110 Corporate Governance & Ethics

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Attorney Gatekeepers

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Provided by the Association of Corporate Counsel
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In recent years, the role of the in-house counsel has evolved dramatically. The corporate scandals at the turn of the century propelled a wave of regulatory and legislative initiatives to deter such misconduct. Many of the new rules target the in-house counsel, and add the role of "gatekeeper" to their already long list of duties and responsibilities. This sudden re-writing of the role of in-house counsel had caught many off-guard, and the sheer number of new rules and regulations are extremely difficult to harness.

This InfoPAK[SM] will serve as an introductory guide to the new legal order that in-house counsel must follow. This InfoPAK should not be construed as legal advice or legal opinion on specific facts or representative of the views of ACC or any of its lawyers unless so stated. This InfoPAK is not intended as a definitive statement on the subject of the role of the in-house counsel but a resource that provides practical information for the reader.

This material was compiled by Steptoe and Johnson, LLP at the direction of Association of Corporate Counsel. For more information, please visit www.steptoe.com

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Effective Compliance and Ethics for the Small Law Department

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This InfoPAK[SM] is designed to provide corporate counsel with a general overview of the requirements of an effective ethics and compliance program under the Federal Sentencing Guidelines and to suggest useful strategies for the Small Legal Department for creating and maintaining such a program. This information should not be construed as legal advice or legal opinion on specific facts, or representative of the views of ACC or any of its lawyers, unless so stated. This is not intended as a definitive statement on the subject but a tool, providing practical information for the reader. We hope that you find this material useful. Thank you for contacting the Association of Corporate Counsel.

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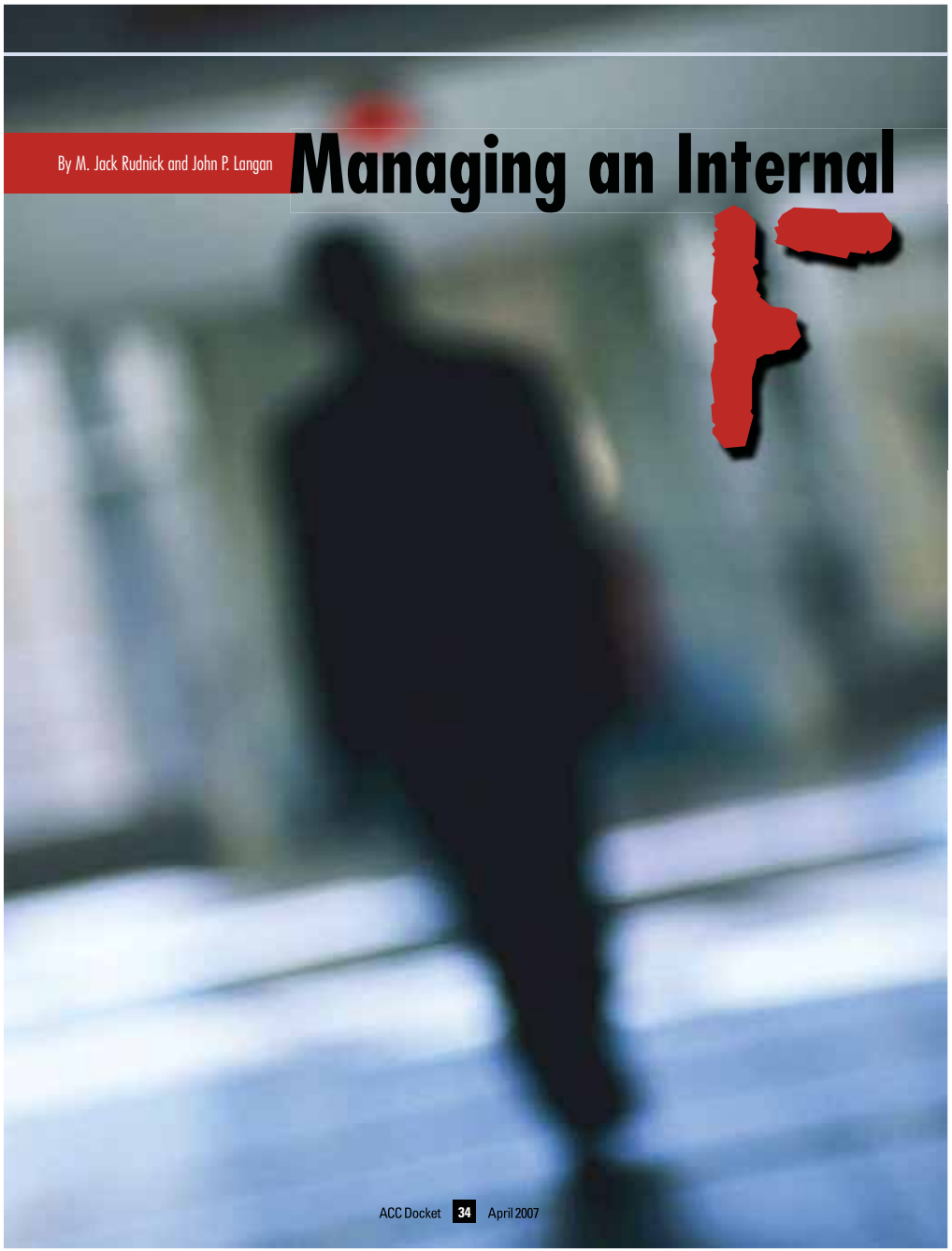

By M. Jack Rudnick and John P. Langan

Managing an Internal Corporate FRAUD Investigation and Prosecution

Routine reports of corporate malfeasance, jury verdicts against formerly untouchable senior officers, the emergence of a new cottage industry in corporate compliance—all spawned by the collapse of Enron and fueled by the enactment of Sarbanes-Oxley. The business of corporate fraud and white collar crime has risen to new heights.

Now more than ever, in-house counsel should know how to properly investigate and pursue internal allegations of fraud, theft, and corporate malfeasance. Otherwise, counsel may find themselves on the wrong end of the next audit committee inquiry, an inquiry focused not on the underlying problem, but on how in-house counsel responded to it. In this atmosphere of intense scrutiny, no one is safe from criticism.

The bad news is that lying, cheating, and stealing are as old as mankind, and fraudulent schemes come in many shapes and sizes. They are as creative as the sinister minds that dream them up. The good news is that, from an in-house counsel's perspective, the proper approach to investigating and handling such schemes is consistent and almost formulaic. This is true despite the fact that a surprisingly wide array of legal expertise comes into play when addressing corporate fraud: civil and criminal litigation; corporate governance and compliance; employment law; insurance coverage and recovery; corporate finance and regulation; and tax law, among other areas.

Aided by a hypothetical example,[1] this article spells out the steps in handling a case of theft or corporate malfeasance—from initial detection and internal investigation, to criminal and civil prosecution, through post-prosecution review of better controls and remedial safeguards. A few simple suggestions can help you avoid the common problems that arise in such cases and manage the matter in your position of responsibility.

Typical Fraud Scheme

Mark was doing well in his career. He was a valued and trusted senior officer of the company, having worked his way up the corporate ladder over two decades. He now enjoyed the title of senior vice president of finance of one of the company's most profitable divisions. Sure it was a lot of responsibility, but Mark liked his job.

The problem started when Mark caught up with a college buddy who was the CFO at a similarly sized company in the mid-west. His friend was making triple what Mark was making and with far less responsibility. It was just wrong! Mark made the added mistake of mentioning the discussion to his wife, Ashley. Admittedly, the timing was bad since Mark and Ashley had just agreed to forgo buying that great beach-front property from Ashley's parents, and college tuitions would start soon for his twin daughters. Just an extra $100,000 per year in income could make the difference between a comfortable existence and a stressful life.

