may serve as fodder for litigation

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202 Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); see also In re WorldCom, Inc. Sec. Litig., 2005 WL 638268 at * 8 (articulating strict liability standard applicable to corporations under the 1933 Act.).

against the company. None of these factors excuse ignoring red flags. However, all of these factors should be considered in determining the proper scope of an investigation.

To be clear, where allegations are serious and appear to have substance and where, if true, they would have a material effect on the company's financial statements, officers and directors are obligated to conduct investigations that are broad enough to get to the bottom of the issues. In other circumstances, however, such as where the possibility of serious wrongdoing appears improbable or speculative, a full scale investigation may not be necessary. In short, issues regarding the proper scope of the investigation should be the subject of discussion. The scope of the investigation, including its limitations, should be clearly expressed to regulators.[203]

Finally, while the client ultimately is responsible for determining the scope of the investigation,[204] there may be circumstances where a limitation in scope may violate a duty to the corporation or may be otherwise illegal. It is possible that the client will determine to limit investigative scope to prevent implication of a key employee or to cover up the wrongdoing of senior management. As discussed above, counsel's duty is not to the particular director or member of management but to the corporation as a whole. Upon becoming aware of illegal activity, or even of a decision that – if implemented – would violate a fiduciary duty and cause harm to the

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[203] Many of the risks inherent in limiting investigative scope were dramatized by the criticism of Vinson & Elkins' Enron investigation, the scope of which was severely limited as to persons interviewed and material reviewed, and was subject to an extremely tight time deadline. See Timothy E. Hoeffner & Susan M. Rabii, n. 197 above.

An investigation for Qwest by Boies Schiller also received similar poor reviews from some. Anne C. Mulkern, Internal Probe of Qwest's Deals Found Few Problems, Denver Post, Oct. 4, 2002, at C-01 (independence of firm questioned); Andrew Backover, Blame Spreads Far in Telecom's Fall, USA Today, Aug. 18, 2003, at B (investigation found no problems with transactions that Qwest later admitted were improper).

[204] EC 7-7.

corporation, counsel under ethical rules should elevate the issue within the corporation. If such efforts prove unfruitful, counsel has permissive grounds for withdrawal or even, if the violation is likely to cause substantial injury, to report client confidences to the SEC. 17 C.F.R. § 205.3(d)(2).

3. Self-reporting

Another important issue is whether and when to report the possibility of unlawful activity to regulatory authorities. Regulators' published commentaries and rules on compliance suggest that prompt self-reporting of unlawful conduct is always in the client's best interests (see Appendix H below). The Thompson Memo provides: "In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors." Similarly, the Seaboard Report factors include whether the company promptly reported to SEC staff the results of its review: "Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered?" In the U.S. Sentencing Guidelines for Organizations (Appendix H at H-5), punishment is mitigated based on a company's efforts in self-reporting, cooperation with authorities, and acceptance of responsibility. The CFTC states that it considers the company's good faith in uncovering and investigating misconduct, the company's cooperation with Division's staff in reporting misconduct, and the company's actions with respect to Division's staff. The NASD likewise states that it considers whether, prior to detection or intervention by the regulator, the company accepted responsibility to a regulator, voluntarily employed corrective measures, revised procedures to avoid recurrence of the misconduct, and attempted to pay restitution or otherwise remedy the misconduct. NYSE Rule 351 and NASD Conduct Rule 3070 go even further, requiring companies promptly to report any violation of securities laws or regulations.

In light of these regulatory pronouncements, clients often ask counsel whether self-reporting a recently discovered problem is legally required or only a matter of prudence.[205] Ethical considerations and legal requirements do not always mandate full, real time disclosure of all potential problems to regulators, although they mandate truthful disclosure when disclosure is made. In many, if not most, circumstances, reporting evidence of unlawful activity to regulators will be the proper or even required course of action. Some entities, particularly those in highly regulated industries, or with a history of problems, may adopt a policy approaching zero tolerance, and will determine that virtually any evidence of wrongful conduct must be reported promptly to regulators.

Often, however, the decision whether to self-report is a difficult one. Given the substantial costs to a corporation of many regulatory investigations, a public company may justifiably determine not to self-report in some circumstances. Those circumstances cannot be determined in advance. Each case is different. What is mandated is careful consideration by the client, with the assistance of counsel, of the relevant considerations. In general, a client determining whether to self-report should consider the following, among other relevant factors: (1) the nature and extent of possible wrongdoing and the circumstances of its discovery (for example, if the problem was discovered in the context of an acquisition transaction requiring regulatory approval, self-reporting might be desirable even if the issue could be remediated promptly); (2) whether the possible wrongdoing is in the past or is ongoing; (3) the cost and collateral consequences of reporting; (4) the possibility of harm to the corporation, its shareholders, or other constituencies; (5) who is alleged to have engaged in wrongdoing; and (6) whether there are (or are likely to be)

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205 This does not apply to on-going illegal activity, such as the improper destruction of documents, which constitutes obstruction of justice. Counsel have an affirmative obligation to try to ensure preservation of documents relevant to the potential wrongdoing.

other investigations or proceedings with respect to the possible wrongdoing or related matters, including by a governmental or regulatory body. The client should consider that a decision not to disclose likely will be viewed as a failure to cooperate if the government later discovers the wrongdoing, and may lead to a corporate penalty or even indictment – the ultimate penalty that could put the corporation out of business. Where the possibility of wrongdoing appears high-level or widespread, or where it is ongoing, establishing a satisfactory compliance program is essential to a corporation's interests, and, therefore, full disclosure of the problem will often be the only sensible course.

4. Exercise of judgment

Supreme Court Justice Robert H. Jackson famously observed that "[w]ith the law books filled with a great assortment of crimes, a prosecutor stands a fair chance of finding at least a technical violation of some act on the part of almost anyone."[206] That observation applies no less to investigative counsel hired by a corporation than to a federal prosecutor working for the government. Investigations often address conduct that is problematic, but not clearly unlawful, and the investigative record is never perfect. Counsel is required to exercise discretion concerning how to characterize events, to judge witness credibility and motive, and to determine whether conduct crossed the line from questionable or inadvertent to improper. In making these assessments,

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206 Robert H. Jackson, The Federal Prosecutor (Apr. 1, 1940) (published in 24 J. Am. Jud. Soc'y 18 (1940)). See Abraham S. Goldstein, Conspiracy to Defraud the United States, 68 Yale L.J. 405, 408 (1959) (observing that the terms "conspiracy" and "defraud" have taken on very broad and unspecific meanings); Ralph K. Winter, Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America, 42 Duke L.J. 945, 954-55 (1993) (noting that mail and wire fraud statutes, whose underlying doctrine "posits a duty of agents to inform their principals of material facts such as kickbacks," have been interpreted to criminalize a "wide range of conduct involving conflicts of interest, alleged misrepresentations, or the failure of agents to inform alleged principals of certain facts").

investigative counsel has a client – a client who may be keenly interested in whether conduct is characterized as improper or criminal and in how investigative counsel exercises discretion. Sometimes that client will have an interest in protecting the employees under investigation; other times, it will have an interest in trying to build a case against those employees. It will rarely be disinterested. It is important for investigative counsel to be aware of the different constituents who have a stake in how counsel's discretion is exercised, and to be cognizant of the consequences that would flow from exercising discretion broadly or narrowly.

Most of the commentary on this issue involves situations where counsel "under charged" during the course of an investigation. We have all read about investigations conducted by counsel who is too close to management, or had some prior involvement with the transactions under review, and were not sufficiently skeptical of motives and events and, consequently, failed to ferret out wrongdoing. But the issue can also arise in the other direction, and investigative counsel also may err by being too quick to find there was unlawful conduct based upon minimal or equivocal evidence.

There are many incentives that may cause investigative counsel to "over charge." For example, the various Justice Department and regulatory pronouncements reward corporations (and their counsel) who uncover wrongdoing and root out wrongdoers.[207] There is a one-way

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[207] See Cutler, Remarks Before D.C. Bar, n.177 above, at 6:

> The larger lesson is the continuing importance of what we refer to as cooperation . . . . First, I believe the Commission is placing a greater emphasis than ever before on assessing and weighing cooperation when making charging and sanctions decisions. . . . Second, I think the Commission is using a more graduated scale when it assesses cooperation. There are cases in which the Commission has found cooperation early in an investigation to have been inadequate, and taken that into consideration, even if the conduct of the same party was later exemplary. In other words, the Commission no longer

(footnote continued)

regulatory ratchet; except in rare instances, regulators do not punish corporations and their counsel for being overly aggressive in determining that unlawful conduct occurred.

Similarly, investigations undertaken when there is new company management who were not employed at the time of the transactions under review, or where there has been a decision to restate financial statements, often find problems in a broad swath of conduct, as there is an incentive in those situations to redress even marginal issues so the company, under new management, can have a fresh start and not be burdened by grey area decisions made by former management. In addition, no counsel is a hero for missing conduct that is later characterized as a crime, so investigative counsel often has an incentive to stretch to find problems.

> begins and ends its assessment by asking, 'did this party cooperate, yes or no?' Now, it routinely goes on to consider, if the party did cooperate, how much? How often? You should expect that we will seek to reflect the answers to these sorts of questions when we resolve investigations and actions.

Thompson memo:

> The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation. . . . [S]uch conduct should weigh in favor of a corporate prosecution. The revisions also address the efficacy of the corporate governance mechanisms in place within a corporation, to ensure that these measures are truly effective rather than mere paper programs.

See also Arthur F. Matthews, Defending SEC and DOJ FCPA Investigations and Conducting Related Corporate Internal Investigations: The Triton Energy/Indonesia SEC Decree Settlements, 18 Nw. J. Int'l L. & Bus. 303, 418 (1998); SEC Litig. Rel. No. 19517, SEC Charges Six Former Officers of Putnam Fiduciary Trust with Defrauding Clients of $4 Million (Jan. 3, 2006) (announcing that the SEC was not commencing an enforcement action against corporation because of corporation's "swift, extensive and extraordinary cooperation" including terminating and disciplining any responsible employees).

Balancing these concerns may be difficult. There are substantial costs of not finding all unlawful conduct. Improper conduct may go unremedied. If later found, the original investigation may be undermined, wasting time, money and goodwill. The failure to uncover wrongdoing may also call into question, in the eyes of prosecutors and regulators, the adequacy of the company's cooperation. And, a wrongdoer may be allowed to stay in place.

However, counsel's decision to characterize as criminal conduct that no reasonable prosecutor would prosecute is also not cost-free. An overly aggressive decision to characterize innocent conduct as wrongful is not just unfair. It can also impose regulatory costs on a corporation, result in a drop in shareholder value, lead to the departure of key executives, and cause the loss of business. Such an outcome would injure the shareholders directors are charged with protecting. Just as under enforcement may compromise corporate governance, so too may over enforcement: a too zealous investigation, and one that does not take into account all the facts and circumstances and draw the right distinctions, can create a perception of unfairness antithetical to good corporate governance and can undermine the trust between client and counsel which is so integral to good corporate governance in the first place.

There is no substitute for judgment. We believe that, in characterizing the evidence, counsel should not act as a zealous advocate for the client in construing the facts in the light most favorable to the client. But counsel also should not act like an overzealous prosecutor and take the worst view of the evidence from the client's perspective.

5. Employee discipline

Retaining a key employee in the face of some evidence of wrongdoing is likely to strain the corporation's relations with regulators. The DOJ and SEC view continued employment of potentially culpable employees as serious flaws in the corporation's compliance program, giving rise to potential enforcement consequences. The Thompson Memo states:

> In evaluating a corporation's response to wrongdoing, prosecutors may evaluate the willingness of the corporation to discipline culpable employees of all ranks and the adequacy of the discipline imposed. The prosecutor should be satisfied that the corporation's focus is on the integrity and credibility of its remedial and disciplinary measures rather than on the protection of the wrongdoers.

The Seaboard Report includes among its factors in determining whether the corporation is complying, "[a]re persons responsible for any misconduct still with the company? If so, are they still in the same position?" Similarly, the CFTC considers whether the company "adequately addressed the employment of the persons responsible for the misconduct, to the extent that they were employed by the company when the conduct was discovered." Then U.S. Attorney for the Southern District of New York, James Comey, stated that the government views a company's continued employment of an individual in the face of evidence of criminal activity as a "serious flaw in the corporation's compliance program and reflective of a problematic corporate culture." Interview with United States Attorney James B. Comey, 51 United States Attorneys' Bulletin 1, 5 (Nov. 2003).

Notwithstanding these pronouncements, the decision whether to retain key employees can be a difficult one and the lodestar remains the exercise of business judgment. A lawyer acting to further corporate governance should guide the corporation in its consideration of a number of factors, in addition to the impact a decision to retain a wrongdoer will have on the company's relationship with prosecutors and regulators, including (1) whether the purported wrongdoing occurred in a personal or professional capacity; (2) the nature and extent of alleged wrongdoing; (3) the strength of the evidence of wrongdoing; (4) whether the employee gained a personal benefit from the conduct; (5) whether the employee had a supervisory role or was otherwise responsible for setting the tone at the top of the company; (6) whether the employee played a role in sensitive areas such as internal controls or financial reporting; (7) the employee's compliance history; and (8) the presence or absence of mitigating circumstances.

In some instances, such as where the corporation is trying to send a message about compliance, the corporation may choose to terminate the employment of all employees involved in the conduct, even those who did not personally engage in wrongdoing, but who supervised others and failed to detect a problem. Board or Audit Committee members may conclude that their own fiduciary obligations require them to terminate an employee in whom they have lost confidence based on the investigative findings, even in the absence of a conclusion of wrongdoing. In other instances, such as where the employee in question is particularly valuable to the company, the Board might properly determine that actual evidence of wrongdoing (as opposed to serious, but unsupported, allegations by regulators) is required before it will take action. And, in still other instances, the Board might determine that termination is not required, notwithstanding evidence of improper conduct. This may be the case where the conduct was modest in scope, and historical, or where the conduct in question is the product of bad professional advice. The client should weigh whether a termination or other discipline (or administrative suspension) best serves the shareholders' interests by considering the value of the employee to the corporation or the impact of discipline on other employees, as compared with the possible harm to the corporation's reputation or stock value or to the corporation's relations with regulators if no action is taken.

A related, and somewhat easier question is what to do with employees who refuse to cooperate with investigators. In many situations, employees will owe a fiduciary duty to their employers to cooperate with investigations. If employees fail to cooperate with an investigation, employers may justifiably refuse to indemnify attorney's fees and terminate that person's employment.

6. Paying counsel fees, retention of counsel and severance

A frequent issue is whether the company should retain counsel for employees or pay fees for counsel representing employees. The Thompson Memo suggests that corporations may be at risk for doing so, except when required. It states that prosecutors, "in weighing the extent and value of a corporation's cooperation," may consider "a corporation's promise of support to culpable employees and agents . . . through the advancing of attorneys fees."[208]

Resolution of this issue is easy in some circumstances, such as where contract or corporate law requires corporations to advance counsel fees. Recent Delaware case law suggests that such fees should be advanced even where the liability does not necessarily relate to actions by the employee in his official capacity.[209]

Moreover, paying counsel fees may help achieve more accurate results of the investigation or may serve to boost employee morale. The rote incantation that lawyers can

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208 This prosecutional pressure has received some recent criticism. Judge Lewis Kaplan held that government pressure on KPMG to cut off paying the legal fees and other defense costs of former employees criminally charged with promoting illegal tax shelters violated the Fifth Amendment due process rights and the Sixth Amendment right to counsel of those defendants. United States v. Stein, 435 F. Supp. 2d 330, 338-81 (S.D.N.Y. 2006).

See also Duggin, 2003 Colum. Bus. L. Rev. at 963:

> Prosecuting attorneys should not attempt to influence the ability of corporate constituents to retain counsel. An organization's advancement of legal fees to individuals under investigation or charged with crimes related to their responsibilities as officers, directors or employees of the entity should not be considered as an adverse factor against the organization in charging decisions, plea negotiations, or in determining the government's position with respect to criminal sentencing proceedings.

209 Homestore, Inc. v. Tafeen, 888 A.2d 204 (Del. 2005) (holding that Homestore executive entitled to advancement of legal fees to defend civil and criminal charges, notwithstanding Homestore's contention that executive had acted out of personal greed and not in his official capacity).

sometimes act in ways that delay or impede an investigation wrongfully assumes the worst of the legal profession. Lawyers are guided by ethical principles and can and often do play an important role in ensuring the integrity, accuracy and fairness of the investigation and thus ultimately for corporate governance and the regulators as well. Counsel can aid the investigative process by advising their clients of the importance of cooperating, if they believe their clients' interests will be thereby well served. They may also bring to the attention of the investigating attorney context and extenuating factors necessary for the investigation to render a balanced, fair and accurate result, freeing investigative counsel to focus on the inculpatory facts – secure in the knowledge that any mitigating facts will not be ignored by individual counsel. In some circumstances, cost and speed factors will counsel against hiring lawyers for the employees, but that decision should not be based on an assumption that counsel will impede an investigation.

A related issue is whether a corporation should pay severance to a recently released member of senior management prior to completion of the investigation. Regulators occasionally object to such payments believing that they create a presumption there will not be a finding of wrongdoing, which may prejudice the investigation or give the appearance that the company condones wrongdoing. There are circumstances, however, where payment of severance is contractually obligated. Also, severance payments may help insure that the corporation gains valuable compliance from a potentially culpable person who would otherwise refuse to cooperate, or bring closure to a civil settlement agreement that would be extremely valuable to the corporation.

As a practical matter, providing severance payments will in some instances be impractical or even imprudent, in light of Section 1103 of SOX, which empowers the SEC to "petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision," any "extraordinary payment" to a corporate officer while an SEC investigation is ongoing.[210] The statute does not define "extraordinary payments," though the SEC has made clear that it interprets the term broadly, and, in the sparse litigation under Section 1103 thus far, courts have generally adopted the SEC's view.[211] The statutory language has been interpreted broadly enough to encompass any severance payment, even a payment pursuant to a previously existing contractual obligation. Section 1103 requires a minimal showing by the SEC in order for a 45-day freeze to be entered, which is then extendible to 90 days.[212] If the SEC commences an enforcement action against the prospective recipient of the frozen payment prior to the expiration of the freeze, the freeze then stays in place until the conclusion of the SEC's enforcement action on the merits.[213]

Section 1103 has thus added a potent new weapon to the SEC's arsenal, and the SEC has been alert for opportunities to use it. In some instances, upon being informed of a corporation's intention to make such a payment, the SEC has requested that the funds be placed in escrow.[214] This is a request that any corporation seeking to be viewed as a cooperator may find difficult to reject. Indeed, given the government's greatly heightened sensitivity to severance payments, many corporations will not even attempt to make such payments, out of concern such an attempt will be

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210 15 U.S.C. 78u-3(c)(3)(A)(i).