It was with this thought that Mark went to work the next day. He started his daily business of overseeing the financial operations of the company. This included such complex projects as reviewing the finances of major merger targets, along with such mundane tasks as approving invoices for endless outside vendors used by the company. Boy, was the company spending a lot of money on outside accounting and law firms! And those rates for the top partners—yet another group of professionals making more money than Mark. That's when he got an idea.

How hard would it be to dummy up a few invoices from an approved, but infrequently used vendor, submit them for approval, intercept the processed check, and deposit it in an account opened using a fictitious corporate name? Who would notice, considering all the money the company spent last year? He would only do it once or twice, more as an experiment than anything else. Who would get hurt?

Ten years and $1.5 million later, Mark was now a highly paid senior officer, even without considering the tax-free nature of his "side" income. Colleges were paid for, he and Ashley owned a great condo in the Bahamas, and they had a nice stock portfolio for retirement. Yes, life was good until an accounts-payable clerk called the outside vendor about one of its recent invoices. It was an innocent inquiry, but the response from the vendor—that it had not performed services for the company in years—was unexpected.

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Initial Detection

Detecting Mark's scheme is the first step. The accounts-payable clerk had a few choices when she stumbled upon the suspicious information. She could have ignored it because rules enforcement was not a focus at the company. She could have shared the information with Mark, sensing that he was involved but not wanting to "get him in trouble." She could have been afraid to disclose the information based on the company's historical ambivalence toward corporate ethics or lip service to confidentiality protections surrounding the company's "anonymous" fraud hotline.

This is where written policies and procedures, and an effectively communicated compliance program, are necessary. Gone are the days that a company can rely on the auditors to detect wrongdoing. Companies must now establish a formal Code of Ethics/Conduct which is routinely updated and communicated to employees. The code should be formulated with the aid of outside employment counsel and emphasize the real protections afforded anyone who comes forward with information. An anonymous tip or hot line must be established and routinely published to employees, along with rules governing the confidentiality of the communication.

Also important are employment policies clearly stating that the company owns the communication systems used by the employee, including email and voicemail received and generated by employees. The policy should state that the company has the right in its sole discretion and without prior notice to monitor and review data composed, sent, or received through its computer systems, and that the monitoring activity may limit the level of privacy employees can expect.

A working and effective compliance program is also critical. Adopting systems for routine auditing, establishing mechanisms for reporting suspicious information, and creating a top-down atmosphere of strict ethical behavior so it becomes part of the company's core culture are all at the heart of a good compliance program. Such a program will help detect Mark's theft against the company at an early stage, or deter it all together based on an atmosphere of zero tolerance.

A good compliance program can be particularly important where the wrongdoing is not just a crime against the company, but one against the public at large. Change our hypothetical from Mark embezzling funds to a small group of employees, led by Mark, illegally removing and disposing of large amounts of asbestos from a portfolio of commercial properties owned by the company. Or perhaps a key financial officer of a public company discovers he or she has been responsible for misstating the company's earnings and then decides to cover the mistake to keep their job.

In either case, laws have been broken and government prosecutors will be interested in whether the crime is an isolated incident of a few, or part of the core culture of the company. The answer may impact the level of criminal liability facing the company, and even whether senior management is drawn into the investigation and criminal charges.

The *United States Sentencing Commission Guidelines Manual*,[2] in conjunction with the *Federal Sentencing Guidelines*,[3] set forth the elements of an effective corporate compliance program. Summarily stated they include:

- prevention and detection procedures;
- high level of oversight;
- due care in delegating substantial discretionary authority;
- company-wide training and communications with periodic updates;
- auditing, monitoring, and reporting including allowing for anonymity and confidentiality mechanisms;
- consistent enforcement; and
- response and prevention.[4]

The 2004 amendments to the *Guidelines* now include a list of modifications synchronizing them with *Sarbanes Oxley* and the emerging number of public and private regulatory requirements.

An effective program under the *Guidelines* will help the company mitigate any potential fine range, in some cases up to 95 percent, if there is also prompt reporting to the authorities and non-involvement of high level personnel in the actual offense.[5] It can also help investigators conclude that the conduct was isolated, and not caused by the company's senior management. At a minimum, suspicious information, such as the call about Mark, will be reported to the appropriate compliance officer and the wrongdoing detected early.

In our hypothetical story, suspicions about Mark have been reported using the anonymous "hotline." Proper controls are in place for in-house counsel to monitor credible reports from the hotline. The information has been reviewed by in-house counsel, a few calls made, and internal financial records reviewed. It appears clear, at least initially and before talking with others within the company, that a stream of payments approved by Mark were never received by the vendor. Now what? The next few moves will be critical in conducting a proper and effective investigation.

The Investigation

The team investigating the situation should be carefully selected, usually a senior auditor at the company, someone from corporate security, in-house counsel, and other trusted individuals. They should have no conflict of interest (such as persons reporting to Mark might have) that could in any way impact their neutrality or judgment. They will gather documents and evidence, interview employees and perhaps outside vendors, and pursue all leads to determine the extent of the wrongdoing.

It is important that the investigatory team starts with an open mind, and not let preconceived notions of what the facts might be dictate the conclusions reached. Memoranda generated should avoid using the term "fraud," "theft," "cover up," "incompetency," or other conclusory terms, and files should be labeled using similarly neutral language. Investigative team members should be reminded that they are "writing for publication" so they should avoid vindictive remarks or other personal commentary and record just the facts. Final conclusions should not be expressed until after the suspected employee's response to the charges has been obtained and evaluated.

The investigating team must keep in mind at all times that civil litigation, and perhaps a criminal referral, will follow almost inevitably from the work they do. Investigative findings, comments and opinions about mistakes made by the company, theories of wrongdoing that do not pan out, and suspicions against employees that are never substantiated—a more sensitive group of documents can hardly be imagined. Therefore, all reasonable steps should be made to maximize the privilege protections of this information.

In that regard, it is imperative that the company document at the outset that the investigation is being launched and overseen at counsel's direction. All subsequent requests for action should come from a lawyer in writing to maximize the protections afforded. In this way, counsel can oversee the investigation while also watching out for the broader interests of the company.

The company should consider directing the investigation through *outside* counsel to avoid any confusion over the multiple roles often played by in-house counsel. Investigative material, including opinions and conclusions reached by the team, must be labeled as privileged, and separate files should be maintained to segregate the privileged material.

Although the initial information from a routine audit or an anonymous tip is not likely afforded privilege or protection under the work-product doctrine (because it was not gathered at the behest of an attorney or because litigation is pending), subsequent information may be protected

> If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all.

from discovery if any future investigation is properly handled.[6] The courts will look to the level of involvement of the attorney in directing the investigation or audit.

How likely is it, really, that the facts of the case and statements can be protected from disclosure in subsequent civil litigation? The work-product doctrine generally protects only mental impressions, conclusions, opinions, or legal theories of an attorney.[7] Thus, purely facts or statements, regardless of whether an attorney collected them, are usually not afforded protection under the work-product doctrine.

The facts, however, may be protected under the attorney-client privilege. To assist in thwarting later legal challenges, counsel overseeing the investigation should make every effort to create a paper trail showing that the reports and/or facts derived from the investigation were created:

- for the purpose of securing legal advice;
- by an employee who was acting at the direction of a supervisor;
- at the direction of a supervisor who sought the information to obtain legal advice for the corporation;
- within the scope of the reporting employee's corporate duties; and
- solely for the eyes of those persons within the corporate structure who need to know the information.[8]

Confronting the Suspected Employee

Confrontation of the employee needs to be carefully planned, witnessed, and documented. It should occur at the end of the investigation when all other available facts are gathered. At the interview, the employee's response or "story," including any admissions or concessions, must be documented. This may involve asking the employee to sign a written statement with the account provided. Depending on how the situation develops, this evidence can prove invaluable in later civil or criminal proceedings. It can also prove useful in defending against later complaints of the employment action taken by the company.