211 See, e.g., SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1034 (9th Cir. 2005) (en banc).

212 15 U.S.C. 78u-3(c)(3)(A)(iv).

213 15 U.S.C. 78u-3(c)(3)(B)(i).

214 See, e.g., SEC Press Release No. 2003-184, Commission Settles Civil Fraud Action Against Vivendi Universal, S.A., Its Former CEO, Jean-Marie Messier, and Its Former CFO, Guillaume Hannezo, (Dec. 23, 2004) (former CEO was required to relinquish claim to severance package that SEC had escrowed under Section 1103); Yochi J. Dreazen, SEC, In Inquiry Into Vivendi, Seeks to Freeze Messier Payouts, Wall St. J., Sept. 17, 2003, at A18.

viewed as uncooperative. In short, a contemplated severance payment may never reach its intended recipient, as a result of a negotiated escrow or a court-ordered freeze, followed by an enforcement action in which – if successful – the SEC obtains a monetary recovery which it can satisfy with the escrowed or frozen funds.

A Board of Directors should carefully weigh the costs and benefits of such payments in light of the evidence that exists at the time and the stage of the investigation. In some circumstances, the advantage of paying severance may outweigh concerns about regulators' perceptions. When a Board concludes that severance is appropriate, it may be advisable for it to precondition any payment of severance on full cooperation and on the absence of any finding that the employee in question is culpable.

7. Waiving attorney-client privilege

Though the Thompson Memo provides that waiving attorney-client privilege is not an "absolute requirement," the DOJ often expects organizations that are the subject of investigations to waive attorney-client privilege. Similarly, the CFTC assesses whether the company willingly waives attorney-client privilege and work product protection for internal investigation reports, corporate documents, and employee testimony. Moreover, regulators often cite waiver of privilege as a factor in determining cooperation.[215] One difficulty for clients, among others, is that waiver of the privilege renders otherwise privileged documents, information, and advice readily discoverable by future civil litigants.

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[215] See, e.g., SEC Litig. Rel. No. 19517, n. 207 above (SEC not commencing an enforcement action against corporation because of corporation's cooperation, including not asserting any applicable privileges).

Recently, regulators have been increasingly willing to enter into partial waiver agreements, whereby the privilege is ostensibly waived only as to the regulators. Courts, however, have been reluctant to recognize the limited waiver exception and many courts have held that the privilege, once waived as to regulators, is waived as to all.[216]

The determination of whether to waive is a critical one for the corporation. A waiver may be the most effective way for a corporation to root out wrongdoing, to ensure that it is compliant in the future, and to win credit from the government, avoiding either a criminal charge or hefty civil penalties. For a corporation faced with true wrongdoing, there may be no practical alternative to self-reporting and a waiver: where a corporate employee engages in misconduct, the corporation itself is harmed. It is thus perfectly appropriate and may be in the best interests of the corporation both to report such misconduct to the government and to provide the government with all the materials, including memoranda of witness interviews, necessary for the government to prosecute the wrongdoer. Such swift and pro-active cooperation can send a message to employees that the corporation is committed to compliance and has a zero tolerance policy with respect to corporate misconduct.

However, a reflexive decision to waive is not cost-free. The promiscuous waiver of the privilege can have several deleterious consequences that must be considered by the corporation

216 See, e.g., In re Royal Ahold N.V. Sec. & ERISA Litig., 230 F.R.D. 433, 438 (D. Md. 2005) (holding that limited confidentiality agreement under which interview memos were disclosed to the government was not sufficient to preserve confidentiality of interview memos from class action plaintiffs); In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289, 314 (6th Cir. 2002) (rejecting concept of selective waiver); In Re Natural Gas Commodity Litig., 03 Civ 6186 (VM) (AJP), 2005 U.S. Dist. LEXIS 11950, at *22-33 (S.D.N.Y. June 25, 2005) (discussing case law concerning non-waiver agreements). But see Saito v. McKesson HBOC, Inc., Civ. A. No. 18553, 2002 Del. Ch. LEXIS 125 (Oct. 25, 2002) (holding that "the corporation did not waive the work product privilege when it gave documents to the SEC and the USAO under [a] confidentiality agreement").

and that prudent counsel will raise with the corporation both during an investigation and, ideally, even before an investigation. First, the privilege exists in part to promote good corporate governance—it encourages employees to consult with counsel regarding conduct they observe or participate in. The waiver of the privilege may undermine sound corporate governance by chilling the very consultation and informed decision-making that the privilege is designed to promote. Second, survey results suggest that if the attorney client privilege continues to be eroded, it may undermine pro-active corporate self-regulation, and vigorous internal investigations. See ACC Survey, n. 67, above. Even though employees can be given no assurance of absolute confidentiality in consulting with company counsel (see pp. 86-87, above), a waiver of the privilege may lead employees to be hesitant to discuss sensitive or difficult issues since the waiver all but guarantees that their every word will end up in the hands of a government regulator. In addition, it has been suggested that the lack of a clearly defined government privilege waiver policy may undermine the willingness of corporations to cooperate with prosecutors. Waiving attorney-client privilege to government authorities can mean waiving the privilege to the world, providing ammunition to the plaintiffs' bar to bring lawsuits deleterious to shareholder value.[217]

A similar privilege issue exists as to auditors. Many outside auditors demand access to attorney work product from the internal investigation as a precondition to signing off on outstanding audits and continuing to work with the client.[218] A client is often torn between the

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217 Richard Ben-Veniste & Raj De, Federal Privilege Waiver Demands Impact Corporate Compliance, 20 No. 7 White Collar Crime Rep. 2 (Mar. 30, 2006).

218 The ABA's Task Force on the Attorney-Client Privilege believes the auditor's needs and the interests served by the privilege should be balanced as follows:

> [A]uditors can be provided with summaries of the factual information that has been developed, including access to transcripts of interviews that are not otherwise protected. We do not believe, however, that the auditor should have access to the

(footnote continued)

likelihood that attorney work product, including interview memos, will be fully discoverable by future civil litigants and the auditor firm's demand that it satisfy itself with respect to the scope and results of the internal investigation before it will issue a report on the company's financial statements.

This presents a difficult issue for many public companies—an issue just as difficult as whether to waive the privilege. If the auditor demands access to the work product of counsel, the company may have no choice but to accede. The auditor can refuse to issue an opinion in the form necessary for a company to file financial statements with the SEC and, frequently, to meet reporting requirements under debt covenants, whether in public or private instruments. Few new auditors will agree to an engagement that would entail restricted access to company documentation and the large auditing firms have generally refused to accept such limitations in their engagement letters. There may be, however, circumstances where it is neither in the corporation's interest nor the auditor's for work product to be produced to the auditor.

8. Withdrawal

One particularly problematic issue is when to withdraw as investigative counsel and how to withdraw. In general, counsel must withdraw from representation of a client where such

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> investigating counsel's notes of interviews, legal assessments or legal advice to the client. The requirement by auditors that any of those materials generated by counsel be shared with it would unnecessarily impede the ability of counsel fully to investigate, report and advise the corporate client and potentially would interfere with and weaken the ability of corporations to engage in self-policing. Instead, we suggest that the auditor can rely on investigating counsel's provision of non-protected materials and its assurance, as contemplated by the Treaty, that counsel fulfills its professional responsibility in advising the client with respect to its disclosure obligations.

Report on Audit Issues, June 14, 2006, at 10, available at www.abanet.org/buslaw/attorneyclient/materials/hod/0806_report.pdf.

representation would result in a legal or ethical violation (see pp. 93-94, above). Model Rule 1.16(a)(1) compels a lawyer to withdraw if "the representation will result in violation of the rules of professional conduct or other law." Similarly, DR 2-110B.2 requires withdrawal if "[t]he lawyer knows or it is obvious that continued employment will result in violation of a Disciplinary Rule." Moreover, Model Rule 1.2(d) prohibits a lawyer from assisting a client in conduct the lawyer knows to be criminal or fraudulent. See pp. 52-53, above.

In certain circumstances, discord between investigative counsel and the client may serve as a basis for permissive withdrawal. Model Rule 1.16(b)(4) and DR 2-110C both allow counsel to withdraw upon disagreement with a client as to future course of action.[219] Both rules permit withdrawal, moreover, if withdrawal can be accomplished without a "material adverse effect on the interests of the client."[220]

Thus, ethical rules contemplate permissive withdrawal where outside counsel disagrees with the client as to future action, or whenever such withdrawal does not harm the client. Theoretically, grounds for permissible withdrawal include disagreement between outside counsel and the client as to issues arising from internal investigations, such as investigative scope, disclosure issues, employee discipline decisions, and whether to self-report possible wrongdoing or turn over interview memos or key documents to the regulators.

Sometimes counsel and client will differ based on good faith disagreement over the corporation's interests. Other times, however, they will differ because the client will want to do the

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[219] Model Rule 1.16(b)(4) allows withdrawal where "the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement," while DR 2-110C.1.e allows withdrawal where the client "[i]nsists, in a matter not pending before a tribunal, that the lawyer engage in conduct that is contrary to the judgment and advice of the lawyer but not prohibited under the Disciplinary Rules".

[220] DR 2-110C; Model Rule 1.16(b)(1).

investigation in a manner that the lawyer views as inconsistent with his or her reputation. There may be matters in which counsel will have an interest in using all of the resources possible to uncover potential wrongdoing, while the client decides that such a use of resources is not in the company's interests. There also may be situations in which investigative counsel believes that a wrongdoing employee must be disciplined in order for the company, and counsel, to maintain credibility with the regulators, while the client believes that such action will come at an unacceptable cost to the client.

This poses a conundrum. Lawyers frequently are retained for internal investigations because they have a reputation for "uncovering and discovering all the facts" and "making the tough calls against management." Various regulators may feel they can trust certain lawyers because they will report to them a bad fact if there is one. The client's decision to end or restrict an investigation, or to make decisions concerning management that will not be well received by regulators—even though lawful and consistent with their fiduciary obligation to act in the shareholders' best interest—may not only be contrary to the investigative lawyers' advice, but may also hurt the lawyer's reputation and diminish his or her ability to get similar work in the future. Under these circumstances, the investigative lawyer's decision to resign—for his or her own reputational reason—may have an adverse effect on the client as it may signal to the regulator that there is a problem with the investigation and that the client may not be as hard-nosed as they might like the client to be. Faced with this dynamic, companies may feel they are hostage to their investigative counsel, who, through the threat of withdrawal, may dictate the scope and course of the investigation.

This problem has been compounded by a heightened scrutiny of the activities of lawyers, including an interest by regulators in pursuing aiding and abetting charges against lawyers.[221] The prospect of becoming a target for regulators may cause investigative counsel to advocate future actions by corporate clients that are not necessarily in the shareholders' interests, but rather formulated to preserve investigative counsel's reputation for thoroughness.

If such a disagreement does arise, the lawyer needs to defer to the client's decision-making authority, assuming it involves no unethical or illegal course of action. The lawyer cannot allow his or her self-interest, such as concerns regarding his or her reputation, to interfere with vigorous representation of the client's interests.[222] With adequate consultation and a clear retainer agreement before the investigation proceeds, such tension between investigating counsel and the client should be a rare occurrence.

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221 As discussed above, the SEC may proceed against attorneys for aiding and abetting fraud or participating in or causing misstatements, and may be pressing such charges more frequently against lawyers for providing improper advice. See pp. 47-49, above; see also In re Feldman, Rel. No. 33-7014 (Sept. 20, 1993) (finding that an attorney aided and abetted Section 5 violations when he persisted in advising his client of an erroneous legal position even after being put on notice that the Commission staff disagreed with such position). See generally Carrie Johnson, SEC Chairman Faults Corporate Advisers, Wash. Post, Mar. 5, 2005, at E03 (reporting that the SEC has lodged 76 cases against lawyers in the past three years).

Though the SEC has not initiated noteworthy proceedings against lawyers for conducting improper internal investigations, the Commission's reported service in 2004 of a Wells notice on an attorney in connection with his role in conducting an internal investigation for Endocare suggests that such cases may be forthcoming. See Otis Bilodeau, SEC Threatens Ex-Brobeck Lawyer Over Client's Probe, People Say, Bloomberg.com, Dec. 6, 2004, available at www.bloomberg.com. See also SEC Press Rel. No. 2004-67 at 28 (May 17, 2004) (describing Lucent settlement agreement; penalty imposed, in part, because of interview between former CEO, outside counsel, and Fortune magazine, in which outside counsel characterized Lucent's fraudulent booking as a "failure of communication," where interview occurred after Lucent and SEC had already agreed to settle); cf. Michael Bobelian, Ex-General Counsel Pleads Guilty in Case of Securities Fraud, N.Y.L.J., Sept. 23, 2004, at 2 (former General Counsel of Computer Associates concealed information from law firm conducting internal investigation: United States v. Woghin, 04 CR 847 (E.D.N.Y.) (ILG)).

222 See DR 5-101: lawyer shall not accept or continue employment "if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own . . . personal interests . . . ."

When counsel does withdraw, regulators should not necessarily draw any inference from the withdrawal. As is true with all other difficult issues, handling corporate investigations requires the exercise of judgment. No two corporations are exactly alike and no two investigations are exactly alike. Investigative counsel should be sufficiently flexible to apply judgment to the facts presented by the engagement and help the client safeguard its best interests. Great lawyers may counsel non-cooperation just as they may counsel cooperation. A corporation devoted to corporate compliance may chose not to cooperate in a particular instance just as a corporation with lax ethics might decide that it must cooperate in a different instance. What is called for is honesty; care and thoroughness in the areas that are investigated; and tough and unconflicted advice. The best lawyers—and those who are recognized as the best at promoting good corporate governance—have those characteristics.

If the foregoing is true, then the decision of counsel to withdraw or the decision of the client not to continue with counsel need not be understood to be a red flag with respect to cooperation. Counsel may withdraw because the client wants him or her to cooperate and counsel thinks that is unwise, or counsel may withdraw because he or she wants to cooperate and the client says no. The ethical principles need not be bent for internal investigations. Counsel who prevails, through hard-nosed advice, is the best counsel for corporate governance regardless whether in a particular case the advice is to cooperate or not.

VIII. <u>Other Issues Considered</u>

The Task Force has considered two possible modifications to existing law that, some urge, might help counter the pressures on lawyers to acquiesce in or even assist a client's wrongful course of conduct. One modification would be to recognize a tort cause of action for lawyers discharged in retaliation for advising against or making a report concerning possible violations of law. The other would be to enact federal legislation to restore aiding and abetting liability for lawyers (and others) in private litigation under the securities laws. While the Task Force does not recommend either of these measures, they warrant discussion.

A. A cause of action for retaliatory discharge: further study needed

A cause of action could be recognized for a lawyer discharged by her employer, whether a law firm or a company, in retaliation for reporting up or out under the SOX or ethical rules, or otherwise raising in good faith ethical issues. In certain of the recent major scandals, it does appear that internal lawyers were concerned that, if they "pushed" certain issues, they might lose their jobs. The existence of a cause of action for retaliatory discharge might give internal lawyers "strength" to raise unpopular but important issues, if necessary even to the Board, and likewise might encourage associates and partners in law firms to come forward with necessary advice.

There is some limited protection against retaliation under existing law which may militate against the need for creating this cause of action. SOX § 806 provides a claim for employees of public companies (including in-house lawyers) who suffer retaliatory employment actions for acting as whistleblowers in an investigation of fraud or securities violations. 18 U.S.C. § 1514A. Further, ABA Model Rule 1.13(e) mandates that when a lawyer reasonably believes that he or she has been discharged because of reporting up the ladder pursuant to Rule 1.13, or withdraws in circumstances that require or permit such action, the lawyer must see that the Board of Directors is informed of the discharge or withdrawal (see p. 73, above). The prospect of such an after-the-fact disclosure to the Board may tend to deter retaliatory discharges.

Currently, no statutory or common law tort claim for retaliatory discharge is available in New York to a lawyer who claims that his or her employment was terminated for raising ethical concerns.[223] The sole remedy for a New York lawyer raising ethical concerns comes from the Court of Appeals decision in Weider v. Skala, 80 N.Y.2d 628, 593 N.Y.S.2d 752 (1992), where the Court recognized a contract claim by a law firm associate for breach of an obligation implied in his employment-at-will contract.

Weider is quite limited. First, the Weider court recognized an "implied-in-law-term" based only on DR 1-103A, the reporting rule.[224] Emphasizing this limitation, the court cautioned, "[W]e, by no means, suggest that each provision of the Code of Professional Responsibility should be deemed incorporated as an implied-in-law term in every contractual relationship between or among lawyers." 80 N.Y.2d at 637,593 N.Y.S.2d at 756. Thus Weider provides no clear basis for a lawyer suing for retaliatory discharge arising out of a situation involving DR 4-101 (the analog to ABA Model Rule 1.6) or DR 5-109 (the analog to ABA Model Rule 1.13), the rules most directly pertinent to the issues of corporate governance reviewed in this report (see pp. 72-93, above).

Second, the Weider court declined to recognize a tort of retaliatory discharge, stating that "we have consistently held that 'significant alteration of employment relationships, such as [Weider] urges, is best left to the Legislature.'" 80 N.Y.2d at 639, 593 N.Y.S.2d at 757 (citations omitted). See also Connolly v. Napoli Kaiser & Bern, 12 Misc. 3d 530, 536, 817 N.Y.S.2d 872, 877 (Sup. Ct. N.Y. Co. 2006) (observing that "Wieder was intended to be a narrow exception to the employment-at-will doctrine").

223 New York provides statutory whistleblower protection, in some circumstances, only to public employees (Civil Service Law § 75-b) and to private employees disclosing violations of law that create "a substantial and specific danger to the public health or safety" (Labor Law § 740).

224 DR 1-103A provides: "A lawyer possessing knowledge of. . . [misconduct violating] DR 1-102 that raises a substantial question as to another lawyer's honesty, trustworthiness or fitness in other respects as a lawyer shall report such knowledge" to an appropriate tribunal or authority.

Thus legislation would be needed in New York if the remedies available to a New York lawyer who raises in good faith questions about ethics or violations of law are to be expanded. Such legislation could enlarge the number of NYCPR provisions on which a lawyer could sue. It could also allow for remedies not available in a contract action, e.g., for attorneys fees and for damages from any anxiety, embarrassment and/or humiliation suffered by the lawyer. One model for such a New York statute might be New Jersey's "Conscientious Employee Protection Act", N.J.S.A. 34:19-1 to 34:19-8; see Parker v. M & T Chemicals, Inc., 566 A.2d 215 (N.J. Super Ct. 1989).

There are, however, concerns about the advisability of such legislation (which we assume would be general in scope, not limited to lawyers). One is that creating a cause of action for a retaliatory discharge might give rise to much litigation without really benefiting corporate governance. The attorney-client relationship is a personal one, and a variety of reasons can motivate a client to discharge a lawyer. Retaliation as the motive for a discharge would be easier to allege than to prove.[225] Further, it would be difficult at best for such a cause of action to reach more subtle types of retaliation, such as a reduction in the access of an internal lawyer to corporate decision-makers in response to some past or feared reporting up. Finally, some concern has been expressed that the existence of such a potential claim might be used as leverage by a lawyer seeking to resist legitimate disciplinary actions.

It is difficult to evaluate the extent to which the above concerns should be viewed as substantial. However, numerous states have whistleblower type protections, either by court decision or legislation, that appear to include lawyers within their scope. The experience of those

[225] Those advocating recognition of such a cause of action argue that it would not likely result in frequent frivolous claims, given that the assertion of such a claim, especially if not clearly meritorious, would carry a significant career risk for the lawyer-claimant.

states with whistle-blowing or retaliation claims by lawyers may provide some empirical basis on which to conclude whether New York should adopt such a law. See Crews v. Buckman Laboratories International, Inc., 78 S.W.3d 852, 857 (Tenn. Sup. Ct. 2002) (in-house counsel may bring "a common-law action of retaliatory discharge resulting from counsel's compliance with an ethical duty that represents a clear and definitive statement of public policy"); Burkhart v. Semitool Inc., 5 P.3d 1031 (Mt. 2000) (in-house counsel may bring a retaliatory discharge action pursuant to Montana's Wrongful Discharge from Employment Act, which prohibits "employment discharge in retaliation for an employee's refusal to violate public policy") (citation omitted); GTE Products Corp. v. Stewart, 653 N.E.2d 161, 166-67 (Mass. Sup. Ct. 1995) (court recognizes a "carefully delineated" and narrowly drawn claim of wrongful discharge for in-house counsel); General Dynamics Corp. v. Superior Court, 876 P.2d 487 (Cal. Sup. Ct. 1994) (unanimous recognition of a tort claim for retaliatory discharge by employed lawyers).

The Task Force recommends that this issue be further considered by an appropriate Association committee.

B. Aiding and abetting liability: premature to consider restoration

It is asserted by some commentators that outside law firms in particular operate in a "law-free zone," subject to no meaningful regulation of their own conduct or any realistic risk of liability or other sanctions when their clients violate the securities laws. Koniak, 26 Harv. J.L. Pub. Pol'y at 195); see Gordon, 35 Conn. L. Rev. at 1190 ("Sailing close to or even over the line of illegal conduct is not unduly risky because lawyers who advice on complex transactions for corporate clients almost never face sanctions"). We find this viewpoint exaggerated, particularly in light of the major class action litigations pending against several law firms asserting their liability by reason of alleged involvement with client wrongdoing.[226] Nonetheless, there are three circumstances that do reduce the practical exposure of law firms and lawyers to liability.

First, state and local disciplinary bodies have seldom taken an interest in the area of corporate practice.[227] See Cramton, 58 Bus. Law. at 175 n.138 ("disciplinary authorities lack the resources and the will to charge large law firms lawyers with misconduct in matters that are complex and would require large effort").[228] The SEC has seldom found referral of cases to state disciplinary bodies to be a fruitful exercise.[229]

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226 Among the most prominent such claims are those pleaded against Vinson & Elkins in connection with Enron and against Buchanan & Ingersoll in connection with Adelphia (see p. 43 and n.39, above). Both these firms have denied any liability.

227 One exception, but dating back almost 15 years, was the extensive investigation by a New York disciplinary body of Kaye Scholer in connection with its representation of Lincoln Savings Bank. (see n.33, above).

228 See also Susan P. Koniak, When the Hurlyburly's Done: The Bar's Struggle with the SEC, 103 Colum. L. Rev. 1236, 1280 (2003):

> [No case known] . . . in which a lawyer from a major law firm has been disciplined by state authorities for aiding a client's securities fraud. Despite all the settlements after the savings and loan crisis, all the press coverage, and a number of court opinions describing egregious lawyer conduct, there has not been one case of state discipline. The state disciplinary systems lack the expertise in securities law, the staff, and the monetary resources to take on a major securities firm. They can't do it and they don't. Thus, when the bar says leave securities lawyers to the states, it means leave them unregulated.

See Painter Statement, n.80 above, at 1:

> Fact is that state bar discipline is virtually meaningless for policing the practice of securities and banking law.

229 See Greene Speech, n.29 above, at ¶ 84,801:

> In most cases, these disciplinary associations have failed to take any action upon Commission referral and have not notified the Commission of the reason for their inaction.

SEC Chairman Harvey L. Pitt (Pitt Speech, p. 60 above):

(footnote continued)

Second, the Central Bank case eliminated aiding and abetting liability in private civil lawsuits under the securities laws for accountants, but also for lawyers and any other persons alleged to have rendered "substantial assistance" to the primary violators (see pp. 42-43, above).

Third, the SEC, which can assert aiding and abetting (and primary) liability against law firms (and others), historically has been reluctant to proceed against major law firms, though it has proceeded against solos and smaller firms and, with some frequency, in-house lawyers (see pp. 46-47, above).[230]

Is there a need to restore aiding and abetting liability to create a better balance between the pressures on lawyers to acquiesce in problematic client conduct and the professional values supporting the sound advice needed to deter it? In 1993 this Association, in an amicus brief

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> . . .I'm not impressed, or pleased, by the generally low level of effective responses we receive from state bar committees when we refer possible disciplinary proceedings to them.

Cf. SEC Rel. No. 33-8185 (Jan. 29, 2003), at n. 26: ". . . [E]xisting state ethical rules have not been an effective deterrent to attorney misconduct."

230 The SEC's evident reluctance to proceed against law firms reflects in part a sensitivity to the inherent tension in a regulatory agency prosecuting attorneys on whom it depends to secure the voluntary cooperation of their clients with its rules and regulations. This need for caution was indeed emphasized by SEC Commissioner Sommer in his speech urging lawyers to assume responsibilities to the investing public:

> The Commission and its staff must be extremely cautious when it is confronted with a seeming involvement of counsel in securities misconduct. It is too easy, too tempting to believe that an attorney always has knowledge or awareness sufficient to rouse inquiry into the misshapen schemes of his client. It is too facile to conclude that the presence of counsel is a necessary ingredient of every witch's brew. It is too easy to confuse vigorous, even commendable, representation of a client with countenancing misconduct. Before the Commission files a complaint, institutes a Rule 2(e) proceeding or makes a criminal reference, it must be as certain as it can be that it is not confusing counsel diligence for counsel coverup, that it does not demand a standard of conduct beyond that which can reasonably be expected of professionals. (Sommer, p. 31 above, at 83,692.)

in Central Bank, urged that aiding and abetting liability was a necessary part of a "system that creates proper incentives for securities lawyers to exercise due care – and avoid recklessness or intentional misconduct – in securities transactions. . . ." Brief as Amicus Curiae, Sept. 9, 1993, at 4. Some commentators urge that Congress should restore aiding and abetting liability in private class action litigation to strengthen the resistance by lawyers to wrongful client conduct. See Cramton, 58 Bus. Law. 170, 182-83; Koniak, 103 Col. L. Rev. at 1279; Joseph F. Morrissey, Catching the Culprits: Is Sarbanes-Oxley Enough?, 2003 Col. Bus. L. Rev. 801, 852-56 (2003); James M. McCauley, Corporate Responsibility and the Regulation of Corporate Lawyers, Va. Lawyer Register 1, 8 (Nov. 2002); Developments, 107 Harv. L. Rev. at 1621 ("Destruction of aiding and abetting liability could eviscerate the incentives that drive securities lawyers to monitor closely their client's conduct").

Those opposing restoration of aiding and abetting liability point to the danger of abusive class action claims brought to force settlements, especially since a well pleaded claim, even if ultimately wanting for proof, can often withstand a motion to dismiss at the pleading stage.[231] See John R. Kroger, Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective, 76 U. Colo. L. Rev. 57, 123 n.303 (2005) (incentivizing private enforcement actions, such as by rolling back Central Bank, "might easily lead to frivolous litigation"). They also question the need for any such legislation absent a showing of more than isolated instances of affirmative lawyer misconduct.

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[231] The prospects of such motions to dismiss may have somewhat improved, and the deterrence to frivolous claims somewhat increased, by the more rigorous pleading standards imposed by the post-Central Bank Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u. The empirical evidence for any such impacts, however, is not strong. See generally Stephen J. Choi and Robert B. Thompson, Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA, NYU Law and Eco. Research Paper No. 06-26 (available at http.//ssrn.com/abstract=912531).

Lawyers, as noted above, do face pressure to give the welcome “yes” answer (or say nothing) to a valued client or fellow corporate officer, when a firm “no” would be the proper advice. However, there is no empirical basis known to the Task Force, or reason to believe, that instances of affirmative law firm or lawyer misconduct are more than isolated incidents.[232] But see Cramton, 58 Bus. Law. at 173 (“Current practices have resulted in a widespread problem, not just a failure of individual law firms”); id. at 175 (. . . there is a systemic problem that requires systemic solutions”).

The Task Force believes it is premature even to consider a restoration of aiding and abetting liability until the impact of the SEC’s reporting up regulations, adopted in 2003, can be assessed, and the current judicial disagreement concerning the possible primary liability of lawyers is resolved.

Congress, in SOX, directed the SEC to establish and enforce “minimum standards of professional conduct” for the lawyers who practice before it representing public companies, specifically mandating the SEC’s “reporting up” lawyer conduct rules. The decision of Congress to place this authority in the SEC’s hands was sensible, given the traditional disinterest of state disciplinary bodies in corporate practice and, as the Supreme Court has observed, the “magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities. . . .” Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. ____, 126

232 Lawyer passivity in the face of questionable client conduct undoubtedly is somewhat more frequent than affirmative lawyer misconduct. But such inaction generally did not give rise to aiding and abetting liability even before Central Bank. E.g., Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971) (Rule 10b-5 does not impose liability “on anyone whose conduct consists solely of inaction”). Therefore such purely passive inaction, no matter how prevalent, could not support the restoration of such liability.

S. Ct. 1503, 1509 (2006).[233] The way in which the SEC exercises its powers under § 307 may have an important impact on lawyer conduct, hopefully to encourage conduct supportive of sound corporate governance. So far the SEC has not brought any proceedings for violations of its lawyer conduct rules, and no additional "minimum standards of professional conduct" have been promulgated.[234] It seems prudent to see how, in particular, the SEC will apply its lawyer conduct rules, and assess their impact, before further consideration is given to any possible restoration of aiding and abetting liability.

Another uncertainty is created by the question, as yet unsettled by the courts, whether lawyers can be sued as primary violators for conduct previously litigated under the aiding and abetting rubric. (see pp. 43-45, above). The extent to which these primary liability theories will ultimately be sustained remains to be seen. This uncertainty further warrants deferring consideration of restoring aiding and abetting liability.

We do not say that such liability should be restored if the SEC proves inactive in enforcing its reporting up rules and if the courts ultimately reject the primary liability theories now being pressed against lawyers. We say only that it is premature even to consider this highly contentious issue until these uncertainties are resolved.

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233 See, however, for a view critical of the SEC's general record in identifying securities laws violations and initiating enforcement actions, Kroger, 76 U. Colo. L. Rev. at 121-22, 125-29.

234 For a reasoned forecast of a conservative approach by the SEC to enforcement of its lawyer conduct rules, see Perino, n.44 above.

There is, of course, a risk that the SEC could go too far in regulating lawyers in ways that would not advance the interest in good corporate governance, but rather result in defensive advising by lawyers overly focused on their own exposure to SEC sanctions. In determining the content of any further "minimum standards of professional conduct," the Commission needs to find a middle ground that neither ignores the corporate bar nor intimidates it.

Conclusion

The subject of the lawyer's role in corporate governance is a complex matter. The "right answers" are not susceptible to empirical proof. No one can speak with confidence, at any level of generality, concerning the involvement (or non-involvement) of lawyers with the recent prominent corporate frauds. The shroud surrounding attorney-client dealings, a product of the attorney-client privilege and confidentiality, obscures such facts with respect to many alleged frauds. Nor is it possible to muster empirical proof to demonstrate that preserving confidentiality is essential to the optimal functioning of the attorney-client relationship.

Relying as we must on our own experience, the observations of practitioners, regulators and commentators we respect, and common sense, we do believe that any "reform" undermining the confidential nature of a lawyer's relationship with his or her client would represent an overreaction to the recent scandals and a cure worse than the disease.

Nonetheless, there ought to be a new determination by the corporate bar to play its proper role as confidential advisor counseling compliance with the law -- and conduct exceeding its minimum requirements -- in a clear and forthright manner. We believe our recommendations of best practices should be helpful in facilitating the effective performance of this role. Clear advice, including escalating a problem up the corporate hierarchy when necessary, should obviate almost all serious potential violations of law coming to a lawyer's attention.

No lawyer should knowingly acquiesce in client conduct clearly violating the securities laws, whether or not the lawyer's services are directly implicated in the wrongdoing. Reporting up often will be obligatory in such an instance under the SEC lawyer conduct rules and the ABA's Model Rules. Those rules also permit withdrawal and, depending on the circumstances, may also permit reporting out if reporting up fails to end the wrongdoing. A lawyer should not shrink from those actions, if confronted with the rare circumstances that warrant them.

November 2006

Membership of the Task Force[235]

Thomas H. Moreland, Chair

Arthur Ainsberg	Edward Labaton
Robert J. Anello	Lewis J. Liman
Wayne M. Carlin	Michele C. Mayes*
John J. Clarke, Jr.	Robert H. Mundheim
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Roberta S. Karp	Mark P. Zimmett*
Daniel J. Kramer*	

235 Subcommittee chairs are noted by an asterisk.

Hon. Jed S. Rakoff (U.S.D.J., S.D.N.Y.) and AUSA Eric O. Corngold abstained from voting on the Task Force's report.

The Task Force gratefully acknowledges the counsel of James A. Grayer, and the drafting and research assistance of Joshua Hill, Joshua A. Naftalis and Alexander Solomon.

Appendix A

Persons Interviewed or Consulted by the Task Force[1]

Stephanie Abramson
Chief Legal Officer and Chief Corporate Development Officer
Heidrick & Struggles Intl., Inc.
Former partner, Morgan, Lewis & Bockius

William Allen
Of Counsel, Wachtell, Lipton, Rosen & Katz
Professor of Law & Business, New York University
Chancellor, Delaware Chancery Court (1985-97)

Joseph W. Armbrust, Jr.
Partner, Sidley Austin LLP

Erica Borden Baird
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Alan L. Beller
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Director,
SEC Division of Corporate Finance (2002-06)

Richard C. Breeden*[2]
Court-appointed monitor of MCI, Inc.
SEC Chairman (1989-93)

Daniel Bursky
Partner, Fried, Frank, Harris Shriver & Jacobson LLP

John C. Coffee*
Professor of Law
Columbia Law School

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1 Present and former affiliations are for identification only. None of the interviewees or consultants spoke as representatives of their employers. All interviews were conducted on a not-for-attribution basis to encourage a candid dialogue.

2 An asterisk indicates the interviewee spoke at a meeting of the entire Task Force.

Stephen M. Cutler*
Partner, WilmerHale
    Director,
    SEC Division of Enforcement (2001-05)

James F. Flanagan
PricewaterhouseCoopers LLP

Stephen Fraidin
Partner, Kirkland & Ellis, LLP

Michael Gallagher
PricewaterhouseCoopers LLP

Samir A. Gandhi
Partner, Sidley Austin LLP

Marc S. Gerber
Partner, Skadden, Arps, Slate, Meagher & Flom LLP

Harvey J. Goldschmid*
Professor of Law
Columbia Law School
Of Counsel, Weil, Gotshal & Manges LLP
    SEC General Counsel (1989-99)
    SEC Commissioner (2002-05)

Bruce Green*
Professor of Law
Fordham Law School
Reporter, ABA Task Force on Attorney-Client
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Edward F. Greene
General Counsel
Citicorp Global Corporate and Investment Bank
    SEC General Counsel (1981-82)
    Former partner, Cleary Gottlieb Steen & Hamilton

Judah Gribetz
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Benjamin W. Heineman, Jr.
Former Senior Vice President, Law and Public Affairs
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Michele S. Hirschman*
First Deputy Attorney General
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William W. Horton
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Former General Counsel, HealthSouth Corporation

Stanley Keller
Partner, Palmer & Dodge LLP

Harvey R. Kelly
Forensic Accountant
Alix Partners

Phyllis G. Korff
Partner, Skadden, Arps, Slate, Meagher & Flom LLP

Peter Lawson
Executive Vice President, General Counsel, Secretary
Motorola

Carl D. Liggio
Of Counsel, McCollough, Campbell & Lane LLP
Former General Counsel, Ernst & Young

Louis Lowenstein
Professor Emeritus of Finance and Law
Columbia Law School

Mark F. McDade
PricewaterhouseCoopers LLP

Sheldon Raab
General Counsel, Fried, Frank, Harris, Shriver & Jacobson LLP

Walter G. Ricciardi
Deputy Director, SEC Division of Enforcement

Donald M. Roberts
Chair, Audit Committee
York International Corp. (1999-2005)

Jeffrey Rubin
Partner, Hogan & Hartson

Norman D. Slonaker
Partner, Sidley Austin LLP

Ronald Soiefer
Vice President, General Counsel and Secretary
Unilever US, Inc.

Michael Stubbs
Chair, Audit Committee
Dover Corp.

Linda Thomsen
Director, SEC Division of Enforcement

Larry D. Thompson
Senior Vice President Government Affairs,
Senior Counsel and Secretary, PepsiCo., Inc.
Deputy U.S. Attorney General (2001-03) and
Chair, President's Corporate Fraud Task Force
(2002-03)

Lynn E. Turner
Managing Director of Research
Glass Lewis & Co.
SEC Chief Accountant (1998-2001)

Michael R. Young
Partner, Willke Farr & Gallagher LLP

Donald Zoeller
Adjunct Professor
Fordham Law School
Former partner, Mudge Rose Guthrie Alexander
& Ferdon

The Task Force also benefited from the views expressed by the presenters at its CLE program conducted on February 28, 2006: The Role & Responsibility of Corporate Counsel: What are Their Gatekeeping Obligations?:

Jill E. Fisch
Professor of Law, Fordham Law School
Member of the Task Force

Susan Hackett
Senior Vice President and General Counsel
Association of Corporate Counsel

Susan P. Koniak
Professor of Law, Boston University Law School

Sheldon Raab
General Counsel, Fried, Frank, Harris, Shriver &
Jacobson LLP

Mark K. Schonfeld
Regional Director
North East Regional Office, SEC

In addition to the above, members of the Task Force participated in round table discussions with i) a group of General Counsel of major corporations, chaired by Michael Fricklas, General Counsel of Viacom, Inc., at the Association, ii) a group of managing partners of law firms at the Association, and iii) a group of corporate associates at Kramer Levin Naftalis & Frankel LLP.