Using investigatory resources to learn background information about the suspected employee prior to the interview is an effective tool that should be used cautiously. If there is a legitimate, non-discriminatory basis for personal background investigation (*i.e.*, asset and real property search, court records, etc.) because the company has a good faith basis to believe the employee has engaged in criminal conduct and the investigation will further help determine whether the suspicions are true, then proceeding with the investigation may be warranted. Watch for particular state privacy laws and provisions of the *Fair Credit Reporting Act*[9] to ensure you do not run afoul of existing law. Use good judgment as to whether investigative tactics (including those of third parties hired by you) are appropriate. If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all. Make sure to tailor the information sought to a legitimate business purpose in furtherance of the investigation; don't go on a fishing expedition.

If the employee raises new information in the interview that requires further investigation, but the company is concerned about retaining the employee in active status, he or she can be suspended with or without pay pending completion of the investigation. If the employee refuses to cooperate with the investigation, he or she should be reminded that cooperation is an essential function of the job and a failure to cooperate may provide an independent basis for discipline, including termination. Carefully drafted Codes of Conduct or implementing policies will specifically address this issue so the independent basis for action will be clear. Similarly, they will make it clear that retaliation against any other company employee participating in the investigation is strictly prohibited and will serve as an independent basis for action.

When should company counsel advise Mark that he should consult with private counsel? While this is an issue on which in-house counsel may differ, our perspective is not until the confrontational interview has been held. Until that point, it may be argued that the company does not yet have the employee's side of the story, so a final determination of culpability has not yet been reached. Once the employee has answered questions, given his statement responding to the charges, and provided whatever other information that may prove useful to the investigation, it may well be in the company's interest to have the employee engage experienced counsel. Care should be taken, however, to make it clear to the employee that counsel interviewing him/her are counsel to the corporation and not the employee by providing the employee with the "corporate Miranda."[10]

One factor in deciding how to approach the employee will be whether the company needs him or her to address the wrongdoing going forward—such as when a key financial officer is in a unique position to reconstruct the misstated earnings in past financial reports. Will cooperation be forced or voluntary? How badly does the company need the targeted employee's help to further investigate the extent of the fraud or correct the damage? Is the employee at the center of the scheme or a lesser player? These questions must be addressed in formulating your approach.

Action Based on Investigative Findings

Your investigation is complete, you have confronted the employee, obtained whatever helpful information may be gleaned from the employee, and the investigative team has reached the conclusion that fraud has been committed. Once the company has confirmed that wrongful conduct has occurred, action must be taken.

Options for handling the employee include disciplinary action short of termination, suspension with or without pay, or termination. Before communicating the decision to the employee, make sure that an experienced employment lawyer reviews the basis for it. The company must be able to comfortably articulate a non-discriminatory business reason for the decision—preferably something that the average person would understand and accept as reasonable.

The decision and the basis for it should also be communicated to company officers, the board, the audit committee, and any key supervisors. Throughout the investigation, be prepared for an emotional reaction from the company's senior officers or board—anger, frustration, or even an irrational demand for a course of action that is not in the best interests of the company. In-house counsel must manage these issues carefully so that cooler heads prevail.

Until now, things have been handled with great confidentiality. But news of the employee discipline or termination cannot be contained and the company is wise to consider the nature of any response to the natural questions that arise. At this point, the company must decide how to handle the public relations aspect of the situation, at least internally. A consistent message must be formulated and used by management.

Insurance Coverage

In the midst of handling a fast moving internal investigation, containing the information within the company, and absorbing the emotional body-blow of learning that one of your own is a thief or liar, it may be easy to forget the steps needed to preserve the company's insurance rights. After all, this is not a slip and fall claim which would naturally trigger in-house counsel's focus on insurance. The company's risk manager may not even be part of the investigative team. Failing to take proper action relative to insurance can be a costly mistake, one the second-guessers will seize upon to lay blame when the dust has settled.

So when do you act and what do you do? It depends on the language of your policy and outside coverage counsel should be consulted. Generally speaking, the answer is:

> When you know of circumstances that could form the basis for a company loss, in-house counsel should promptly notify the company's risk manager and all brokers handling the company's insurance and bonding policies.

Counsel must follow up with these brokers or directly with the carriers to insist upon *written confirmation* that the necessary parties have received proper notice.

A typical error is trying to determine which policies might provide coverage and narrowing your list of parties to be notified. With the complexity of insurance coverage these days, this is a mistake. Insurance policies that may be triggered include the company's general liability policy, commercial crime/fidelity policy, commercial property policy, and perhaps even an employee fidelity bond. The usual insurance policy conditions to keep in mind include:

- the requirement that the insured provide timely notice of the incident;

ACC Extras on…Employee Law, Embezzlement, and Fraud

- *Internal Fraud: Weeding out the Enemy*
  - Practical Law Article—International Resource
  www.acc.com/resource/v4649
- Indicia of Corporate Fraud
  - This **quick reference** includes a list of pointers to consider when dealing with internal fraud concerns.
  www.acc.com/resource/v3685
- *Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud*
  - This *ACC Docket* article covers 10 red flags you need to be aware of when on the lookout for financial mismanagement and corporate fraud.
  www.acc.com/resource/v7714

- the insured's obligation to provide a high enough level of cooperation with respect to the insurer's investigation; and
- the requirement that the insured should avoid committing any act which could prejudice the insurer's ability to subrogate the claims against the culpable parties. Exclusions often seen are claims for fines, sanctions, and penalties, and also claims arising out of any dishonest, fraudulent, criminal or malicious act, or omission of an insured.

As discussed later in this article, the company at an early stage will have already engaged its own outside counsel to investigate the fraud and perhaps commence a civil action against the wrongdoers. This may well be at odds with insurance policy language, which gives the carrier input or even control over the selection of counsel to pursue the loss. The problem arises because the normal insurance loss involves a past event impacting a simple monetary claim that can be quantified and assessed.

But allegations of internal malfeasance are different. First, the company does not usually know whether it has suffered a loss, or the extent of the loss, until a thorough investigation has taken place—an investigation that for a wide array of reasons should occur under the watchful eye of the company's hand-picked outside counsel. Second, investigation of the claim is fast-moving and complex, it is not conducive to the delays associated with insurance carrier dealings, nor is it of a nature to be handled by a panel counsel insurance defense lawyer. And lastly, there is more at stake in an internal fraud situation than the actual monetary loss—company exposure to allegations of criminal wrongdoing, government compliance obligations, internal employment and HR issues, public image, and business risk issues, etc.

It is for these reasons that we advise companies to select and move forward with the outside counsel of their choice with respect to conducting the investigation, and address later any complaints of insurance carriers over what attorney was selected. We acknowledge that a dispute over the selection can arise with the carrier but, in our experience, rarely does if counsel is selected with experience in such matters.

Indeed, in cases where an insurance claim has been paid and the loss subrogated, we have never seen a carrier reject the continued retention of the original counsel selected by the company (normally a firm that has been involved for months in developing the complex facts and evidence supporting the claim). So long as the company is providing a sufficient level of cooperation and communication with its insurers, the issue can usually be resolved on an amicable basis.

Civil Litigation

At the core of most employee theft cases are common law claims for fraud, conversion, breach of fiduciary duty, as well as statutory violations such as racketeering. Obviously, maximizing the likelihood of recovering at least some of the stolen property or locating other assets to be seized is at the heart of this strategy. But early litigation also provides a mechanism for obtaining provisional remedies such as temporary restraining notices, orders of attachment, or accelerated motions for other preliminary injunctive relief. Assets can be frozen and important evidence preserved.