The Task Force also appreciates the comments received from many other members of the bar.

Appendix B

Table of Authorities

Cases[238]

238 Does not include cases cited only in Appendix C to the report.

Statutes, Rules & Regulations

SEC Releases & Reports

Ethical Rules & Opinions

Books & Treatises

Reports

Speeches, Statements, Testimony & Hearings

Articles - Legal Periodicals and Reporters

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Articles – Newspapers, Magazines

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Mark Gimein, *What Did Joe Know?; Joe Nacchio's Qwest Booked Hundreds of Millions in Bogus Deals. He Says That's News to Him*, Fortune, May 12, 2003 .... D-22 n.24

Kris Hudson, *Qwest's Re-audit May Clear Books, Not Air*, Denver Post, Oct. 13, 2003 .... D-23 n.26

Carrie Johnson, *SEC Chairman Faults Corporate Advisers*, Wash. Post, Mar. 5, 2005 .... 178 n.221

Roger Lowenstein, *The Company They Kept*, The Contrarian Review, Feb. 1, 2004 available at www.contrarianreview.com/esleep.html. D-10 n.4

Other

Appendix C

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In re American Continental Corp./Lincoln Savings & Loan Secur. Litig., 794 F. Supp. 1424 (D.Ariz. 1992).

FDIC v. Clark, 978 F.2d 1541 (10th Cir. 1992).

FDIC v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), rev'd and remanded on other grounds, 512 U.S. 79 (1994), reaff'd on remand, 61 F.3d 17 (9th Cir. 1995).

Greycas, Inc. v. Proud, 826 F.2d 1560 (7th Cir. 1987).

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Lincoln Savings & Loan Ass'n v. Wall, 743 F. Supp. 901 (D.D.C. 1990).

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SEC v. Frank, 388 F.2d 486 (2d Cir. 1968).

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[1971-72 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360 (D.D.C. 1972);

[1977-78 Tr. Binder], Fed. Sec. L. Rep. (CCH) ¶ 96,027 (D.D.C. 1977);

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IN-HOUSE COUNSEL

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SEC v. **Jay Lapine**, United States District Court for the Northern District of California, Civil Action No. C-01-3650 (VRW); Litigation Release 17189; October 15, 2001, http://www.sec.gov/litigation/litreleases/lr17189.htm

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In the Matter of **Douglas C. Brandon, Esq.**, Admin. Proc. File No. 3-10799; June 12, 2002, http://www.sec.gov/litigation/admin/34-46068.htm

SEC v. **Bruce Hill** et al., (United States District Court for the District of Massachusetts, Civil Action No. 02-CV-11244 (EFH); Litigation Release 17578; June 21, 2002, http://www.sec.gov/litigation/litreleases/lr17578.htm

In the Matter of **Johann M. Smith**, Admin. Proc. File No. 3-10851; July 29, 2002, http://www.sec.gov/litigation/admin/34-46279.htm

In the Matter of **James Fitzhenry**, Admin. Proc. File No. 3-10943; November 21, 2002, http://www.sec.gov/litigation/admin/34-46870.htm

In the Matter of **David C. Watt**, Admin. Proc. File. No. 3-10951; November 25, 2002, http://www.sec.gov/litigation/admin/34-46899.htm

In the matter of **Andrew S. Marks**, Litigation Release 17871; December 3, 2002, http://www.sec.gov/litigation/litreleases/lr17871.htm

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SEC. v. Rocky Mountain Energy Corporation, Inc., John N. Ehrman, **W. Roderick Johnson**, and John W. Ehrman, Jr. (Defendant Solely for Purposes of Equitable Relief), Case No. H-03-CV-1133 (U.S.D.C., S.D. Tex.); Litigation Release 18069; April 3, 2003, http://www.sec.gov/litigation/litreleases/lr18069.htm

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Appendix D

"Where Were the Lawyers?" -- A Tentative
Answer with Respect to Nine Scandals

I. Enron

A. The Alleged Fraud

It would be redundant here to summarize the extensive literature concerning the Enron scandal. The essential facts, which led to numerous criminal convictions and guilty pleas, are set forth in two commissioned reports prepared, respectively, for the Bankruptcy Court and Enron's Board. Final Report of Neal Batson, Court-Appointed Examiner, Nov. 4, 2003 ("Batson Report"); Special Investigation Committee of the Board of Directors of Enron Corp., Report of Investigation, Feb. 1, 2002 ("Powers Report"). Appendix C to the Batson Report ("Role of Enron's Attorneys") exhaustively reviews the conduct of Enron's inside and outside lawyers.

B. Where Were the Lawyers?

The Batson and Powers Reports make clear that Vinson & Elkins, Enron's principal outside counsel, Andrews & Kurth, another outside firm, and numerous inside Enron counsel were involved in drafting, reviewing or opining on many of the transactions and disclosures that contributed to Enron's ultimate collapse. E.g., Batson Report 48-55 and Appendix C; Powers Report at 25-26, 178.[1] It is also apparent that, in some instances, these lawyers did raise questions about those transactions and the quality of Enron's public

[1] With respect to allegations against Vinson & Elkins in the Enron securities class action, see the decision denying its motion to dismiss. Enron, 235 F. Supp. 2d at 656-69, 704-05. The allegations against Kirkland & Ellis, which represented CFO Andrew Fastow and the entities he controlled, are reviewed at 235 F. Supp. 2d at 669-73. Its motion to dismiss was granted, principally because it had not drafted any disclosures that reached the public. Id. at 705-06.

disclosures. One inside Enron lawyer, Jordan Mintz, went so far as to obtain advice on the company's disclosures from special outside counsel, the Fried Frank firm. Powers Report at 190 n. 84. However, such concerns did not reach the Enron Board, or at least not with the urgent emphasis they appear to have deserved. Batson Report 114-17; Powers Report 190, 198-99; Ellen Joan Pollock, Enron's Lawyers Faulted Deals But Failed to Blow the Whistle, W.S.J., May 22, 2002 (Vinson & Elkins says it reported to Enron's in-house lawyers, as Enron had instructed). But see Fisch & Rosen, 48 Vill. L. Rev. at 1114-22 (contending Enron Board had ample information concerning risks created by management conduct, but failed to act); Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, 35 Conn. L. Rev. 1125 (2003) (similar).

The Batson Report, though not reaching any final conclusions of culpability, does opine that "there is sufficient evidence from which a fact-finder could determine" that the two outside firms and several inside lawyers committed malpractice based on Texas Rule 1.12, the Texas version of the ABA "reporting up" Model Rule 1.13(b), or aided and abetted breaches of fiduciary duty by Enron officers, or committed malpractice by negligence in connection with several transactions. Batson Report 48-55.[2]

Note, however, the more generous view of the Enron lawyers' conduct, in at least some respects, tentatively offered by Milton C. Regan, Jr., in Teaching Enron, 74 Fordham L. Rev. 1139 (2005). He suggests that the lawyers may not have appreciated the wrongful nature of

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[2] The Batson Report considered only possible claims that could be brought on Enron's behalf by its trustee in bankruptcy. The possibility liability of Vinson & Elkins to investors under the federal securities laws is the subject of the pending Enron class action cited above.

some of the corporate conduct because of such factors as its complexity and the fragmented nature of the legal work performed.

II. WorldCom

A. The Alleged Fraud

The WorldCom fraud arose during the dot-com meltdown of the late 1990's. WorldCom's former CEO, Bernard J. Ebbers, believed that the only way the company could survive was through growth. In the second half of the 1990s, WorldCom acquired more than 60 companies, becoming the second largest long-distance operator. Most of Ebbers' personal wealth was concentrated in his holdings of WorldCom stock. As WorldCom's stock price fell and Ebbers began to receive margin calls, he secured more than $250 million in loans and guarantees from the company.

Knowing that WorldCom's financial results were materially below the financial guidance that had been given to Wall Street -- and that, in fact, the company was not even profitable -- certain of WorldCom's senior officers embarked on a scheme to manipulate the company's reported financials. Between 1998-2000, WorldCom improperly reduced certain reserve accounts held to cover the liabilities of various acquired companies, adding billions to the revenue line.

When those reserves did not produce sufficient revenue, in early 2001 CFO Scott Sullivan, as he has admitted, directed key staff members to capitalize as long-term investments certain operating costs -- line costs (i.e., the cost of leasing lines from other carriers) -- that should have been expensed. In May 2001, within eight weeks of the commencement of this line cost fraud, WorldCom successfully issued an $11 billion debt offering, the largest in U.S.

history. The due diligence conducted by lawyers for the underwriters of that offer did not uncover the recently commenced and ongoing line-cost fraud.

This line-cost fraud continued until it was uncovered by WorldCom's Internal Audit Department in May 2002. On June 25, 2002, WorldCom announced a massive $3.8 billion restatement of its financial statements for 2001 and for the first quarter of 2002. Within a month, WorldCom filed for bankruptcy. After several revisions, the final restatement amount was greater than $11 billion -- the largest restatement in history. In March 2004, CFO Sullivan pleaded guilty to fraud and conspiracy charges. A year later, Ebbers was convicted on nine counts of fraud, conspiracy, and filing false statements. A handful of other former employees have also pleaded guilty to fraud charges. On the civil side, the SEC settled with the Company in 2003, with WorldCom agreeing to a $500 million fine and a $250 million contribution of stock. In 2005, WorldCom's accountants, underwriters, and directors entered into settlements with investors totaling more than $6.7 billion.[3]

B. Where Were the Lawyers?

The Worldcom fraud has also been well reported. See Special Investigative Committee of the Board of Directors of Worldcom, Inc., Report of the Investigation (March 31, 2003) (the "Special Committee Report"); Dick Thornburgh, Bankruptcy Examiner, First Interim Report (November 4, 2002) ("Examiner's First Report"), Second Interim Report (June 9, 2003)

[3] These record-breaking settlement amounts included, uniquely, payment of some personal funds by the directors. These settlements followed a decision by Judge Denise Cote denying the underwriters' motion for summary judgment on their due diligence defense, finding that there were fact issues concerning whether the underwriters had failed to investigate certain alleged "red flags," whether or not these red flags, if pursued, would have revealed the fraud. In re WorldCom, Inc., Sec. Litig., 346 F. Supp. 2d 628, 682-84 (S.D.N.Y. 2004).

("Second Examiner's Report"), and Third and Final Report (January 26, 2004) ("Final Examiner's Report"); Richard C. Breeden, Corporate Monitor, Restoring Trust, Report to the Hon. Jed S. Rakoff On Corporate Governance For the Future of MCI, Inc. (August 2003) (the "Breeden Report"), filed in In re Worldcom, Inc., Case No. 02-13533 (S.D.N.Y.).

None of these reports found any lawyers to have been complicit in or knowledgeable about the line-cost fraud that led to Worldcom's ultimate downfall. However, all do document structural problems and deficiencies within Worldcom's in-house legal department that helped foster a corporate culture where this type of fraud could occur, a culture viewed by the Examiner as reflecting "a virtual complete breakdown of proper corporate governance principles. . . ." (Second Examiner's Report at 3). The Special Committee Report concludes that the legal department was not "structured to maximize its effectiveness as a control structure upon which the Board could depend." (Special Committee Report at 31). According to the Report, "[a]t Ebbers' direction, the Company's lawyers were in fragmented groups, several of which had General Counsels who did not report to Worldcom's General Counsel for portions of the relevant period; they were not located geographically near senior management or involved in its inner workings; and they had inadequate support from senior management." (Id.) Moreover, Ebbers did not include the Company's lawyers in his "inner circle" and "appears to have dealt with them only when he felt it was necessary." (Id. at 277). Finally, according to the Special Committee Report, Ebbers "let [the attorneys] know his displeasure with them personally when they gave advice – however justified – that he did not like" and generally "created a culture in which the legal function was less influential and less welcome than in a healthy corporate environment." (Id.)

While counsel did not know of the line-cost fraud, according to the Bankruptcy Examiner they did have some awareness of some other instances of what the Examiner terms "deceit" or "deficiencies":

> Worldcom loaned Ebbers more than $400 million over a period of approximately 18 months, from September 2000 until 2002. Ebbers guaranteed or pledged Worldcom stock as security for in excess of $1 billion in personal and business loans during this period. (<u>Examiner's First Report</u> at 72). The Worldcom in-house lawyer who served as counsel to the Compensation Committee knew that at least some of the company's loans to Ebbers were not being made to cover margin calls (thus, arguably, for a business purpose), but rather to, among other things, cover millions of dollars in construction costs on Ebbers' home, pay $2 million to an Ebbers family member for personal expenses, and to fund more than $22 million for his own personal business interests. (<u>Id</u>. at 80-81). The lawyer allegedly advised the Committee that approval by the full Board of the loans and guarantees was not necessary. (<u>Id</u>. at 75).
>
> In late September 2000, shortly after Ebbers had quickly exhausted a $50 million loan received from the company, the Compensation Committee denied Ebbers an additional loan he sought. In response, Ebbers entered into a forward sale of three million shares of Worldcom stock, producing approximately $70 million in proceeds. Upon news of the sale, Worldcom's stock price dropped $2.25 per share. (<u>Examiner's Second Report</u>, at 121-22). Regarding this forward sale, according to Examiner, (i) in-house counsel knew that the forward sale fell within the "black-out" period 30 days prior to the next quarterly earnings release during which company officers were not permitted to sell stock; (ii) in-house counsel spoke to two different outside law firms both of which expressed concern and, in one case, a "high" degree of concern, as to whether the sale violated the insider trading laws; and (iii) the evidence indicates that Ebbers had access to non-public information at the time of the sale placing him on notice of a likely earnings and revenue shortfall (the company's October 26, 2000 announcement reported a 30% earnings shortfall). (<u>Id.</u> at 142-44). According to the Examiner, counsel should at least have questioned Ebbers about his possible possession of non-public information. (<u>Id</u>. at 145).
>
> In September 2000, the company entered into a $6 billion deal to acquire Intermedia Communications, Inc. The deal was, by all accounts, a disaster and ultimately cost the company several billion dollars. The Intermedia transaction was approved by the Board in a telephonic meeting after approximately 60-90 minutes of due diligence and a 35-minute presentation attended by both in-house and outside counsel. There were no written materials prepared or reviewed by the Board and some directors only

> received two hours notice of the emergency meeting. (Id. at 8, 30). The Examiner found that counsel should have advised the Board concerning the risks of going forward with the transaction with so little due diligence, but that counsel "did not think it was their job." (Id. at 80).

The Examiner concluded that while "the Worldcom culture was not generally supportive of a strong legal function," this "should not have prevented counsel from fulfilling their obligations to their corporate client." (Id. at 12). To the extent that counsel failed to ask questions and contradict Ebbers and other senior officers concerning questionable conduct, counsel may have helped perpetuate a climate at Worldcom where prudent governance was slighted so long as Ebbers was satisfied and the company appeared profitable.

C. The Proposed Remedy

The Breeden Report sets forth a number of recommended requirements specific to the role of counsel, including the following:

> The Audit Committee should meet not less than twice a year with the General Counsel to review issues arising out of compliance activities and the Company's Ethics Office, as well as to assess contingent legal and regulatory risks to the Company (Breeden Report at 101-02);
>
> The Audit Committee should review a report from the General Counsel's Office at least twice each year as to compliance with the Company's prohibitions against any related party transactions between directors or employees and their families and the Company and any of its affiliates (id. at 105); and
>
> The full Board should meet periodically, and not less than annually, with the General Counsel, without the presence of any other employee or officer, to review the resources and leadership of the legal department, the adequacy of compliance and ethics programs, and contingent legal risks to the Company (id. at 144).

III. Adelphia

A. The Alleged Fraud

On June 25, 2002, Adelphia Communications Corporation ("Adelphia"), then the sixth largest cable television provider in the United States, filed a petition for reorganization under chapter 11 of the United States Bankruptcy Code. The filing followed several months after Adelphia first disclosed approximately $2.3 billion in indebtedness as a joint and several co-obligor together with certain members of the Rigas family, its controlling stockholders.

In July 2004, Adelphia's founder and chief executive officer, John Rigas, and its chief financial officer, Timothy Rigas, were convicted of eighteen counts of securities and wire fraud following a jury trial. Michael Rigas, the head of cable operations, was not convicted during that trial but later pleaded guilty to a violation of federal telecommunications law. In April 2005, the U.S. Department of Justice, the SEC, Adelphia and members of the Rigas family entered in to a complex multilateral settlement under which Adelphia paid $715 million into a victim compensation fund, the Rigas family consented to the forfeiture of cable companies and real estate controlled by them that were valued at approximately $967 million and Adelphia agreed to terms of a non-prosecution and cooperation agreement with the Department of Justice. SEC Press Rel. No. 2005-63 (Apr. 25, 2005); see SEC v. Adelphia Comm. Corp., 02 Civ. 5776 (KW), S.D.N.Y. Compl., July 24, 2002.

A welter of civil litigation concerning the circumstances giving rise to these convictions and government settlements is still in its early stages. The alleged wrongdoing at issue is complex and multifaceted. It includes:

1. The entry by Adelphia into co-borrowing agreements among Adelphia, certain third-party banks and members of the Rigas family (or entities controlled by them), under which Adelphia become obligated for over $2 billion in indebtedness incurred by the Rigas family;

2. The use of a "cash management system" under which funds of Adelphia, members of the Rigas family and entities controlled by the Rigas family were commingled and used for various purposes;

3. The Rigas family's use of amounts borrowed under the co-borrowing agreements to purchase $1.8 billion in Adelphia stock;

4. The use by Rigas family members of Adelphia funds to pay for significant non-corporate expenses, including real estate used by the family in New York and Pennsylvania, an undisclosed $1 million per month stipend for chairman and CEO John Rigas and a multi-million dollar golf course project spearheaded by CFO Tim Rigas;

5. Numerous failures to accurately report financial results and otherwise comply with the federal securities laws.

B. Where Were the Lawyers?

Adelphia's primary outside law firm during the period in question (roughly 1998 through early 2002) was the Pittsburgh law firm of Buchanan Ingersoll Professional Corporation. Buchanan Ingersoll has been named as a defendant in the pending consolidated securities class action and related civil lawsuits asserting claims alleged violations of the federal securities laws and various claims arising under common law. In re Adelphia Comm. Corp. Sec. Deriv. Litig., 03 MD 01529 (LMM) (S.D.N.Y.). The SEC has not asserted any claims against the firm.

In the civil lawsuits, it is alleged that Buchanan Ingersoll negotiated the co-borrowing agreements on Adelphia's behalf with third-party banks and prepared other documentation necessary to put those arrangements into place. It is also alleged to have assisted Adelphia in preparing its 1934 Act filings during the relevant period and to have provided "customary" legal opinions to Adelphia in connection with the company's securities offerings. In addition, civil plaintiffs have alleged that, as Adelphia's primary outside counsel, Buchanan Ingersoll must have been aware of the "cash management system" and the allegedly rampant self-dealing by Rigas family members given the "sheer scope" of that activity.

Buchanan Ingersoll asserts that it at all times provided appropriate and professional legal advice based on the information that was made available to it at the time. It has vigorously disputed the civil claims asserted against it in motions to dismiss the various complaints.

While the facts are murky as to many of the alleged misstatements or omissions in Adelphia's filings, Buchanan Ingersoll does appear to have been well-placed to review Adelphia's disclosure of the co-borrowing arrangements given its participation in the preparation of the governing agreements and its role as Adelphia's principal outside counsel for its securities filings.[4]

The utility of any reporting up to Adelphia's Board, had it occurred, is doubtful since, during most of the period in question, the Board of Directors of Adelphia and its Audit Committee were dominated by the Rigases.

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4 According to one article, Buchanan Ingersoll and Deloitte & Touche, the company's outside auditors at the time, have each taken the position that they agreed to the company's omission of certain facts concerning the co-borrowing arrangements from Adelphia's financial statements based on representations from Adelphia's management that the other firm had approved of the treatment. Roger Lowenstein, The Company They Kept, The Contrarian Review, Feb. 1, 2004, available at www.contrarianreview.com/esleep.html.

Attorneys for Tim Rigas asserted during his criminal trial in 2004 that the co-borrowing agreements and other transactions underlying his indictment had been duly authorized by the Adelphia Board and by Buchanan Ingersoll and Deloitte & Touche. Defense attorneys did not call witnesses from those professional firms to support these arguments, however, focusing instead on challenges to the credibility of prosecution witnesses who had pleaded guilty prior to the trial.

IV. Global Crossing Ltd.

A. The Alleged Fraud

Global Crossing Ltd. ("GC") was founded in 1997 to create and sell the use of a worldwide fiber optics network for internet and telecommunication transmissions. It first went public in 1998 and had several additional public offerings thereafter.[5]

In January 2002, it filed for bankruptcy protection. GC then disclosed that Roy Olofson, a former Vice-President of Finance, had in August 2001 written a letter (the "Olofson Letter") to GC's General Counsel, in his capacity as GC's Chief Ethics Officer, alleging deceptive accounting practices that Olofson claimed had created inflated revenue and cash-flow figures. Olofson was fired shortly after he sent his letter, and threatened to and later did bring a lawsuit alleging he had been wrongfully discharged.[6]

The accounting irregularities claimed by whistleblower Olofson, and later by plaintiffs in class action litigation, concerned GC's treatment of reciprocal and concurrent purchases and sales with other telecommunications companies of "indefeasible rights of use" ("IRUs"). An IRU is the right to use a specified bandwidth over a designated communications cable owned by a telecommunications company for a fixed term. As GC disclosed at the time, IRU transactions came to represent a large portion of GC's revenues in 2001. GC, it was alleged, in order to meet financial performance expectations and boost the value of its securities,

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5 In re Global Crossing, Ltd. Sec. Lit., 313 F. Supp. 2d 189, 193 (S.D.N.Y. 2003).

6 In re Global Crossing, Ltd. Sec. Lit., No. 02 Civ. 910 (GEL), 2004 WL 725969, *1 (S.D.N.Y Apr. 2, 2004) (dismissing Olofson's claims, except for a defamation claim).

reported revenue and income from the IRU transactions, principally in pro forma financials, in a misleading manner.[7]

There remains a substantial dispute concerning the validity of Olofson's charges, and the other allegations against GC the in class action litigation. GC's executives maintained, including in sworn testimony before Congress, that the IRU transactions had valid business purposes, but admitted that their timing reflected attempts to meet quarterly revenue and income targets. U.S. House of Representatives, Committee on Energy and Commerce, Capacity Swaps by Global Crossing and Qwest: Sham Transactions Designed to Boost Revenues?, Hearing before Subcommittee on Oversight and Investigations, 107th Cong., 2nd Sess., Sept. 24 & Oct. 1, 2002 ("GC/Qwest Hearing"), at 132-254. An internal investigation report prepared by Coudert Brothers for the GC Board's Special Committee on Accounting Matters largely supported GC's position. Special Committee on Accounting Matters, Report to the Board of Directors of Global Crossing Ltd., Feb. 18, 2003 ("GC Special Committee Report"), filed in In re Global Crossing Ltd., Bankr. S.D.N.Y., Dkt. 02-40188, dkt. entries 2857-58. This Report concluded, inter alia, that the IRU transactions had a legitimate business purpose and were not designed to inflate artificially the market price of GC's stock, though it also faulted aspects of GC's corporate governance. Id. at Tab 1, Letter of Special Committee to Board of Directors, Feb. 18, 2003

7 In re Global Crossing, Ltd. Sec. Lit., 322 F. Supp 2d 319, 325-327 (S.D.N.Y. 2004).

("Spec. Comm. Letter"), at 3-4, 8, 11.[8]

GC disclosed the existence and materiality of these concurrent IRU transactions in its quarterly reports filed with the SEC, though reportedly it had been advised this specific disclosure was unnecessary by its outside counsel and independent auditors. Id. at Tab 2, Letter of Stephen A. Best (Coudert Bros.) to GC Board of Directors, Feb. 18, 2003 ("Best Letter"), at 10-11, 14. The SEC, however, faulted the adequacy of the disclosures, such as their failure clearly to describe the IRU transactions as reciprocal. These charges were settled on consent: a cease and order issued against GC and three executives, and the latter each paid a $100,000 civil penalty. In re Global Crossing Ltd., SEC Rel. No. 34-51517 (Apr. 11, 2005).

B. Where Were the Lawyers?

Based on the above public record, GC may not belong in the same category of egregious frauds as Enron, WorldCom and some other scandals. There have been no admissions of guilt, criminal convictions or adverse judicial determination in the merits,[9] and the SEC's sanctions were comparatively mild. The SEC took no action against any GC lawyers.

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8 The GC Special Committee Report did not purport to "rebut or confirm" several of the allegations concerning the IRU transactions, which it termed "special circumstances." Id. at Tab 3, The Concurrent Exchange of Fiber Optic Capacity and Services Between Global Crossing and the Carrier Customers at 9, 121-24.

9 There was no determination of the merits of the allegations made against GC and numerous other defendants, including its General Counsel, in the consolidated class action litigation. See In re Global Crossing Ltd. Sec. Litig., S.D.N.Y., 02 Civ. 910 (GEL), Second Amended Compl., March 22, 2004. That action and a related ERISA action by GC pension participants were settled in 2004, as against the GC-related defendants, by the payment of $325 million to the class and pension plaintiffs. See Gretchen Morgenson, Global Crossing Settles Suit on Losses, N.Y. Times, Mar. 20, 2004.

The relevant point for this report is that, regardless of whether the corporate conduct was proper or not, GC's inside and outside counsel were in a position to and did render advice concerning that conduct. GC's General Counsel, also a Senior Vice President, and another in-house lawyer actively reviewed and/or negotiated several of the IRU transactions. On at least one occasion, the General Counsel advised against consummating a transaction – his advice was rejected – because of the financial instability of the counter-party (GC/Qwest Hearings at 25, 533-34). GC's outside counsel, Simpson Thacher & Bartlett ("STB"), was actively involved in a few of the IRU transactions, and, like the General Counsel, advised on disclosure issues (GC Special Committee Report, Best Letter at 14).

Common law aiding and abetting and conspiracy to commit fraud claims were asserted against GC's General Counsel and the in-house lawyer by certain banks creditors, which claimed that GC had artificially inflated earnings to lower GC's debt to earnings ratio. JPMorgan Chase Bank v. Winnick, 406 F. Supp. 2d 247 (S.D.N.Y. 2005). The claims were asserted against the in-house lawyer who had negotiated and documented the IRU transactions, and against the General Counsel for his failure to put a stop to them, including after receipt of the Olofson Letter.[10] These claims were sustained at the pleading stage. However, in an unusual aside, the Court termed the claims "weak," and urged plaintiffs to consider whether they were "worth the candle."[11] These claims were thereafter settled.

10 This claim against the General Counsel failed to note that he had received the Olofson Letter only ten days before he left GC for unrelated reasons, and that before he left he had directed STB to investigate the Letter's allegations. See GC Special Committee Report, Spec Comm. Letter at 1, 5.

11 Id., 406 F. Supp. 2d at 259 (denying motion to dismiss claims pleaded under New York law).

The GC Special Committee Report criticized GC's regular outside counsel, STB, for its alleged failure to conduct an adequate investigation into the allegations of the Olofson Letter, and GC's Acting General Counsel, who also continued as an active STB partner, for his alleged lax supervision of the STB investigation. Id. at Tab 4, Global Crossing's Response to Olofson's Allegations, Feb. 18, 2003, at 36-37, 42-44. In essence, the Report concluded that the charges made in the Olofson Letter were largely ill-founded, but that GC had suffered unnecessary reputational damage, being lumped in the public mind with Enron, because the STB investigation was inadequate. (Id. at 45-47). STB vigorously disputed these charges. See Otis Bilodeau, Corporate Lawyer Feud Goes Public, Legal Times, Mar. 18, 2003.[12]

V. HealthSouth

A. The Alleged Fraud

HealthSouth Corp. ("HealthSouth") is one of the country's principal providers of outpatient surgery, diagnostic and rehabilitative healthcare services. The SEC, in September 2002, initiated an inquiry into certain stock trades by then Chairman and CEO, Richard Scrushy, before the Company's August 27, 2002, announcement that it was suspending its earnings forecast for the remainder of the year and was expecting a $175 million shortfall in earnings due to the impact of a change in Medicare billing procedures for group therapy ("Transmittal 1753"). Shortly thereafter several derivative lawsuits were filed against certain Board members, including Scrushy, and related companies of HealthSouth alleging that the Board members had breached their fiduciary obligations to the shareholders.

[12] STB, though not a named defendant, paid $19.5 million as part of the settlement of the GC class action. See Morgenson, n.9, above.

In 2003, the SEC filed a complaint against HealthSouth and Scrushy with allegations of massive accounting fraud and insider trading. SEC v. Healthsouth Corp., U.S.D.C., N.D. Ala., CV-03-J-0615-5, March 19, 2003. The SEC complaint alleged that, "[s]ince 1999, HealthSouth . . . has overstated its earnings by at least $1.4 billion." (Id. at ¶ 1). The DOJ filed a subsequent consolidated criminal action against HealthSouth and individual complaints against several of HealthSouth's current and former corporate officers, including Scrushy, alleging that they perpetrated a $2.7 billion accounting fraud at HealthSouth beginning in 1996 and lasting until 2002.

As the case developed, it became clear that senior management at HealthSouth engaged in an number of improper accounting practices to inflate earnings and revenues to ensure that HealthSouth always met its financial targets. Further, it was alleged that, in an attempt to conceal the fraud, senior management in 2002 began to use a change in Medicare billing procedures to "decrease" the inflated revenues and earnings, vastly overstating what they knew to be the impact of Transmittal 1753 on the company. In testimony it also came out that, over the years, HealthSouth had submitted hundreds of thousands of claims to Medicare based upon improper billing procedures.

The SEC and HealthSouth eventually agreed in June 2005 to a settlement which included a $100 million civil penalty, a $100 million disgorgement, a massive overhaul of corporate governance systems and accounting procedures, and a permanent injunction against HealthSouth from future fraud violations. The outcome of the SEC action against Scrushy is still pending. Sec Litig. Rel. No. 19280 (June 23, 2005).

Fifteen former employees pled guilty to fraud charges including five former CFOs. In June 2005 a jury in Birmingham, Alabama, acquitted Scrushy of all 36 charges.

In February 2006, as finalized in October 2006, class action plaintiffs and HealthSouth agreed to a $445 million settlement of civil claims pursuant to which, inter alia, HealthSouth will pay investors $215 million in cash, stock and warrants, while insurance companies will pay the remaining $230 million in cash. HealthSouth Press Release, Sept. 27, 2006. See In re HealthSouth Corp. Sec. Litig., U.S.D.C., N.D. Ala., CV-03-BE-1500-S, Second Amended Complaint filed Aug. 2, 2004.

B. Where Were the Lawyers?

Like WorldCom, HealthSouth appears to be an example of a company dominated by a powerful CEO and Chairman, who used intimidation and fear to control his officers and even his Board. Corporate governance procedures were extremely weak, resulting in few – if any – real checks and balances.

Testimony before Congress suggests that William W. Horton, an Executive Vice President and General Counsel for HealthSouth from July 1994 through September 2003, as well as the Chief Compliance Officer and the Chief Internal Auditor, were in relatively weak positions within HealthSouth. Horton stated that he would appear at Board meetings only if Scrushy wished him to discuss a particular issue. There were no established procedures to refer allegations of criminal conduct to the legal department.[13] Accordingly, when an employee in 1999 raised concerns with Compliance regarding very specific accounting practices that she believed were fraudulent, apparently Horton was never contacted and the case was closed with

[13] U.S. House of Representatives, Committee on Energy and Commerce, The Financial Collapse of HealthSouth, Hearing before the Subcommittee on Oversight and Investigations, 108th Cong., 1st Sess., Oct. 16, 2003 (the "HealthSouth Hearings") at 80, 82, 90, 92.

no legal involvement.[14] Horton's testimony indicated that he had been uneasy about bringing "bad news" to Scrushy without additional support. For example, when he strongly believed that there were serious problems with how HealthSouth was billing Medicare for group therapy under Transmittal 1753, he did not inform Scrushy directly. He instead went to the CFO and other senior operations people to get them "on board" first, feeling that otherwise Scrushy would just disregard his advice.[15]

In retrospect, Horton was presented with a number of situations where he might have asked more questions. For example, Horton received in November 1998 an anonymous email making specific allegations of fraud from a self-described "fleeced shareholder," who also sent the email to the SEC's Division of Enforcement, HealthSouth's outside auditors (Ernst & Young) and even a lawyer from a plaintiff's class action firm.[16] Horton contacted the CFO and asked him to look into the allegations. Horton testified that he found the rebuttals provided by the CFO to be "credible and responsive to the concerns" raised in the email, and consequently did not bring the email to the Board's or Audit Committee's attention.[17] While in retrospect Horton's choice of the CFO as an information source was unfortunate -- the CFO later pled guilty to fraud -- the auditors and the SEC also took no steps to pursue the shareholder's allegations. No enforcement proceedings have been brought against Horton or any other in-house or outside lawyers for HealthSouth.

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14 Id. at 22-24, 30-31, 82.

15 Id. at 107-08.

16 Id. at Tab 67.

17 Id. at 56-57.

VI. Livent

A. The Alleged Fraud

Livent, Inc., a Toronto, Ontario company that produced live musical theater entertainment, began trading on the Toronto Stock Exchange in 1993 and on NASDAQ in 1995. In late 1998 it was discovered that the company had been engaging in pervasive accounting fraud and falsely portraying its financial condition to the public. On November 18 and 19, 1999, respectively, Livent declared bankruptcy in the United States and Canada.

At the time of the accounting scandal, Livent was a relatively small company with a workforce of only 250 full-time employees and 1,250 part-time employees. Jerald M. Banks served as general counsel and secretary to Livent. It is not apparent whether Livent had outside counsel.

On January 13, 1999, nine former officers of Livent were named in an SEC suit for accounting fraud from 1990 to 1998,[18] and these charges were also the basis of criminal indictments in the Southern District of New York.[19] The alleged fraud included:

> A multi-million dollar kick-back scheme designed to misappropriate funds for the use of Livent's two co-founders;
>
> Accounting manipulations to understate expenses in order to fraudulently inflate earnings, portray unsuccessful theatrical productions as profitable, and to meet quarterly and annual projections provided to Wall Street analysts, including:
>
> 1) The improper shifting of preproduction costs, such as advertising costs, to fixed assets, such as the construction of theaters;

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18 SEC v. Drabinsky, U.S.D.C., S.D.N.Y., 99 Civ. 0239 (TPG). See SEC Litig. Rel. No. 16022 (Jan. 13, 1999).

19 Grand Jury Indictment in United States v. Drabinsky and Gottleib, No. 99 CR. 17 (S.D.N.Y. Jan. 14, 1999).

2) The removal of certain expenses and the related liabilities from the general ledger, literally erasing them from the company's books; and

3) Transferring costs from one show currently running to another show that not yet opened or that had a longer amortization period.

Entering into "revenue generating transactions" whereby Livent would sell production rights to various shows, record the payment as revenue and then sign secret side agreements guaranteeing to refund the purchaser's money.

B. Where were the lawyers?

Banks, the General Counsel, was not charged in either of the above proceedings. However, the SEC brought a separate and injunction action[20] and an administration proceeding[21] against Banks for accounting fraud, which were settled in August 1999. According to the Commission's injunction complaint, Banks had drafted and finalized three secret side agreements and/or negotiated with the legal representatives of the purchasers in revenue generating transactions. The transactions involved the sale of rights to present Livent's theatrical productions in return for fees paid by third parties. On their face, the underlying sales agreements made little economic sense for the purchasers: the fees were nonrefundable and the parties only obtained limited profit participation from productions which Livent had no obligation to make available for presentation.

The secret side agreements, however, required Livent to pay back the amounts advanced by the purchasers. Banks, along with other Livent officers, allegedly concealed the side agreements from the company's independent auditors in order to improperly record revenue

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20 SEC v. Banks, 99 Civ. 8855 (TPG) (S.D.N.Y., filed Aug. 12, 1999). See SEC Litig. Rel. No. 16251 (Aug. 12, 1999).

21 In re Banks, SEC Rel. No. 34-41806 (Aug. 30, 1999).

from the transactions and inflate the company's revenues. As a result of the scheme, Livent made false public filings that contained disclosures and financial statements that were materially false and misleading, in part, because they recognized at least $34 million (Cdn) relating to fraudulent transactions.