Indeed, a number of benefits can drive the company toward litigation as a necessary strategy. For better or worse—in cases of this type—message-sending plays a role in the process. Mark has stolen seven figures from the company and everyone is watching to see how it is handled: Anything less than an aggressive response can be viewed as weakness and an invitation for future trouble.

And then there are the criminal authorities to consider. How significant was the criminal wrongdoing later referred to the government if it was not sufficient to warrant a civil action? The investigators and prosecutors want to know that the company takes these matters seriously. The presence of a timely and aggressive civil action helps to answer any doubt in this regard.

Others are watching, too. The board, audit committee, and shareholders are looking to ensure that the company does everything within its power to recover stolen corporate property or right other wrongs. Among them are the company's insurance carriers which may later seek to pay a claim of loss and subrogate in the civil action. Those involved in that decision and later civil prosecution want to know that their insured was diligent in taking appropriate action. These are among the many considerations in commencing a civil action.

As the case proceeds, the company may well face the question of whether to settle with one individual and "flip" them to secure valuable testimony against another involved in the wrongful conduct. This strategy almost always comes into play. The question of when, with whom, and under what circumstances should the company agree to settle their claims with one wrongdoer is dependent on the circumstances presented.

No doubt, the company has much to offer in terms of avoiding protracted civil litigation, and the cooperator has something of value in return, since proving fraud presents a host of challenges and direct testimony of the scheme can be very helpful. This is where the defendant's selection of experienced criminal or civil counsel will help negotiations and a sensible resolution. Less experienced

Gone are the days that a company can rely on the auditors to detect **wrongdoing.** Companies must now establish a **formal Code of Ethics/Conduct** which is **routinely updated** and communicated to employees.

counsel often cannot see the "end game" and the larger problems facing his or her client.

At some point toward the end of the civil case, the company will be forced to answer the question of what it needs to settle the claims. Interestingly, the answer to this question is almost always the same. The common elements to any settlement involving claims of employee fraud and wrongdoing are:

- admission and contrition;
- confirmation of scope of wrongdoing;
- compensation, symbolic or otherwise;
- cooperation in pursuit of other wrongdoers; and
- conditional release with protections for later default.

Disclosure of Scope

Part of the purpose of the lawsuit is to use discovery to confirm the extent of the wrongdoing. This element of settlement can be among the most important to obtain. If the company is not satisfied they have received it, settlement discussions should break off. The company simply must know the extent of the scheme and that the actions being taken will fully address it: Any suggestion that some of the cancer remains should be unacceptable to the company and its counsel.

Of course, criminal prosecution cannot be threatened as a means to settling a civil claim.[11] If the company has elected not to pursue criminal charges, the parties can proceed right to the interview. But if a criminal investigation is pending, how can the company obtain the type of candid disclosure mentioned above without appearing to be leveraging one action against the other? The answer is timing. The settlement of the civil action can be conditioned on the disclosure and interview needed.

A deal can be struck while the criminal case is pending that an interview will follow once Mark's criminal liability has been addressed. With a criminal case pending, the settlement agreement can provide that a failure to participate fully in the interview will revive the civil claims and trigger large financial penalties. Part of Mark's motive will be to appear cooperative with the company to the criminal authorities.

How can you know if the disclosure is complete and accurate? First, by the time the interview is held, your investigating team should have a very good understanding of what happened. Witnesses should have been interviewed, documents collected, witness statements taken. Whether the story Mark tells "rings true" and is consistent with the other evidence is the first way to check the disclosure. The second is, where legally permissible, by use of a lie detector test, which, by and large, is remarkably effective in confirming the information.

Make sure to select a reputable examiner, preferably someone who the government authorities rely upon. An excellent website is maintained by the American Polygraph Association (APA),[12] which allows for a database search of members by geographical area. According to the APA, "a valid examination requires a combination of a properly trained examiner, a polygraph instrument that records as a minimum cardiovascular, respiratory, and electrodermal activity, and the proper administration of an accepted testing procedure and scoring system." Some states have an official licensing procedure but many do not.[13]

Mark's criminal or civil counsel may wish to weigh in. The better examiners are known and respected by the criminal defense bar, so selecting an expert should not be difficult. Again, timing can address the issue of coordinating the examination with resolution of the criminal case so that Mark is comfortable answering questions. The civil settlement should provide that a failure to properly pass the test unwinds the settlement and leaves the company able to pursue its civil remedies.

One final thought regarding lie detector tests: The company should avoid the temptation to rely on them to investigate the charges. Use the test solely for securing compliance with the terms of settlement. This is because *The Employee Polygraph Protection Act* of 1988 (EPPA)[14], forbids adverse employment action against an employee refusing to take the test. Asking the targeted employee to take an exam will restrict the company's ability to terminate him later without opening the door for counter charges that the lie detector results played a role in the decision.[15]

Usually the **resolution of the civil action** occurs in pieces, with one of the wrongdoers **flipping early** and others continuing to litigate.

Compensation

The ultimate sum settling the civil claims is a function of:

- the amount stolen;
- the impact of the theft on the company;
- the level of culpability of the wrongdoer;
- the total financial net worth of the employee and his or her spouse; and
- a cold assessment of what assets are subject to judgment execution in the civil action.

The settlement amount is, to some extent, a symbolic figure designed to punish as much as anything else. Of course, if the loss has been paid by the carrier and the claim subrogated, the carrier will be involved in fixing or at least accepting the settlement sum.

Cooperation

Usually the resolution of the civil action occurs in pieces, with one of the wrongdoers flipping early and others continuing to litigate. Perhaps Mark was working with someone at the outside vendor's accounting group and they were sharing the ill-gotten gains. No matter, an important element in settling claims with the first party who flips is that they will cooperate fully in any existing or future civil litigation.

In order to minimize the bias arguments that will inevitably arise in later litigation, counsel is wise to secure a comprehensive sworn statement of facts which establish and preserve key testimony of the cooperating party as part of the civil settlement. Cooperation means participating in the civil action willingly and honestly, not fabricating testimony just to be helpful to the company.

Conditional Release

The release given in the civil settlement must be conditioned upon the promises and representations by the employee discussed earlier (*i.e.*, passing the lie detector test, honest disclosure of scope, accurate personal financial disclosure, and cooperation with subsequent investigation and post mortem review). Default in meeting any of these obligations should include the right to unwind the settlement even if the claims would otherwise be time barred. They should also carry with them the right to some additional financial penalties to further ensure compliance.

As discussed in this article, a civil settlement has many moving parts and may appear more complicated than it is. Settlements of this type are almost formulaic in that companies always want the same things and the points of leverage are the same against the offending parties. An outside counsel with experience in this area will have the necessary sample documents as you frame your approach.

Government Notification and Referral

There is some debate as to whether a company has an affirmative duty to report internal criminal activity of its employees if the conduct does not violate other laws or regulations governing the company.[16] The comment to ABA Model Rules of Professional Conduct Rule 8.3 suggests that attorneys should "encourage a client to consent to disclosure where the prosecution would not substantially prejudice the client's interests." State laws may demand reporting, and a wide array of regulations governing a company's operations may mandate it as well.

There is, of course, risk whenever the government is contacted about internal company activity. Government investigators and prosecutors are not prone to taking direction from in-house counsel or anyone for that matter. An innocent referral can lead anywhere, including to the prosecution of company employees or vendors not originally considered part of the wrongdoing. And of course, it can lead to the company itself becoming the subject of an investigation. These issues must be carefully addressed before the referral is made and other regulatory agencies are notified.

For these reasons, part of counsel's ongoing assessment is to look at the fraudulent activity from an outsider's perspective—asking whether there are other victims of the criminal activity besides the company and/or whether there are other regulations violated. What if Mark's dummied invoices were from an environmental testing firm that was charged with ensuring that toxic material was properly handled? Years of forged invoices were generated while Mark was supposed to make sure that proper testing and disposal occurred. Now the company has two issues to investigate—how much did Mark steal and was the testing performed?