Without admitting or denying the Commission's findings, Banks consented to an order barring him from appearing or practicing before the Commission as an attorney for five years and requiring him to pay a $25,000 fine.

A class action litigation was brought by Livent shareholders against Deloitte & Touche ("D&T"), Livent's accounting firm, for facilitating the securities fraud. According to the claim, as part of Livent's 1996 and 1997 audits, Banks was asked to sign a standard representation letter attesting that the revenue generating transactions represented the entire agreement between the parties. In both years, Banks refused to sign the letter. D&T allegedly dropped its request that Banks sign the letter without inquiring as to why he refused.[22]

If in fact Banks drafted and/or negotiated the side letters that were used to facilitate the fraudulent revenue generating transactions, and then refused to sign the representation letters for the auditors, that would suggest that Banks was aware that those transactions were not legitimate, but allowed them to proceed anyway. At the very least, Banks' refusal to sign the representation letters would suggest that he had significant suspicions about the transactions which, had he acted upon them, might have exposed the fraud at an earlier time.

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[22] In re Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 403 (S.D.N.Y. 2001). The case was later settled as against Deloitte, and summary judgment granted against the two dominant executives. Id., 355 F. Supp. 2d 722 (S.D.N.Y. 2005).

VII. Qwest

A. The Alleged Fraud

Between 1999 and 2002, Qwest repeatedly entered into reciprocal or concurrent IRU transactions with other telecommunications companies, including Global Crossing (see D-11, above). The revenues from these IRU transactions -- sometimes pejoratively termed "capacity swaps" -- were material to Qwest's financial statements. For example, Qwest recorded a first-quarter 2001 reciprocal IRU transaction with Global Crossing as a $105 million transaction. Qwest's accounting treatment of these concurrent transactions was more aggressive than Global Crossing's, with all revenues over the term of the IRU recognized upfront, an approach its auditors reportedly told Qwest was "acceptable but aggressive."[23]

This accounting treatment, together with other alleged deficiencies, resulted in serious SEC charges, including that Qwest had fraudulently recognized over $3.8 billion in revenue.[24] Among other conduct, the SEC pointed to numerous instances in which Qwest personnel had entered into written or oral side agreements with IRU counter-parties, which agreements violated GAAP requirements for upfront revenue recognition.[25] During the same

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23 GC/Qwest Hearing at 599 (testimony of Qwest's Audit Committee Chair). Qwest executives maintained their lack of knowledge of any of accounting wrongdoing in sworn Congressional testimony. GC/Qwest Hearing at 587-642.

24 See Compl., SEC v. Qwest Comm. Intl, Inc., Civ. Action No. 04-Z-2179 (OES) (D. Co. Oct. 21, 2004) ("SEC Compl."). For related press coverage of the Qwest saga see, e.g., Jeff Smith & David Milstead, An Unbalanced Sheet; SEC Lays Out How Nacchio May Have Cooked Qwest Books, Rocky Mountain News, Mar. 19, 2005, at 1C; Miles Moffeit & Kris Hudson, Wired for Trouble; At Post-Merger Qwest Aggressive New Culture Led to Questionable Deals, Denver Post, Dec. 15, 2002, at A-01; Mark Gimein, What Did Joe Know?; Joe Nacchio's Qwest Booked Hundreds of Millions in Bogus Deals. He Says That's News to Him., Fortune, May 12, 2003, at 120.

25 SEC Compl. ¶¶ 97-102.

period, members of Qwest senior management are alleged to have accepted discounted stock of Qwest vendors in return for directing business to the vendors. For example, in 2000 Tellium, Inc., issued shares of stock to seven Qwest officers; Qwest subsequently agreed to buy at least $300 million in equipment from Tellium for which, according to the SEC, Qwest had not identified any use.[26] This SEC action was settled by Qwest, inter alia, paying a civil penalty of $250 million and $1 billion in disgorgement.[27]

Additionally, senior Qwest executives allegedly engaged in insider trading by selling off company stock while knowing that Qwest's earnings estimates were unrealistic. Former Qwest CEO Joseph Nacchio is alleged to have sold 2.5 million shares of Qwest stock over five months in 2001 that generated $100 million. He was indicated on 42 counts of insider trading in December 2005.[28] He maintains his innocence.

B. Where were the lawyers?

The public record contains few references to Qwest's General Counsel. It does seem clear, however, that he was a confidante of Nacchio, and knowledgeable, as were Qwest executives generally, about the IRU transactions and the stock allocations from vendors, some of which he received personally.[29] News accounts and congressional testimony do not indicate,

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26 SEC Compl. at ¶ 186; see Kris Hudson, Qwest's Re-audit May Clear Books, Not Air, Denver Post, Oct. 13, 2003, at E-01.

27 SEC Litig. Rel. No. 18936 (Oct. 21, 2004).

28 U.S. Attorney's Office, D. Colo., Press Release, Joseph P. Nacchio Indicted by Federal Grand Jury in Denver (Dec. 20, 2005) available to www.usdoj.gov/usao/co/press-releases/ archive/2005/December/12_20_05.html; see Ken Belson, U.S. Tries Simpler Tack Against Ex-Chief of Qwest, N.Y. Times, Jan. 20, 2006.

29 Jeff Smith, Qwest Inquiry Moves up Ladder, Focuses on Former Top Lawyer, Rocky Mountain News, Aug. 21, 2004 at 1C.

however, whether he was present in the Audit Committee meetings for briefings on the accounting treatment of the IRU transactions or the degree of his involvement in reviewing Qwest's public disclosures.

The SEC has not brought any charges against the General Counsel. He was one of many Qwest defendants in consolidated class actions alleging securities fraud.[30] These cases were recently settled by a payment of $400 million from Qwest and its insurers.[31]

VIII. TV Azteca

A. The alleged fraud

In January 2005, the SEC filed civil fraud charges against TV Azteca S.A. de C.V. ("TV Azteca"), a Mexican issuer whose American depository receipts trade on the NYSE, its parent company, Azteca Holdings, S.A., de C.V. ("Azteca Holdings"), and three current and former TV Azteca officers and directors, Ricardo Salinas Pliego, Pedro Padilla Longoria, and Luis Echarte Fernandez. SEC v. TV Azteca S.A. de C.V., SEC Litig. Rel. No. 19022 (Jan. 4, 2005). The SEC alleges in its complaint that the defendants engaged in an elaborate scheme to conceal Salinas's role in a series of transactions through which he personally profited by $109 million. Id. The SEC complaint alleged further that Salinas and Padilla sold millions of dollars of TV Azteca stock while Salinas's self-dealing remained undisclosed to the market place. Id.

According to the Commission, Salinas and others caused TV Azteca and Azteca Holdings to file periodic reports that did not disclose Salinas's involvement in related party

[30] In re Qwest Comms. Intl, Inc. Secs. Litig., 01 CV 1451 ("In re Qwest"). Second Cons. Am. Class Action Compl. (D. Co. Apr. 5, 2002).

[31] In re Qwest, Partial Final Judgment and Order of Partial Dismissal with Prejudice, Sept. 26, 2006.

transactions between Unefon, a subsidiary of TV Azteca, and a private entity secretly co-owned by Salinas, called Codisco. Id. In the related party transactions, Salinas allegedly purchased from a third party – at a steep discount – approximately $325 million of indebtedness owed by Unefon to the third party. Id. Allegedly, at the time that Salinas purchased the indebtedness, he was aware that Unefon was in negotiations with another large telecom company which would provide substantial cash to Unefon, and enable Unefon to pay off the full amount of the indebtedness that Salinas had purchased at a discount. Id. Only three months later, when Unefon closed the deal with the other telecom company, Salinas allegedly profited by $109 million upon Unefon's repayment of the debt at full value. Id.

TV Azteca allegedly filed false reports with the SEC, concealing Salinas' involvement in the Unefon debt transactions, despite receiving advice from its U.S. counsel, Akin Gump Strauss Hauer & Feld LLP ("Akin Gump") that these transactions were material, reportable transactions under U.S. federal securities laws. Id. According to the complaint, while TV Azteca provided general disclosure of the transactions, it refused to reveal information crucial to investors: that Salinas was behind the transactions and personally profited from them. Id. TV Azteca's resistance allegedly led to the eventual resignation of Akin Gump, who told the company's board of directors and management that it was resigning consistent with its obligations under Section 307 of SOX. Id.[32]

The Commission further alleged that in various filings and public statements from June 2003 through January 2004, TV Azteca and its management discussed publicly the Unefon

[32] Reportedly TV Azteca sought opinions from two other firms, Cleary Gottlieb and Hogan & Hartson, both of which also counseled that disclosure of Pliego's interest was required. Patrick McGeehan, Get the Wrong Answer, Ask Another Lawyer, N.Y. Times, Nov. 21, 2004 available at www.nytimes.com/2004/11/21/business.

debt transactions while either failing to disclose Salinas's involvement, or, in several instances, falsely denying Salinas's involvement. Id. Furthermore, in communications with TV Azteca's independent directors, Salinas, Padilla and Echarte intentionally withheld information from, and even lied to, the directors about Salinas's connection to the underlying transactions and his $109 million profit. Allegedly, Salinas and Padilla compounded their fraud by executing false SOX certifications. Id.

Akin Gump resigned, as reported in a December 24, 2003, New York Times article. Patrick McGeehan, Lawyers Take Suspicions on TV Azteca to Its Board, N.Y. Times, Dec. 24, 2003. The SEC alleged that thereafter Echarte sent an email to Salinas and Padilla, stating, "[t]he damage is done and the situation that we didn't want to explain openly is now in the hands of the public." Id. Shortly thereafter, on Jan. 9, 2004, TV Azteca issued a press release confirming that Salinas indirectly owned half of Codisco. Id.

The SEC's fraud charges were resolved in September 2006 by a judgment on consent, with defendants agreeing to injunctive and significant monetary relief. SEC Litig. Rel. No. 19833 (Sept. 14, 2006).

B. Where were the lawyers?

According to the SEC Akin Gump resigned as TV Azteca's U.S. counsel when TV Azteca refused to comply with Akin Gump's advice that the transactions were material, reportable transactions under U.S. federal securities laws. Id. According to the New York Times December 24, 2004 article, Steven H. Scheinman, a partner in Akin Gump's New York office, wrote a letter to the boards of directors of TV Azteca and Azteca Holdings informing them that Akin Gump was withdrawing as counsel to the company on a pending bond offering and that it might notify the SEC of its withdrawal and the reasons for it.

The SEC's complaint did not include any allegations of wrongdoing by TV Azteca's in-house lawyers who liaised with Akin Gump.

IX. Waste Management

A. The alleged fraud

Beginning in 1992 and continuing until 1997, Waste Management's ("WMX") top management, including Senior Vice President and General Counsel Herbert A. Getz, perpetrated what the SEC called "one of the most egregious accounting frauds we have seen."[33] Defendants fraudulently manipulated WMX's financial results to meet predetermined earnings targets. Because the Company's revenues and profits were not growing fast enough to meet these targets, defendants instead resorted to improperly eliminating and deferring current period expenses to inflate earnings. SEC v. Buntrock et al., No. 02 C 2180 (N.D. Ill., filed Mar. 26, 2002). Pre-tax earnings were inflated by $1.7 billion. Waste Management stock, upon restatement of its earnings in February 1998, lost $6 billion in value. Michael Bologna, SEC Wins Verdict in Civil Trial Against Former Waste Management Exec, 38 Sec. Reg. & Law Rep., 1213, July 10, 2006 (reporting civil trial verdict against former CFO for securities fraud).

Defendants employed a number of improper accounting practices to achieve this, including avoiding depreciation expenses on garbage trucks, assigning arbitrary salvage values to other assets, failing to record expenses for decreases in the value of landfills, refusing to record expenses necessary for write-offs, establishing inflated environmental reserves (liabilities), improperly capitalizing certain expenses, and failing to establish sufficient reserves (liabilities) to pay for income taxes and other expenses.

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33 SEC Press Release No. 2002-44 (Mar. 26, 2002).

Defendants prepared an annual budget in which they set earnings targets for the coming year. Then, in order to reduce expenses and inflate earnings artificially, they used "top-level adjustments" to conform the company's actual results to the predetermined earnings targets. The inflated earnings of prior periods then became the floor for future manipulations.

WMX's longtime auditor Arthur Andersen LLP ("Andersen") allegedly aided the fraud by entering into a secret agreement with defendants to cover up the frauds by writing-off the accumulated errors over long periods of time and changing the underlying accounting practices, but only in future periods.

B. Where were the lawyers?

Getz's basic role in all of this was that he "blessed the Company's fraudulent disclosures." He met with Andersen regularly, particularly concerning the status of landfill permitting and expansion projects. Getz regularly received information on the impact of the "top-level adjustments" and participated in decisions not to disclose such items. Getz had specific involvement in the company's setting of arbitrary salvage values designed to manipulate the books. When Andersen recommended that the company conduct a study concerning its landfill accounting, top management, with Getz's knowledge, ignored the recommendation and never conducted the study. Getz had prior knowledge of, and implicitly or explicitly approved, essentially all of the company's specific improper accounting practices and resulting misrepresentations.

Getz profited from the fraud by receiving bonuses for 1994 and 1995 totaling $472,500. Had the company been reporting true revenue and earnings, the company would not have paid bonus to Getz (or any of the other defendants) in those years.

No findings of fact were made on the record concerning Getz, but on August 26, 2005, he entered into a Consent Decree agreeing to all of the relief sought by the SEC. Without admitting or denying the allegations, Getz agreed to disgorge all of his bonuses ($472,500, plus an additional $477,256 in interest), paid a civil penalty of $200,000, and was permanently barred from serving as a director or officer of a public or SEC reporting company. In re Getz, SEC Rel. No. 34-52452 (Sept. 15, 2005).

No allegations appear to have been made concerning the role of any outside counsel to Waste Management.

Appendix E

Task Force Survey to Law
<u>Firms Concerning SOX Procedures</u>

Note: the survey below was sent by the Association to approximately 100 firms in November 2005 and February 2006. The responses received from 19 firms are summarized in the Task Force Report at pages 122-24.

Sarbanes-Oxley Survey

1. Does your firm have written procedures for implementing the lawyer "reporting up" rules adopted by the SEC (Part 205) pursuant to the Sarbanes Oxley Act of 2002?

   Yes ________ No__________

   If so, and you are willing to provide us with a copy to use on a confidential basis in connection with our work, please attach a copy.

2. Does the principal responsibility for implementing these procedures reside with:

   a. A firm-wide committee _____

   b. A small group of individuals _____

   c. A general counsel _____

   d. An Ombudsperson _____

   e. Other __________

3. How have you informed the lawyers in your firm of the procedures?

   a. Seminars or other in-firm training sessions _____

   b. Firm-wide memo _____

   c. Other (brief details, please) __________

4. Are lawyers required to sign any certification that they understand the firm's procedures and promise to comply with them?

   Yes _______ No________

5. Do your procedures expressly protect subordinate attorneys from retaliation by senior attorneys for reporting up?

Yes __________ No_________

6. Do your procedures provide that a subordinate attorney is not to report to the client?

Yes __________ No ________

7. Since the development of your procedures, have they been utilized in practice to report up any issue?

Yes __________ No________

If so:

a. Approximately how many times has an internal report been made in your firm? _____

b. From whom have the initial reports come? (partners, associates, others)? _____

c. Did any of these reports result in an actual report (whether oral or written) to a client?

Yes ______ (how many? _______) No ______

8. Do you believe the SEC's reporting up rules have a positive impact in reducing the risk of corporate wrongdoing?

Yes __________ No ________

9. Which of the following best states your opinion about the impact of the SEC's reporting up rules to date on lawyer-client relationships: (Choose one)

_______ The impact has been positive;

_______ The impact has been negative;

_______ There has been no significant impact.

10. Should the SEC's reporting up rules be (choose one):

_______ Continued

_______ Revoked

_______ Modified [please state in what manner.]

Comments

Comments:

> We welcome any comments you may care to give, either to supplement any of the above answers or more generally. We also would be pleased to receive your comments by phone, if you prefer.

All comments will be held in strictest confidence.

Appendix F

Model "Up-The-Ladder" Policy
For New York Law Firms

Introduction

This memorandum sets forth the policies and procedures established by the Firm for addressing matters that potentially involve "up-the-ladder" reporting pursuant to the New York Lawyers Code of Professional Responsibility (the "Code") or the lawyer conduct rules that were promulgated by the SEC pursuant to the Sarbanes-Oxley Act of 2002 (the "SEC's lawyer conduct rules"). All lawyers in the Firm are expected to be familiar with these rules and to comply with the Firm's policies with regard to them.

Responsibilities Under the Rules of Professional Conduct

New York Disciplinary Rule ("DR") 5-109 sets forth New York's rule on "up-the-ladder" reporting. It applies to all lawyers for all organizations. Under DR 5-109, when a lawyer knows that an officer or employee of a client is "engaging in action, intends to act, or refuses to act in a matter related to the representation" that violates the law and is "likely to result in substantial injury to the organization" the lawyer must "proceed as is reasonably necessary in the best interest of the organization," which may include referring the matter to the "highest authority that can act on behalf of the organization." [Attach text of DR 5-109].

Special Responsibilities with Respect to Public Companies

The SEC's lawyer conduct rules impose special "up-the-ladder" reporting obligations on lawyers for public companies. Under these rules, when an attorney "appearing and practicing" before the SEC becomes aware of "evidence of a material violation" of U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law by an issuer, or by any officer, director employee, or agent of the issuer, the lawyer must report "up-the-ladder". "Evidence" of a material violation is "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur." The SEC's lawyer conduct rules are published at 17 C.F.R. Part 205. [Attach copy].

Reporting Obligations within the Firm

The Firm recognizes that the Code and the SEC imposes duties on individual lawyers. The Code also imposes obligations on law firms, however. It is therefore important to informed and measured application of all of our obligations that the Firm address matters which potentially involve "up-the-ladder" reporting with uniform policies and procedures that draw on the broad experience of the Firm in a variety of areas. Accordingly, the Firm has established a Corporate Governance Compliance Committee (the "Compliance Committee") for the purpose of coordinating and directing the Firm's compliance with the rules governing "up-the-ladder" reporting on a day-to-day basis and in specific situations that may arise in the course of our work. The current members of the Compliance Committee are [______].[1]

Specific Procedures

The following procedures shall apply to Firm attorneys worldwide:

1. An attorney who in the course of his or her representation of an organization becomes aware of facts and circumstances that may trigger an "up-the-ladder" reporting obligation imposed by the Code or the SEC's lawyer conduct rules *is required* to discuss such facts and circumstances with the partner or of counsel in charge of the matter.

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[1] It is recommended that the Compliance Committee include the General Counsel of the Firm, an Ethics Partner or the equivalent, and other senior lawyers with relevant expertise or experience (i.e., corporate and securities, professional responsibility, etc.)

2. Where in the judgment of the partner or of counsel in charge there is at least possible issue as to whether "up-the-ladder" reporting is required by the Code or the SEC's lawyer conduct rules, the partner or of counsel may consult with his or her practice group leader or another appropriate senior lawyer to discuss the relevant facts and circumstances but *is required* to consult with a member of the Compliance Committee.

3. If after discussion the partner or of counsel in charge believes that an "up-the-ladder" obligation *could potentially* be required, he or she *must* promptly contact a member of the Compliance Committee. If after the partner or of counsel in charge concludes that there is no obligation to report, any other attorney involved in the matter who has a continuing concern as to whether the "up-the-ladder" reporting requirements of the Code or the SEC's lawyer conduct rules are being followed, that lawyer *is required to* discuss these concerns promptly with a member of the Compliance Committee.

4. If at any time any other lawyer, although not working on the particular matter giving rise to the possible obligation within the Firm, has any question as to whether there is a reporting obligation under the Code or the SEC's lawyer conduct rules in a particular case, the lawyer *is required to* consult with a member of the Compliance Committee.

5. While the potential need for "up-the-ladder" reporting is under discussion, no attorney may discard or destroy any documents (including e-mails and drafts) that are pertinent to the matter. The Compliance Committee may direct the attorneys involved in the matter to prepare appropriate internal memoranda for transmission to the Compliance Committee, and will determine what other documentation, if any, is appropriate.

6. If the Compliance Committee determines that any action is necessary, it will promptly (a) inform the Executive Committee of the Firm and (b) prepare the appropriate report,

which may be written or oral as determined by the Compliance Committee. In connection with this determination, the Compliance Committee will consult with any lawyer in the Firm it deems appropriate, but the partner or of counsel in charge of the matter that gives rise to any reporting obligation shall not participate in the final determination as to whether a report shall be made.

7. Where a report is made, the Compliance Committee will monitor the response by the client as appropriate and determine how the Firm shall proceed, in consultation with senior management of the Firm and others as appropriate.

8. If any lawyer in the Firm believes that it is necessary or appropriate for the lawyer to disclose confidential information outside the client, the lawyer *is required to* consult in advance with a member of the Compliance Committee.

Training

The firm will conduct mandatory training sessions for all Firm lawyers on the "up-the-ladder" requirements of the Code and the SEC's lawyer conduct rules. Each new lawyer joining the Firm will be required to attend such a session, or view a videotape of one, within two weeks of starting at the Firm. Thereafter the Firm will conduct periodic sessions to keep you informed of developments in the area. In addition, each practice group in each office shall take appropriate steps to insure that their attorneys are aware of their obligations under this memorandum.

Attorney Certification

To assure that all Firm lawyers are aware of the Firm's policy concerning compliance with the "up-the-ladder" obligations of the Code and the SEC's lawyer conduct rules, each lawyer will be required to sign an annual certification, in the form provided by the Firm from time to time, that he or she has read this policy, understands it and intends to abide by it. All lawyers newly joining the Firm will also be asked to sign such a certification promptly after joining the Firm.

Confidentiality

The members of the Compliance Committee will keep confidential all information conveyed to them to the extent consistent with the interests of the Firm, its clients and the legal obligations of each lawyer concerned. Absolute confidentiality may not be possible if action is necessary to protect clients or the Firm, or to comply with the SEC's lawyer conduct rules, the Code, or any other applicable legal requirement. The Firm expects and intends that all inquiries to the co-chairs of the Compliance Committee, who will be designated as co-general counsels of the Firm for matters relating to the firm's "up-the-ladder" reporting obligations, as well as deliberations, legal advice and other responses to inquiring lawyers, will be protected by the attorney-client privilege and other applicable protections. All participants should treat all communications accordingly.

Retaliation Prohibited

It is essential that lawyers raise concerns as directed in this memorandum so that the Firm can assure compliance with all applicable legal, ethical and other requirements. Accordingly, no report made in good faith under this memorandum will result in any adverse employment or other action. Any lawyer who believes that he or she has been subjected to adverse employment or other action because of complying with this policy must report that belief immediately to the Compliance Committee or to the Executive Committee.

Questions about these policies and procedures and their application in particular cases should be referred to the Compliance Committee or the Firm's General Counsel.

Appendix G

Suggested Statement of Best Practices
For the Role of the Lawyer in Corporate Governance

1. **Set the Tone at the Top.** Managing partners, successful senior lawyers and other firm leaders should be prominent in the establishment and promotion of all initiatives concerning ethics and professional responsibility.

2. **Promote a Culture that Encourages Consultation with at Least Two Independent Partners.** Where difficult issues arise concerning the role of the lawyer in a corporate transaction the lawyer should consult with at least one partner who is not involved in the matter.

3. **Emphasize the Lawyer's Duty of Independence.** Lawyers should be encouraged to ask clients about their reasons for entering into corporate transactions that raise concerns with respect to propriety or legality, and offer advice and counsel on the wisdom as well as the technical legality of such transactions.

4. **Establish High Profile and Active Ethics Committees.** The Firm should identify and publicize the availability of a committee, a group, or several identified lawyers who keep current on developments in the field of lawyer regulation and are responsible for keeping lawyers abreast of important developments.

5. **Appoint a General Counsel, Ethics Partner and/or Ombudsperson**

6. **Set up User-Friendly Mechanisms for Associates to Raise Issues.** The law firm should provide several mechanisms for associates and young partners to raise issues. There should be a clear and well-known policy of non-retaliation for raising issues.

7. **Establish Written Policies for Raising Ethics and Professional Responsibility Issues.** At a minimum, every firm should have a written policy for how it is handling compliance

with the up the ladder reporting obligations of the New York Lawyers Code of Professional Responsibility and the lawyer conduct rules promulgated by the SEC pursuant to the Sarbanes-Oxley Act.

8. **Conduct In-House CLEs.** In-house CLE's on professional responsibility issues should be held often. Department heads and other senior active, successful partners must take an visible role in these presentations.

9. **Distribute Firm-Wide Memos on Important Developments in the Law of Professional Responsibility.**

10. **Adopt a Compensation Structure that Encourages Active Participation in the Firm's Ethics and Professional Responsibility Initiatives**

Appendix H

Government and Exchange Guidelines on Corporate Cooperation and Internal Investigation

A. Department of Justice and U.S. Sentencing Guidelines for Organizations

1. Thompson Memo

In 2003, then Deputy Attorney General Larry Thompson issued a memorandum, entitled "Principles of Federal Prosecution of Business Organizations", that revised[1] the guidelines prosecutors are to follow in considering charges against corporations.[2] Now referred to as the Thompson Memo, this document clarified that prosecutors should always consider the company itself as a potential defendant, and it underscored that a company's cooperation is a key factor that the government will consider in its charging decisions. The Memo also explained that "[t]he main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation."[3] In addition to these two goals, the revisions to the policy "address the efficacy of the corporate governance mechanisms in place within a corporation, to ensure that these measures are truly effective rather than mere paper programs."[4]

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1 On June 16, 1999, Deputy Attorney General Eric E. Holder, Jr. authored the predecessor memo, entitled "Federal Prosecution of Corporations." Memorandum from Eric E. Holder, Jr., Deputy Att'y Gen., to All Component Heads & U.S. Atty's (June 16, 1999).

2 Memorandum from Larry Thompson, Deputy Att'y Gen., to Heads of Dep't Components & U.S. Atty's (Jan. 20, 2003) ("Thompson Memo"), available at http://www.usdoj.gov/dag/cftf/ business_organizations.pdf.

3 Id.

4 Id.

The Memo indicated that, in addition to the considerations applicable to individuals,[5] federal prosecutors should weigh nine factors in deciding whether to investigate, charge, or negotiate a plea with a company. These factors fall into roughly three groups: (1) the nature and extent of the wrongdoing; (2) cooperation with the investigation and self-reporting of malfeasance; and (3) the collateral consequences of prosecution and the adequacy of other remedies. While the nature and extent of the company's wrongdoing will typically be the most important consideration, it is notable that three of the nine factors address cooperation and compliance, and they are:

> 4. the corporation's timely and voluntary disclosure of wrong-doing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection[];[6]
>
> 5. the existence and adequacy of the corporation's compliance program; [and]
>
> 6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies[.][6]

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5 The Thompson Memo noted the following factors "normally considered in the sound exercise of prosecutorial judgment": "the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of noncriminal approaches." Id. at ¶ II.A.

6 In 2005 the Department of Justice directed each U.S. Attorney and department head to establish a review process for supervisory approval of all requests to corporate entities for waiver of the attorney-client privilege and work product protection. See Memorandum from Robert D. McCallum, Jr., Acting Deputy Att'y Gen., to Heads of Dep't Components & U.S. Atty's (Oct. 21, 2005), available at http://www.abanet.org/poladv/mccallummemo212005.pdf. While this directive appears to be intended to assure appropriate supervision and review of waiver requests, it does not appear to indicate a weakening of the DOJ's interest in obtaining privileged materials. Indeed, the October 21 memo reiterates the importance that the DOJ continues to attach to such materials, by quoting from the Thompson Memo, which continues in force as the DOJ's statement of

(footnote continued)

Id.

a. Cooperation and Self-Reporting

The General Principle set forth in Paragraph VI of the Thompson Memo makes clear the Justice Department's emphasis on cooperation and voluntary disclosure by organizations: "In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors."[7] It goes on to explain that cooperation is multifaceted: "In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection."[8] Likewise, the Thompson Memo warns corporations that efforts to impede a government investigation or prosecution will count against them:

> Another factor to be weighed by the prosecutor is whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction). Examples of such conduct include: overly broad assertions of corporate representation of employees or former employees; inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation including, for example, the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed

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policy on charging corporations. The directive further notes that waiver review processes may vary from district to district, so that each U.S. Attorney will retain the prosecutorial discretion to determine how best to seek "timely, complete, and accurate information from business organizations." Id.

7 Thompson Memo at ¶ VI.A.

8 Id.

> production of records; and failure to promptly disclose illegal conduct known to the corporation.[9]

b. Ethics and Compliance Programs

As part of this emphasis on cooperation, the Thompson Memo also states that federal prosecutors will consider the quality and vitality of a company's compliance program:

> Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program.[10]

Companies will receive credit only if the programs are "designed for maximum effectiveness in preventing and detecting wrongdoing by employees" and if management enforces them rather than "tacitly encouraging or pressuring employees to engage in misconduct."[11] A program that only exists "on paper" is simply insufficient.[12]

c. Remediation

The Thompson Memo's final cooperation factor states that the government rewards companies' "willingness to make restitution and steps already taken to do so."[13] The

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9 Id. at ¶ VI.B.

10 Id. at ¶ VII.

11 Id. at ¶ VII. B.

12 Id.

13 Id. at ¶ VIII.A.

remedial measures that a company takes, including disciplining employees and making full restitution, "says much about its willingness to ensure that such misconduct does not recur."[14] Overall, it is the "integrity and credibility" of these measures that count.[15]

2. U.S. Sentencing Guidelines for Organizations

The U.S. Sentencing Guidelines for Sentencing of Organizations ("USSG" or "Sentencing Guidelines") dovetail with the Thompson Memo's emphasis on cooperation and corporate compliance.[16] The introductory commentary explains that "[t]hese guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program."[17]

Perhaps more so than the Thompson Memo, the Sentencing Guidelines place great emphasis on corporate compliance programs.[18] Section 8B2.1 "sets forth the requirements for an effective compliance and ethics program."[19] Amended in response to § 805(a)(5) of SOX, it institutes more rigorous criteria for compliance programs and places greater responsibility on directors and management to oversee these programs. Section 8B2.1(a) provides that in order

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14 Id. at ¶ VIII.B.

15 Id.

16 These Sentencing Guidelines are found in United States Sentencing Commission, 2006 Federal Sentencing Guidelines Manual, Chapter Eight (Sept. 19, 2006), available at www.ussc.gov/2006guid/tabcon06_1.htm.

17 USSG ch. 8, introductory cmt.

18 See David Meister & Albert Berry III, Revised Guidelines Stress Self-Audits, Nat'l L.J., Mar. 21, 2005, at S1 (noting § 8B2.1 is the "centerpiece" of the revised Organizational Guidelines).

19 USSG § 8B2.1, cmt. background.

"[t]o have an effective compliance and ethics program . . . an organization shall — (1) exercise due diligence to prevent and detect criminal conduct; and (2) otherwise promote an organizational culture that encourages ethical conduct and commitment to compliance with the law." It then goes on to set forth seven steps of an effective compliance and supervisory program, placing particular emphasis on the Board and upper management's responsibilities to monitor the program.[20]

Section 8C2.5 sets forth the "culpability score" calculus that district judges are to consider in imposing fines, and it rewards companies that are considered to be, in effect, good corporate citizens. For example, subsection (f) provides for a downward departure if a company had in place an effective compliance program.[21] Subsection (g),[22] entitled "Self Reporting, Cooperation, and Acceptance of Responsibility," provides for a downward adjustment of varying

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20 Id. at § 8B2.1(b).

21 Id. at § 8C2.5(f).

22 Id. at § 8C2.5(g) provides:

> (1) If the organization (A) prior to an imminent threat of disclosure or government investigation; and (B) within a reasonably prompt time after becoming aware of the offense, reported the offense to appropriate governmental authorities, fully cooperated in the investigation, and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract **5** points; or
>
> (2) If the organization fully cooperated in the investigation and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract **2** points; or
>
> (3) If the organization clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract **1** point.

amounts if the organization self-reports wrongdoing, "fully cooperate[s] in the investigation," and accepts responsibility for its actions.[23] The application notes clarify that

> [t]o qualify for a reduction under subsection (g)(1) or (g)(2), cooperation must be both timely and thorough. To be timely, the cooperation must begin essentially at the same time as the organization is officially notified of a criminal investigation. To be thorough, the cooperation should include the disclosure of all pertinent information known by the organization. A prime test of whether the organization has disclosed all pertinent information is whether the information is sufficient for law enforcement personnel to identify the nature and extent of the offense and the individual(s) responsible for the criminal conduct. However, the cooperation to be measured is the cooperation of the organization itself, not the cooperation of individuals within the organization. If, because of the lack of cooperation of particular individual(s), neither the organization nor law enforcement personnel are able to identify the culpable individual(s) within the organization despite the organization's efforts to cooperate fully, the organization may still be given credit for full cooperation.[24]

Moreover, the Sentencing Guidelines punish, or provide for an upward departure, where a corporation obstructs justice and impedes a government investigation.[25]

In a significant development, the U.S. Sentencing Commission voted unanimously on April 5, 2006, to delete the following sentence from the application notes (which had been added to the notes only two years ago):

> Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of

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[23] Id. USSG § 8C4.1 provides credit, similar to a USSG § 5K1.1 credit ("substantial assistance to authorities"), to a corporate defendant that "has provided substantial assistance in the investigation or prosecution of another organization that has committed an offense, or in the investigation and prosecution of an individual not directly affiliated with the defendant . . . ."

[24] Id. at § 8C2.5, cmt. n.12 (emphasis added).

[25] Id. at § 8C2.5(c).

> subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.

The proposed change took effect on November 1, 2006.

This action by the Sentencing Commission followed public hearings in March 2006 at which the Commission heard testimony urging repeal of the language in question. Also in March 2006, the House Judiciary Subcommittee on Crime, Terrorism and Homeland Security heard testimony from organizations urging Congress to use its oversight powers to restrain prosecutors from routinely seeking privilege waivers as part of corporate cooperation.

This amendment to the Guidelines commentary may relieve some of the pressure that corporations have felt to waive privilege in connection with government investigations. At the same time, the Thompson Memo—including its discussion of waiver of privilege—remains in force as the Justice Department's statement of policy on charging corporations. Accordingly, unless parallel changes are made to the Thompson Memo, corporations will likely continue to be asked to waive the attorney-client privilege in order to minimize the risk of criminal prosecution.

3. Recent DOJ Statements

Recent statements by Justice Department officials reinforce this expectation of full and extensive cooperation. In a February 2005 speech, Christopher Wray, then the Assistant Deputy Attorney General for the Criminal Division, underscored that cooperation is both expected and must be "true" and "authentic":

> Our message on this point is two-fold: Number one, you'll get a lot of credit if you cooperate, and that credit can make the difference between life and death for a corporation. Number two, you'll only get credit for cooperation if it's authentic. You have to

get all the way on board and do your best to help the Government.[26]

He explained that the bar has been raised both by the DOJ's increasing expectations and by companies that have successfully navigated and survived government investigations with "A+" cooperative efforts.[27] Wray volunteered that a company that promptly discloses problems will receive credit, but a company that at first tries to "lay low" is less likely to receive a break from the government.[28] David Kelley, then the U.S. Attorney for the Southern District of New York, in fact implied that companies that impede governmental investigations will be punished: "Those who do not respond fully and truthfully, or who willfully turn a blind eye to protect a business relationship, will face the risk of criminal prosecution and conviction."[29]

Further reflecting the trend of crediting cooperation, many companies subject to federal criminal investigations have negotiated deferred prosecution and even non-prosecution agreements.[30] These "alternative resolutions" can "work to ensure that companies accept

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26 Wray, ABA Remarks, n.182 in Report above (emphasis in original).

27 Id.

28 Id.; see also George J. Terwilliger III, Responding to Investigations, Nat'l L.J., Aug. 15, 2005, at 13 ("Failure to cooperate can harden prosecutors' attitudes significantly and render a bad situation even worse.").

29 U.S. Attorney's Office, S.D.N.Y., Press Release, Nine Individuals Charged for Submitting False Audit Confirmation Letters to Ahold Subsidiary U.S. Foodservice (Jan. 13, 2005), available at http://www.usdoj.gov/usao/nys/pressreleases/January05/aholdvendorpressrelease.pdf.

30 See generally Steven R. Peikin, Deferred Prosecution Agreements: Standard for Corporate Probes, N.Y.L.J., Jan. 31, 2005; at 4; Alan Vinegrad, Deferred Prosecution of Corporations, N.Y.L.J., Oct. 9, 2003, at 4.

responsibility and cooperate" with the government.[31] While such "pretrial diversion" had been offered to companies in the past, there has been a noticeable increase in its use since the Thompson Memo explicitly announced the government's preference for corporate cooperation and implementation of compliance programs.[32]

4. Summary

Thus, the Department of Justice and the U.S. Sentencing Commission both reward and expect cooperation with federal prosecutors. Significant credit is given to organizations that get the facts out and aid the government in its investigations, and that have instituted compliance and ethics procedures. Failure to cooperate may increase the likelihood of criminal charges being brought and more severe penalties being pursued.[33]

B. **Securities and Exchange Commission**

1. Seaboard Report

On October 23, 2001, using its authority under Section 21(a) of the Securities Exchange Act of 1934, the SEC issued a "Commission Statement on the Relationship of

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31 Wray, ABA Remarks, n.182 in Report above.