Even if the company has concluded that the work was performed, the criminal referral will raise this same question and the government will want it answered to its satisfaction. The company must consider notifying relevant government agencies in a manner that assures regulators that the situation is being handled responsibly. It is a delicate moment because the company cannot control the regulators' reactions. But ignoring the situation should not be among the options considered because it is a sure way to create suspicion and a negative reaction down the road.

On the question of timing, there is built in flexibility which allows the company to investigate the allegations first, before making a determination that criminal wrongdoing or regulatory violations have occurred. The last thing the company wants is to accuse an employee of a crime only to find later that it was wrong or it could not prove the charges (exposing the company to retaliatory claims of defamation, unfair employment action, or malicious prosecution). The investigation period gives the company time to take stock and make some strategic decisions about whether making a referral is warranted or desirable.

There can be a fair amount of strategy in making a successful referral including evaluating whether one is warranted, addressing issues of selecting the prosecuting agency, addressing which regulatory bodies should be notified and in what manner, deciding when to make the referral, determining the key point of communication for the company, and setting the tone for the aggressiveness of the referral as a victim of the crime.

In making a referral, counsel must be prepared for a complete and unrestricted look at evidence gathered from the investigation. This is so because asserting any claim to privilege, while well within the company's rights, will be viewed as uncooperative. The US Sentencing Commission voted in March 2006 to eliminate the language from the Federal Sentencing Guidelines that required corporations to waive the attorney-client privilege if they wanted to earn credit for cooperation. Even with this change, however, companies should be prepared for the government's assumption that the privilege will be waived and the prosecutor's negative reaction if it is not. The last thing the company wants is to raise questions in the government's mind as to its own level of cooperation and involvement in the wrongdoing.

Properly managed, a criminal referral will minimize the chance that the government will blame the company for the acts committed while also establishing a solid working relationship with the investigators and prosecutors. A strong relationship is marked by mutual cooperation and respect, a level of trust that the company is being forthright in disclosing information and addressing the situation, a diligent pursuit of the investigation and prosecution, at least periodic communication, and keeping a balanced perspective in terms of other priorities of the prosecutor's office and the company.

Admission and Contrition

It may sound trite, but after all the time, trouble, expense, and public embarrassment of addressing internal fraud and theft, companies often times insist on obtaining a formal admission of wrongdoing and an "I'm sorry" from the employees. With the amount of leverage involved, this element of settlement normally can be achieved rather easily. People in Mark's position usually have little bargaining position.

In most cases, the criminal authorities can be substantially aided in their investigation by the work already done by the company's existing legal team—particularly when the fraud is complex and document-intensive. Sharing information is an inevitable part of the cooperative relationship. The company must assume that information provided to the government will be later shared with the employee's criminal defense counsel, if it falls under Federal Rule 16 or constitutes *Brady* material.[17]

As discussed before, relevant fact-based records may be the subject of disclosure requests in later civil litigation. But the more sensitive documents to consider are the investigative reports which may be generated by the company's internal team or referral memorandum provided to the government which lays out the company's findings. Both documents are likely to contain opinions and conclusions, along with other potentially sensitive information such as lie detector test results and evidence which is critical of the company in allowing the malfeasance to occur. The company should review and consider the content of these documents before finalizing them for government review.

While the "defensive" thinking discussed above is part of making an appropriate referral, counsel should remember the numerous positive advantages of triggering a prosecution against the offending employee. On the plus side, the presence of a parallel criminal prosecution when pursuing civil claims is obvious. The civil case may be temporarily delayed or even stayed by the criminal case, but the resulting conviction can provide invaluable support in pursuing the civil action.

Many times, the elements of the crime admitted or forming the basis for the conviction are the same as in the civil litigation, giving the civil team irrefutable admissions

or even collateral estoppel/issue preclusion impact on key elements in the civil case. Huge savings in time and money can be achieved in letting the criminal case play out on a parallel course with the civil case.

At minimum, pressing the civil action during the prosecution of a criminal case can give rise to Fifth Amendment testimonial assertions which, in turn, generate valuable negative inferences in the civil action. An unrebutted negative inference can, under appropriate circumstances, provide strong evidence supporting a dispositive motion and an accelerated victory in the civil action.[18]

And of course, a pending criminal prosecution presents the opportunity to avoid the need for any civil litigation at all, when a monetary recovery is secured by way of restitution in the criminal case. The opportunity to avoid protracted and embarrassing civil litigation against the offending employee by obtaining a comprehensive Judgment of Restitution in the criminal case is no doubt appealing.

Setting aside these home-run impacts, the advantages of the company drafting behind a criminal investigation—with its much larger breadth and jurisdictional reach—is clear. Voluntary witness interviews, grand jury subpoenas, and the full weight of a state or federal prosecutor's office behind an investigation can help gather evidence at a speed and in a manner that cannot compare with the discovery mechanisms available in civil litigation.

Deciding where to refer the criminal complaint in terms of government agency depends on a number of factors including the nature and proof of the wrongdoing. In addition to the cold assessment of what state or federal laws have been broken, other considerations come into play including:

- jurisdictional reach of the prosecuting office;
- resource availability of that office;
- strength and reputation of the office in pursuing complex white collar cases; and
- the relationship the company and its outside counsel enjoy with the offices under consideration.

In making the referral, it is important to establish a clear and single line of communication between the company and the government. The best contact point is the lead company counsel overseeing the internal investigation, since it allows for the regular oversight of questions posed by the government, assurance that complete and accurate information is provided, and the ability to monitor the direction and scope of the investigation from a more objective vantage point.

The last point is one of timing and controlling information. On the theory that some control is lost once a government investigation is triggered, in-house counsel are well served to know as much as they possibly can before making the referral, first completing the entire investigation before referring the matter to those outside the company. Most investigations of this type—involving claims of employee theft or fraud—are conducted as a high priority item that is expeditiously handled by the internal investigative team.

As the investigation proceeds, in-house counsel should assume that the corporate rumor mill will eventually pick up that something is going on. The challenge is to conduct a complete investigation before filing charges of criminal wrongdoing, while not waiting so long that valuable evidence is lost or the company becomes the subject of criticism for not making a timely referral. Daily assessment of these competing goals must occur, with outside counsel assisting the senior decision-making team in terms of when to contact the authorities.

Remedial Steps—Can it Happen Again?

Typically, a company has spent six figures in detecting, investigating, pursuing, and fully addressing the wrongdoing. The matter has gone on for months, if not years, and there is enough embarrassment to go around. It is natural to want to close the case and move on. But counsel is well-advised to conduct a complete post-mortem of the events leading to the fraud.

The company's board and shareholders, the audit committee, corporate security, and the company's outside insurance carriers, among others, have a vested interest in understanding how Mark's scheme was able to be formulated and successfully carried out. What improvements can be made to avoid it ever happening again?

This is where securing Mark's post-resolution cooperation can be particularly helpful. If the criminal case ends in some form of plea deal and a good working relationship has been established with the prosecuting authorities, the company can often secure this type of interview as part of the restitution package. As discussed earlier, such a meeting should certainly be negotiated as part of any civil settlement.

And who better to advise you regarding what controls need adjustment than Mark, the person who found a way around them? This meeting should be held after all other aspects of the case have been resolved so that Mark feels comfortable speaking freely. Often, someone in Mark's position is relieved to talk frankly outside the criminal and civil proceedings.

Take advantage of the opportunity presented for real candor to get the most from the interview. Prepare your outline of questions so that you understand every step of the scheme, what controls were compromised, and how the fraud was successfully perpetrated.

Once you have a full understanding of what happened, ask Mark what would have stopped him and what suggestions he has for improving controls. There is often a twisted pride in the accomplished theft and a desire of the wrongdoer to tell his secrets. Take advantage of it. Of course, others in accounting, operations, human resources, and elsewhere can be helpful in developing a short list of improvements to the company's internal controls.

Minimizing Risk Through Prudent Corporate Governance

Much can be learned from managing an internal fraud investigation and prosecution, as painful as such an experience can be. New controls and procedures can be identified, adopted, or improved upon. Lessons can be learned that can substantially improve the operations of a business.

In any organization, however, the human factor makes corruption a risk at any level—a risk that can never be fully eliminated. Because the complex machine of corporate decision-making ultimately boils down to people, there are no controls or safeguards that can 100 percent assure protection against greed. The best minds behind formulating new controls and firewalls can always be outsmarted by the criminal imagination.

The best we can do is minimize the risk through prudent corporate governance and operations, and be ready to take appropriate action when wrongdoing is suspected.

Have a comment on this article? Email editorinchief@acc.com.

Notes

1. The "story" described below is a fictional account; however, it is loosely based on the post-conviction explanation of a senior corporate officer for his seven-figure embezzlement scheme carried out over a ten-year period.
2. Available at: *www.ussc.gov/2005guid/gl2005.pdf*.
3. 18 U.S.C. § 3553.
4. *See* United States Sentencing Commission Guidelines Manual, § 8B2.1 *et seq*. (2005), available at: *www.ussc.gov/2005guid/gl2005.pdf*.
5. *See www.ussc.gov/corp/ORGOVERVIEW.pdf*.
6. *See First Chicago Int'l v. United Exchange Co. Ltd.*, 125 F.R.D. 55 (S.D.N.Y. 1989).
7. *See* Fed. R. Civ. P. Rule 26(b)(3) (2006) and your respective state's statute.
8. *Diversified Industries, Inc. v. Meredith,* 572 F.2d 596, 609 (8th Cir. 1977); *see, e.g., First Chicago*, 125 F.R.D. 55; *see, e.g., Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487 (7th Cir. 1970). Every precaution should be made to adhere to these points, especially the last one because dissemination of the information to a third-party with no need to know the information may constitute a waiver of the privilege.
9. 15 U.S.C. § 1681 et seq.
10. *See* Model Rules of Profl Conduct R 1.13(a); see also *www.law.cornell.edu/ethics/comparative/index.htm#1.13*, for a comparison of each state's rule. To prevent ethical violations and/or disqualification from representing the corporation, before interviewing an employee, "Miranda" style warning should be set forth to the employee. The lawyer should ensure that the employee is fully aware of and understands the following vital points: that the lawyer does not represent the employee; that the employee's statements may not be privileged, especially when they relate to the organization's business; and that the employee is advised to obtain independent counsel.
11. *See e.g.*, Model Rules of Profl Conduct R. 8.4 (2004); *see also www.law.cornell.edu/ethics/comparative/index.htm#8.4*, for a comparison of each state's rule.
12. Available at: *www.polygraph.org.*
13. For a list of licensing offices, see *www.polygraph.org/statelicensing.htm*.
14. 29 U.S.C. § 2001 *et seq*.
15. For a brief summary outlining the "checklist" for both employers and polygraph administrators *see www.polygraph.org/eppa.htm*.
16. *See, e.g.,* 18 U.S.C. § 4 (Misprision of Felony statute); *Shehorn v. Daiwa Bank, Ltd.*, No. 96 C 1110, 1996 U.S. Dist. LEXIS 7905 (N.D. Ill. 1996) (applying 18 U.S.C. § 4 to corporations).
17. *See* Fed. R. Civ. P. Rule 16 (governing pretrial conferences, scheduling and case management); *see also Brady v. Maryland*, 373 U.S. 83, 83 S. Ct. 1194 (1963). In a criminal proceeding, evidence in possession of the government material to either guilt or punishment of the accused is deemed "Brady material." Any evidence that can be designated as such must be turned over to the accused in accordance with the Due Process Clause of the U.S. Constitution. While viewed by some as a broad form of additional discovery for the criminal defendant, it is actually just a narrow way in which an accused can obtain information bearing only on his guilt or sentencing.
18. *Securities and Exchange Commission v. Global Telecom Services, L.L.C.*, 325 F. Supp. 2d 94 (D.C. Conn. 2004); *see also, Willingham v. County of Albany*, No. 04-CV-369 (DRH), 2006 U.S. Dist. LEXIS 46941 (N.D.N.Y. July 12, 2006).

FRASER MILNER CASGRAIN LLP

To: Participants of "Staying One Step Ahead: Important Considerations for Corporate Counsel"

Date: October 18, 2005

Subject: Ethical Issues and Challenges for In-House Counsel

MEMORANDUM

In-house counsel face a number of ethical issues and challenges unique to their practice. In this memorandum, we discuss some of the ethical duties and obligations owed by a solicitor to his client in light of the Law Society of Upper Canada's Rules of Professional Conduct as well as recent Canadian and American decisions. In particular, this memorandum provides an overview of the principles of the duty of confidentiality, the duty of loyalty and the rule of solicitor-client privilege, specifically focusing on the challenges in-house counsel face in fulfilling these duties and obligations.

PART I: The Lawyer's Duty of Confidentiality and Loyalty

I. The Rule of Confidentiality

The lawyer's duty of confidentiality is an ethical rule that covers a wide range of communications between solicitor and client. Rule 2.03 of the Rules of Professional Conduct[1] describes the responsibility of lawyers with respect to confidential information:

> A lawyer at all times shall hold in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship and shall not divulge any such information unless expressly or impliedly authorized by the client or required by law to do so.

A lawyer owes a duty of confidentiality to all of his clients, regardless of any differences that may arise between them. As it is a wide-ranging duty,[2] a lawyer should not even disclose having been retained[3] or even consulted by an individual.[4]

[1] LSUC, Rules of Professional Conduct, Rule 2.03.
[2] *Ibid.*
[3] Note that some circumstances may require disclosure of the fact that the lawyer has been retained. For example, matters that are being litigated before the courts will normally involve disclosure of some information.
[4] Note that the wide-ranging nature of the duty means that the lawyer has the obligation even with respect to someone who has not retained his/her services. Therefore, the "phantom client" who calls the office for an initial consultation is still entitled to have the communications kept confidential.

II. The Underlying Principle of the Duty of Confidentiality

The duty of confidentiality encourages clients to seek legal advice[5]. Clients need to feel comfortable disclosing information and must be confident that discussions will remain confidential[6]. Further, in order for a lawyer to competently advise a client(s), the lawyer must be certain that all necessary information is disclosed. Particularly relevant in the context of in-house counsel, it has been said that:

> The policy goal behind the duty of confidentiality is to ensure that the lawyer is fully informed by the client on all relevant facts so that the lawyer can properly advise the client, including understanding any improper conduct so that the lawyer can advise the client against it or to take steps to mitigate against it.[7]

If in-house counsel is to provide legal advice to the client organization, that lawyer must be in a position to advise the client of any legal or professional concerns in relation to a proposed course of action. Therefore when approaching in-house counsel for advice, an organization's representatives will want to be sure that the lawyer is someone who can be trusted. Without the principle of confidentiality, an organization's representatives may unwittingly engage in a potentially illegal business transaction without fully understanding the legal implications, as a result of a reluctance to consult counsel for fear that confidential information may be made public.

III. Exceptions to the Rule of Confidentiality

A lawyer is permitted to disclose confidential information under certain circumstances. The Rules of Professional Conduct provide for justified or permitted disclosure:[8]

(a) When required by law or by order of a tribunal of competent jurisdiction, a lawyer shall disclose confidential information, but the lawyer shall not disclose more information than is required.