32 See Peikin, Deferred Prosecution Agreements, n.30 above ("A sea-change in the use of DPAs in corporate cases can be traced to January 2003," when the Thompson Memo was issued.); see also, e.g., U.S. Attorney's Offices, E.D.N.Y., S.D.N.Y., Press Release, The Bank of New York Resolves Parallel Criminal Investigations Through Non-Prosecution Agreement with the United States (Nov. 8, 2005) (stating non-prosecution agreement was result of "BNY's acceptance of responsibility, continued cooperation, remedial measures, and agreement to compensate victims of its unlawful conduct"), available at http://www.usdoj.gov/usao/ nys/pressreleases/November05/BankNYnonprosecutionagreementpr.pdf.

33 See E. Lawrence Barcella, Jr., Kirby D. Behre, & James D. Wareham, Cooperation with Government is a Growing Trend, Nat'l L.J., July 19, 2004, at S2 (noting "emerging trend in the prosecution and defense of corporate crime: Cooperating with the government – not by choice – is often the only road to survival for both corporations and their executives.").

Cooperation to Agency Enforcement Decisions."[34] The Seaboard Report, as it is known, reaffirmed and clarified the Commission's policy of giving credit to companies for "self-policing, self-reporting, remediation" of misconduct, and "cooperation" with SEC investigations.[35] The report presents the Commission's formal framework for approaching corporate cooperation.

The Seaboard Report arose out of the SEC's investigation of Chestnut Hill Farms, a division of the Seaboard Corporation. The Report announced a settled administrative proceeding against the controller of Chestnut Hill Farms, whom the Commission determined had misstated certain assets and expenses in the company's financials. While the SEC entered a cease-and-desist order against the controller, it explained that it would not be taking action against Seaboard, the parent company. The Commission then took the extraordinary step of explaining why it did not bring charges against the company and then laid out the criteria it would consider in deciding whether to charge companies that cooperate.

Before outlining the specific factors it would weigh, the Commission included three caveats to its general approach. "First, the paramount issue in every enforcement judgment is, and must be, what best protects investors."[36] Second, the SEC explained that it will approach cooperation on a case-by-case basis; the guidelines are not rules or commitments, and they do not "confer[] any 'rights' on any person or entity."[37] Third, the Commission underscored that

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34 SEC Rel. No. 34-44969, 76 SEC Docket 220 (Oct. 23, 2001) ("Seaboard Report"). Section 21(a) of the 1934 Act authorizes the Commission to issue a report of investigative findings if it determines that an enforcement action is not warranted.

35 Id.

36 Id. at 2.

37 Id.

the factors the report laid out are not exhaustive and do not establish a safe harbor from enforcement proceedings.[38] It also emphasized that cooperation is essential to the Commission's overall enforcement mission because it conserves the SEC's resources.[39]

Next, the SEC set forth thirteen factors that it would consider in determining whether to award "credit for self-policing, self-reporting, remediation[,] and cooperation."[40] These factors can be divided into roughly four categories: (1) the nature, level, and impact of the misconduct; (2) the amount of self-policing and self-reporting by the company; (3) any internal remedial measures adopted in response to the misconduct; and (4) cooperation with law enforcement and regulatory investigations. The Seaboard Report highlighted the central role of an effective internal investigation in discussing the criteria that the Commission would consider in assessing a corporation's cooperation:

> Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?[41]

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38 Id.

39 Id.

40 Id. at 2-4.

41 Id. at 3-4.

2. Evolution of Seaboard: Punishing Efforts that Impede Investigations

As noted, the Seaboard Report exists as the Commission's stated policy regarding cooperation. In the view of some practitioners, however, the SEC's enforcement program has evolved to a point of appearing in some cases to affirmatively punish companies for inadequate cooperation.

For example, in a May 2004 press release announcing its $25 million settlement with Lucent, the SEC underscored that its decision to sanction the company (in addition to the individual wrongdoers) was based on Lucent's "lack of cooperation."[42] Similarly, Banc of America agreed to a settled a cease-and-desist order that made findings of, among other things, inadequate responses to document requests that had the effect of impeding the SEC staff's investigation and delaying their investigatory work.[43]

Furthermore, SEC officials have admonished companies that efforts to interfere with Staff investigations will be punished. Associate Director of Enforcement Paul Berger explained that "[c]ompanies whose actions delay, hinder[,] or undermine SEC investigations will not succeed. Stiff sanctions and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interests of investors."[44] Likewise, then Enforcement Director Cutler commented, "Any effort to impede an SEC investigation may itself

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42 SEC Press Release 2004-67, Lucent Settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud (hereinafter, "SEC Press Release 2004-67"), available at http://www.sec.gov/news/press/2004-67.htm.

43 See In re Banc of America Securities LLC, SEC Rel. No. 34-49386, 82 SEC Docket 1264 (Mar. 10, 2004).

44 SEC Press Release 2004-67, n.42 above.

become the subject of an enforcement proceeding."[45] And, on multiple occasions, Cutler stressed that the "integrity of the investigative process" is sacred and a complementary goal to cooperation.[46] Former SEC General Counsel Prezioso has also warned that independent investigations "are worse than useless if conducted ineffectively."[47]

3. Sanctions

Coupled with this evolving expectation of cooperation is the SEC's escalation of the level of monetary penalties. In an April 2004 speech, Cutler explained that the SEC's approach to fines had changed: "We're clearly in the midst of an evolution, if not a revolution in thinking. In a decade, we've gone from a regime in which monetary penalties were imposed only rarely to one in which large penalties seem to be part of virtually all significant settlements."[48] He also noted that the SEC now "start[s] with the presumption that any serious violation of the federal securities laws should be penalized with a monetary violation."[49] While sanctions of more than $10 million were considered large only a few years ago, hundred-million-dollar penalties are now not uncommon. Thus, the incentives to cooperate, and the costs of not cooperating have increased dramatically.

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45 Kathleen Day, SEC Gets Tough on Hindering Investigations, Wash. Post, Mar. 19, 2004, at E1 (quoting Cutler).

46 Cutler, UCLA Speech, p. 49 in Report above; see also Cutler, Remarks Before D.C. Bar, n.177 in Report above.

47 Prezioso, Vanderbilt Remarks, n.176 in Report above.

48 Stephen M. Cutler, Speech at 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), available at http://www.sec.gov/news/speech/spch042904smc.htm.

49 Id. (emphasis added).

On January 4, 2006, acting unanimously, the SEC issued a Statement Concerning Financial Penalties, setting forth the factors it will consider in deciding whether and how to impose penalties in enforcement actions against corporations.[50] The Statement identifies two principal considerations that will guide the SEC's determination whether a corporate penalty is appropriate: (1) [t]he presence or absence of a direct benefit to the corporation as a result of the violation, and (2) the degree to which the penalty will recompense or further harm the injured shareholders.

The January 4 Statement also highlights seven additional factors that will bear upon the decision whether to impose a corporate penalty: (1) the need to deter the particular type of offense charged in the proceeding; (2) the extent of the injury to innocent parties; (3) whether complicity in the violation is widespread throughout the corporation; (4) the level of intent on the part of the perpetrators; (5) the degree of difficulty in detecting the particular type of offense; (6) the presence or absence of remedial steps taken by the corporation; and (7) the extent of cooperation with the SEC and other law enforcement agencies shown by the corporation.

Thus, the SEC continues to identify cooperation as a factor that will be considered in the process of determining sanctions. It remains to be seen, through the development of future cases, whether the weight attached to cooperation will change and whether the Commission will continue to impose civil money penalties at the recent, escalated levels.

4. Culture of Compliance

Finally, the SEC has underscored the importance of instilling a culture of compliance in companies. Then SEC Chairman William H. Donaldson suggested that the first

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50 SEC Press Release No. 2006-4, Statement of the Securities and Exchange Commission Concerning Financial Penalties, available at http://www.sec.gov/news/press/2006-4.htm.

priority of any Board of Directors should be to fix the company's "moral compass" and define the ethical standards that make up the "corporation's DNA."[51] Furthermore, Cutler has directly compared the Seaboard Report's concern with a culture of compliance with the parallel emphasis found in the Thompson Memo and the Sentencing Guidelines.[52] Like Donaldson, Culter noted that it is important that directors and executives set the "tone at the top," and that means "[y]ou've got to talk the talk; and you've got to walk the walk."[53] Every company must have a strong culture of ethics that is communicated to employees, and every company and employee must live by this code.

C. New York Stock Exchange

1. Cooperation Memo

On September 14, 2005, the NYSE issued its "Cooperation Memo" to all member firms detailing the Exchange's position on cooperation.[54] Like the SEC and Justice Department, the NYSE rewards cooperation. In the NYSE's view, its member firms are obligated both to (1) "cooperate with Exchange reviews, examinations[,] and investigations," and (2) "provide disclosure to the Exchange of, among other things, violations of the rules of the Exchange or the

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51 William H. Donaldson, Remarks at 2003 Washington Economic Policy Conference (Mar. 24, 2003), available at http://www.sec.gov/news/speech/spch032403whd.htm.

52 See Stephen M. Cutler, Tone at the Top: Getting it Right, Speech at Second Annual General Counsel Roundtable, (Dec. 3, 2004), available at http://www.sec.gov/news/speech/spch120304smc.htm.

53 Id.

54 See Susan Merrill, Exec. V.P., NYSE Div. of Enforcement, NYSE Information Memo No. 05-65 (Sept. 14, 2005) ("NYSE Memo 05-65"), available at http://apps.nyse.com/commdata/PubInfoMemos.

federal securities laws."[55] The Memo further explains that reduced sanctions are available to those firms exhibiting "exceptional or extraordinary cooperation."[56] As NYSE Regulation spokesman Scott Peterson commented, the Exchange's policies are "something new" and they are different from the disclosure requirements owed to the SEC.[57] He explained, "We saw a need to highlight those differences, and wanted, at the same time, to be more transparent about our approach to awarding credit for extraordinary cooperation."[58]

Under these twin affirmative duties of cooperation and disclosure, "the Exchange expects those who belong to the Exchange community to provide complete information promptly and in a straightforward manner."[59] Such disclosure of wrongdoing should be "full, accurate, comprehensible[,] and timely," and the Memo cautions members not to interfere with Exchange investigations. The Exchange also expects "active participation without evasion or delay."[60] Moreover, it clarifies that "parties to an investigation are not entitled to dictate the terms or conditions under which it will proceed."[61] In other words, the NYSE requires any member firm under investigation to open its doors to regulators and follow the Exchange's directions. The Memo states in no uncertain terms that failure to fulfill these duties will lead to charges being brought: "Where obligations of disclosure and cooperation are not met . . . Enforcement stands

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55 Id.

56 Id.

57 Kip Betz, Big Board Memo Says Firms Can Lessen Sanctions Via Cooperation, Sec. Reg. & L. Rep. (Sept. 19, 2005) (quoting Peterson).

58 Id.

59 NYSE Memo 05-65, n.54 above.

60 Id.

61 Id.

ready to protect the market and the investing public by bringing charges for these violations and seeking the appropriate sanctions."[62]

NYSE Memo 05-65 indicates that credit will be given for "extraordinary cooperation."[63] "Only where a respondent can demonstrate a record of disclosure and cooperation that is proactive and exceptional may these serve as mitigating factors."[64] While the Memo notes that each case is different, it lays out eight factors the Exchange will weigh in considering whether to award extraordinary cooperation credit: (1) prompt, full disclosure of possible misconduct coupled with thorough internal review; (2) candor with the Exchange about the facts; (3) waiver of attorney-client privilege; (4) the breadth, depth, and timeliness of remedial action taken by the firm; (5) cooperative responses to investigative requests; (6) aiding the limited jurisdiction of the Exchange; (7) the presence of a culture of compliance; and (8) partnering with the Exchange to uncover wrongdoing.[65]

Like the SEC and other government agencies, the Exchange rewards cooperation in part to leverage its own limited resources by benefiting from member firms' own internal investigative efforts. But NYSE Memo 05-65 explained that the level of cooperation "is not the only determinant" and that other factors will be considered, such as the type of wrongdoing, customer harm, the length of the violation, and prior problems.[66]

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[62] Id.

[63] Id. (emphasis added).

[64] Id. (emphasis added).

[65] Id.

[66] Id.

2. Sanctions Memo

On October 7, 2005, the NYSE issued a statement on sanctions.[67] Entitled "Factors Considered by the New York Stock Exchange Division of Enforcement in Determining Sanctions," the statement asserts that the securities industry has "undergone an evolution" in recent years and that the "deterrent effect" of the Exchange's sanctions was no longer sufficient.[68] This emphasis on enhanced penalties mirrors the trends of the SEC and Justice Department.

To provide guidance to member firms, the NYSE Memo 05-77 sets forth a non-exclusive framework that the NYSE will follow in making punishment decisions. The factors include: (1) the nature of the misconduct; (2) the harm caused by the wrongdoing; (3) the extent of the misconduct; (4) the respondent's prior disciplinary record; (5) acceptance of responsibility; (6) the implementation of corrective measures; (7) deceptive conduct; (8) disregarding of "red flags"; (9) the effectiveness of the firms supervisory and compliance programs; (10) the size and resources of the respondent; (11) the training of the respondent; (12) reliance on professional advice; (13) discipline from other regulators; and, last but not least, (14) <u>extraordinary cooperation</u>.[69] Hence, the themes of cooperation, disclosure, and compliance that affect charging decisions exist in the sanctioning arena as well.

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67 <u>See</u> Susan Merrill, Exec. V.P., NYSE's Div. of Enforcement, NYSE Information Memo 05-77 (Oct. 7, 2005) ("NYSE Memo 05-77"), available at http://apps.nyse.com/commdata/PubInfoMemos.

68 <u>Id</u>.

69 <u>Id</u>. (emphasis added).

3. NYSE Corporate Governance Standards

On November 3, 2003, the SEC approved the NYSE's proposed amendments to its corporate governance rules set out in Section 303A of the NYSE Listed Company Manual. Some of these rule changes significantly enhance the role of Audit Committees. While not directly tied to the increasing emphasis on cooperation with government authorities, these amendments reflect the NYSE's commitment to strong corporate governance and compliance and make up a part of the overall regulatory landscape.

The NYSE now requires that a majority of a company's Board of Directors be independent.[70] All listed companies must also have an Audit Committee that satisfies Rule 10A-3 of under the 1934 Act,[71] which Rule states that all Audit Committee members must be independent and that the Committee is responsible for appointing and overseeing the company's outside auditor.[72] All Audit Committee members must be "financially literate . . . or must become financially literate within a reasonable period of time after his or her appointment to the audit committee," and "at least one member . . . must have accounting or related financial management expertise."[73] The Audit Committee is required annually to obtain and review a report from the outside auditors that details, among other things, the company's "internal quality-control procedures," any issues these procedures have raised, as well as any "inquiry or

70 NYSE Listed Company Manual, Corporate Governance Standards § 303A.01 (2004).

71 Id. at § 303A.06.

72 17 C.F.R. § 240.10A-3.

73 NYSE Listed Company Manual § 303A.07(a).

investigation by governmental or professional authorities" within the last five years.[74] Moreover, the committee is charged with discussing the company's risk-assessment and risk-management policies,[75] meeting with the outside auditors,[76] "review[ing] with the independent auditor any audit problems or difficulties and management's response,"[77] and meeting with the full Board.[78] In addition, all listed companies are required to disclose and adopt corporate governance guidelines,[79] as well as business conduct and ethics policies.[80] Further "[e]ach listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary."[81]

D. Auditors

Another important force in play in today's regulatory and enforcement landscape is the outside auditor. Whereas the federal government and market regulators wield carrots and sticks that encourage companies to cooperate, the independent audit firms have also pushed companies to self-report problems and conduct internal investigations.

Auditors have a statutory duty to report illegal acts to management and the Board, and, if necessary, to the SEC. Section 10A(b) of the 1934 Act establishes a reporting and

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74 Id. at § 303A.07(c)(iii)(A).

75 Id. at § 303A.07(c)(iii)(D).

76 Id. at § 303A.07(c)(iii)(E).

77 Id. at§ 303A.07(c)(iii)(F).

78 Id. at § 303A.07(c)(iii)(H).

79 Id. at § 303A.09.

80 Id. at § 303A.10.

81 Id. at § 303A.12.

disclosure framework that outside auditors must follow when they become aware of information indicating possible wrongdoing.[82] When an auditor first discovers evidence of a suspected violation during an audit, it must promptly inform management and the Audit Committee.[83] After informing the Audit Committee, if the auditor determines that (1) the illegal act has a "material effect" on the financial statements, (2) senior management has not taken, or the Board has not caused management to take, "appropriate remedial action," and (3) "the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement," then the auditor must apprise the Board of its conclusions.[84] Within one business day of receiving an auditor's report, the Board must notify the SEC of the problem and provide the auditor with a copy of the notice given to the SEC. If the auditor does not receive this notice within the one-day period, then the auditor is required to either (1) "resign from the engagement," or (2) provide the Commission with a copy of the report it prepared.[85] If the auditor chooses to resign, it still must furnish the SEC with its report.[86]

Although Section 10A imposes an escalating reporting requirement on auditors, it is exceedingly rare that the SEC actually learns of corporate wrongdoing from the auditor because of a company's failure to take remedial action. Rather, the Section 10A reporting-out mechanism exists as a last resort. When an auditor becomes aware of suspected wrongdoing, it

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82 15 U.S.C. § 78j-1.

83 Id. at § 78j-1(b)(1).

84 Id. at § 78j-1(b)(2).

85 Id. at § 78j-1(b)(3).

86 Id. at § 78j-1(b)(4).

will often insist that the company conduct an internal investigation, usually at the direction of the company's Audit Committee. This internal review, in turn, can lead to a company's self-reporting and cooperating with the government. Given the requirements of Section 10A and the regulatory expectations in this area, audit firms have used their ability to withhold or qualify audit opinions to induce companies to conduct investigations, institute remedial measures, and even to alter management. In situations where a Section 10A investigation has been undertaken and evidence of an illegal act has been detected, audit firms often will demand that any potential problems be examined and resolved before they are willing to issue their report on the company's financial statements.