(b) Where a lawyer believes upon reasonable grounds that there is an imminent risk to an identifiable person or group of death or serious bodily harm, including serious psychological harm that substantially interferes with health or well-being, the lawyer may disclose, pursuant to judicial order where practicable, confidential information where it is necessary to do so in order to prevent the death or harm, but shall not disclose more information than is required.

[5] R. Scott Jolliffe, Gowling Lafleur Henderson, LLP, "Trusted Advisor or Whistleblower: Lawyer's New Rules on "Up the Ladder" Reporting," at 1, available at http://www.ethicscentre.ca/html/jolliffe.doc.
[6] Gavin MacKenzie, Lawyers and Ethics: Professional Responsibility and Discipline, Toronto: Carswell, 2003, 3-2.
[7] Anna K. Fung, Q.C., CCCA 17th Annual Meeting, August 14, 2005, Vancouver, B.C. Workshop #203 – Corporate Counsel Ethics.
[8] *Supra* note 1, Rule 2.03(2)-(5).

(c) Where it is alleged that a lawyer or the lawyer's associates or employees are:

(i) guilty of a criminal offence involving a client's affairs;

(ii) civilly liable with respect to a matter involving a client's affairs; or

(iii) guilty of malpractice or misconduct,

a lawyer may disclose confidential information in order to defend against the allegations, but the lawyer shall not disclose more information than is required.

(d) A lawyer may disclose confidential information in order to establish or collect the lawyer's fees, but the lawyer shall not disclose more information than is required.

The most common circumstance permitting disclosure of confidential information is where a client has consented to disclosure either expressly or impliedly. The Commentary to Rule 2.03 of the Rules of Professional Conduct indicates that a client's consent to disclosure may be implied under certain circumstances. For example, in order for a lawyer to work on a client's file, it may be necessary to delegate certain tasks to support staff, thereby disclosing some of the information that was provided to the lawyer. In such circumstances, it is generally a good idea that the lawyer make the fact clear to the client that others in the firm will be working on the file, and to ensure that staff members are aware of the confidential nature of the information being disclosed to them.

IV. The Duty of Loyalty

The duty of loyalty, as it pertains to the solicitor-client relationship, was considered by the Supreme Court of Canada in *R. v. Neil*[9]. In that case, the Court stated that in order for clients to have confidence in the legal system, lawyers must be:

> free from conflicting interests. Loyalty, in that sense, promotes effective representation, on which the problem-solving capability of an adversarial system rests.[10]

Loyalty, like confidentiality, is essential to the solicitor-client relationship. The Court points out that the duty of loyalty is "intertwined with the fiduciary nature of the lawyer-client relationship[11]." A lawyer is required to act in the best interests of his client and to avoid conflicts of interest, either with himself or with other clients. The lawyer is expected to be

[9] [2002] 3 S.C.R. 631.
[10] *Ibid* at para. 13.
[11] *Ibid* at para. 16.

committed to the client's cause and to demonstrate "zealous representation." In addition, the lawyer owes the client a duty of candour[12].

The above requirements constitute the various aspects of the duty of loyalty. They exist because:

> A solicitor must be able to provide his client with complete and undivided loyalty, dedication, full disclosure, and good faith, all of which may be jeopardized if more than one interest is represented.[13]

V. The Application of the the Duty of Confidentiality and the Duty of Loyalty to In-House Counsel

In-house counsel owe the same duties of loyalty and confidentiality to their client as other lawyers. Issues of loyalty and confidentiality affect in-house counsel most frequently in situations that give rise to potential incidents of whistleblowing.

Rule 2.02(1.1) of the Rules of Professional Conduct provides that where a lawyer's client is an organization:

> **(1.1)** Notwithstanding that the instructions may be received from an officer, employee, agent, or representative, when a lawyer is employed or retained by an organization, including a corporation, in exercising his or her duties and in providing professional services, the lawyer shall act for the organization.

This Rule, in conjunction with a lawyer's duty of loyalty and confidentiality, demonstrates that counsel must ensure that the best interests of the organization (i.e the client) are represented at all times. That is, the lawyer's fiduciary duty is owed to the organizational entity and not to the officers, directors, and employees who constitute the human face of the organization and provide instructions.

Problems can arise for in-house counsel in circumstances where the representatives of the organization instruct their lawyer to act in conflict with the interests of the organization. An example of this arises in situations of "moonlighting." That is, where a lawyer engages in private practice while working as in-house counsel for the organization.[14]. An employee of the organization may request that in-house counsel represent him personally on a matter that is unrelated to the organization for which the employee works. Conflicts of interest may arise, in addition to the fact that time spent on the individual employee's matter is time

[12] *Ibid.* at para. 19.
[13] *Ramrakha v. Zinner* (1994), 157 A.R. 279 (C.A.), at 73.
[14] *Supra* note 7 at 4.

spent away from the employer organization. Some of the major concerns of in-house counsel in such circumstances include the following[15]:

(a) **Insurance Concerns:** Lawyers need to be certain that their professional insurance covers any work done in private practice;

(b) **Duties of Loyalty to Employer:** Lawyers must consider whether the duty of loyalty owed to the main employer would be breached by engaging in private practice;

(c) **Competence[16]:** Lawyers should ensure that they are able to competently perform the duties required of them by the main employer, in addition to any work that is involved in any additional employment relationships; and

(d) **Conflicts of Interest:** Lawyers must consider their obligations under Rule 2.04 of the Rules of Professional Conduct. Lawyers need to be certain that there are no conflicts of interest between any of the parties represented.

Although in-house counsel could obtain the consent of the employer to engage in private practice, potential problems may still arise and may not be covered by the agreement between the two parties. For example, although the organization may permit in-house counsel to engage in private practice on the side, issues with respect to the lawyer's competence and ability to devote sufficient time to the work of the employer may still arise. Further, agreement between in-house counsel and the organization will not likely address any future unforeseeable conflicts that may arise as the lawyer takes on more private clients.

However, more serious issues arise where representatives of the organization have instructed the lawyer to conduct an illegal, dishonest or fraudulent act, or have advised the lawyer of a course of action being considered, that the lawyer knows to be illegal. In these circumstances, it is important to remember that the lawyer's duty of loyalty is owed to the organization and not to its representatives. Illegal conduct committed by the organization in the past or intended to be committed in the future, is not in the best interests of the organization and the lawyer, therefore, has a fiduciary duty to the organization to report such activity up-the-ladder.[17]The lawyer's duties in these circumstances will be discussed in greater detail in the following paragraphs.

[15] *Supra* note 7 at 5.
[16] Note that Rule 2.01 (2) of the Rules of Professional Conduct require that a lawyer perform any legal services undertaken on a client's behalf to the standard of a competent lawyer, as defined by the Rules to include (among various others) the ability to perform all functions conscientiously, diligently, and in a timely and cost-effective manner.
[17] *Ibid* note 1 at rule 2.02(5.1).

On the other hand, the duties of loyalty and confidentiality owed to the employer organization prohibit the lawyer from disclosing knowledge of illegal conduct occurring within the organization to anyone outside of the organization[18].

Rules 2.02 (5.1) and (5.2) of the Rules of Professional Conduct provide for "up-the-ladder" reporting in circumstances where dishonesty, fraud, crime or illegal conduct is occurring or has occurred within the organization:

> **(5.1)** When a lawyer is employed or retained by an organization to act in a matter and the lawyer knows that the organization intends to act dishonestly, fraudulently, criminally, or illegally with respect to that matter, then in addition to his or her obligations under subrule (5), the lawyer for the organization shall
>
> (a) advise the person from whom the lawyer takes instructions that the proposed conduct would be dishonest, fraudulent, criminal, or illegal,
>
> (b) if necessary because the person from whom the lawyer takes instructions refuses to cause the proposed wrongful conduct to be abandoned, advise the organization's chief legal officer, or both the chief legal officer and the chief executive officer, that the proposed conduct would be dishonest, fraudulent, criminal or illegal,
>
> (c) if necessary because the chief legal officer or the chief executive officer of the organization refuses to cause the proposed conduct to be abandoned, advise progressively the next highest persons or groups, including ultimately, the board of directors, the board of trustees, or the appropriate committee of the board, that the proposed conduct would be dishonest, fraudulent, criminal, or illegal, and
>
> (d) if the organization, despite the lawyer's advice, intends to pursue the proposed course of conduct, withdraw from acting in the matter in accordance with rule 2.09.
>
> **(5.2)** When a lawyer is employed or retained by an organization to act in a matter and the lawyer knows that the organization has acted or is acting dishonestly, fraudulently, criminally, or illegally with respect to that matter, then in

[18] *Supra* note 1, Commentary to Rule 2.03(3).

addition to his or her obligations under subrule (5), the lawyer for the organization shall

(a) advise the person from whom the lawyer takes instructions and the chief legal officer, or both the chief legal officer and the chief executive officer, that the conduct was or is dishonest, fraudulent, criminal, or illegal and should be stopped,

(b) if necessary because the person from whom the lawyer takes instructions, the chief legal officer, or the chief executive officer refuses to cause the wrongful conduct to be stopped, advise progressively the next highest persons or groups, including ultimately, the board of directors, the board of trustees, or the appropriate committee of the board, that the conduct was or is dishonest, fraudulent, criminal, or illegal and should be stopped, and

(c) if the organization, despite the lawyer's advice, continues with the wrongful conduct, withdraw from acting in the matter in accordance with rule 2.09.

The main difference between the two provisions is that the latter subsection requires the lawyer to immediately advise *both* the person from whom the lawyer takes instructions and the chief legal officer, or both the chief legal officer and the chief executive officer, concurrently.

If the lawyer has reached the top and the matter has still not been addressed, the lawyer is required to withdraw from acting in the matter, in accordance with Rule 2.09(7) of the Rules of Professional Conduct, which provides:

(1) A lawyer shall not withdraw from representation of a client except for good cause and upon notice to the client appropriate in the circumstances;

and:

(7) Subject to the rules about criminal proceedings and the direction of the tribunal, a lawyer shall withdraw if:

(a) discharged by the client;

(b) the lawyer is instructed by the client to do something inconsistent with the lawyer's duty to the tribunal and, following explanation, the client persists in such instructions;

(c) the client is guilty of dishonourable conduct in the proceedings or is taking a position solely to harass or maliciously injure another;

(d) it becomes clear that the lawyer's continued employment will lead to a breach of these rules:

(d.1) the lawyer is required to do so pursuant to subrules 2.02 (5.1) or (5.2) (dishonesty, fraud etc. when client an organization), or

(e) the lawyer is not competent to handle the matter.

It should be noted that in many circumstances where a lawyer reports misconduct up-the-ladder, but does not receive a response to his concerns, withdrawal from that particular matter may not be enough. In many cases, the lawyer no longer has the confidence of the organization to continue to act on the matter. In such cases, the lawyer may choose to withdraw completely from the organization – particularly in situations where it is clear to the lawyer that continued involvement will lead to a breach of professional responsibility.

Proposed amendments to the *Criminal Code* provide that:

425.1 (1) No employer or person acting on behalf of an employer or in a position of authority in respect of an employee of the employer shall take a disciplinary measure against, demote, terminate or otherwise adversely affect the employment of such an employee, or threaten to do so,

(a) with the intent to compel the employee to abstain from providing information to a person whose duties include the enforcement of federal or provincial law, respecting an offence that the employee believes has been or is being committed contrary to this or any other federal or provincial Act or regulation by the employer or an officer or employee of the employer or, if the employer is a corporation, by one or more of its directors; or

(b) with the intent to retaliate against the employee because the employee has provided information referred to in paragraph (a) to a person whose duties include the enforcement of federal or provincial law.

However, since rules of professional responsibility prohibit a lawyer from disclosing information about the organization outside of the organization, the above sections are not particularly relevant in this context.

It should also be noted that not every incident will require up-the-ladder reporting. "Trivial misconduct or conduct that is not likely to result in any serious harm to the organization or others need not necessarily be reported[19]." However, it has been established that "misconduct of publicly traded organizations is likely to have serious consequences to the public at large[20]", and as such requires up-the-ladder reporting.

Finally, Rule 2.02(5) of the Rules of Professional Conduct prohibits a lawyer from knowingly assisting or encouraging a client to act dishonestly, fraudulently, criminally, or illegally, or to instruct the client on how to violate the law and avoid punishment.

The Commentary to Rule 2.02(5) adds:

A lawyer should be on guard against becoming the tool or dupe of an unscrupulous client or persons associated with such a client. A lawyer should be alert to and avoid unwittingly becoming involved with a client engaged in criminal activity such as mortgage fraud or money laundering. Vigilance is required because the means for these and other criminal activities may be transactions for which lawyers commonly provide services such as: establishing, purchasing or selling business entities; arranging financing for the purchase or sale or operation of business entities; arranging financing for the purchase or sale of business assets; and purchasing and selling real estate.

Before accepting a retainer or during a retainer, if a lawyer has suspicions or doubts about whether he or she might be assisting a client in dishonesty, fraud, crime or illegal conduct, the lawyer should make reasonable inquiries to obtain information about the client and about the subject matter and objectives of the retainer, including verifying who are the legal or beneficial owners of property and business entities, verifying who has the control of business entities, and clarifying the nature and purpose of a

[19] *Supra* note 7 at 4.
[20] *Ibid*.

complex or unusual transaction where the purpose is not clear. The lawyer should make a record of the results of these inquiries.

The current wording of this Commentary was the result of several amendments made by the Law Society of Upper Canada in response to the federal government's enactment of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTA). This legislation originally required that lawyers (along with financial institutions and various financial intermediaries) report large cash transactions and international electronic funds transfers of $10,000 or more, determine the identity of clients, keep certain records and establish programs for internal compliance. The various law societies were concerned that this legislation would interfere with solicitor-client confidentiality and other professional responsibilities, and as a result, the Federation of Law Societies and the Law Society of British Columbia (and other law societies) challenged the constitutionality of the legislation. Interim relief was eventually granted to lawyers nationwide. In 2003, the federal government repealed the challenged provisions and advised that it would implement a new procedure for lawyers. But this has not occurred as yet.

The Rules of Professional Conduct, provide for a balance between maintaining a lawyer's professional responsibilities to their clients and protecting the public interest. In this way, a healthy solicitor-client relationship is promoted and the legal profession is able to function efficiently.

PART II: The Rule of Solicitor-Client Privilege

One of the major ethical issues and challenges faced by in-house counsel is the confusing and potentially risky application of solicitor-client privilege to their practice. To ensure that confidential communications between in-house counsel and their clients are protected, it is important to fully understand the intricacies of the application of the rule of privilege, particularly in the context of in-house counsel. In this section, we provide an overview of the common law rule of solicitor-client privilege. Specifically, we focus on the common issues and difficulties that arise in its application to in-house counsel.

I. Policy Behind the Rule of Solicitor-Client Privilege

The rule of solicitor-client privilege ('the Rule') is fundamental to the justice system in Canada. Once classified as a rule of evidence, the Supreme Court of Canada has elevated the Rule to a "fundamental civil and legal right".[21] Clients seeking advice must be able to speak freely to their lawyers and to know that whatever they say will not be divulged without their consent. The Rule allows lawyers to properly advise their client to further the administration of justice, ensure the observance of the law and ultimately serve the interest of the public. [22]

[21] *Solosky v. R.* (1980), 105 D.L.R.(3d) 745 at 760.
[22] *Upjohn Co. v. United States*, 449 U.S. 383 at 389

II. Requirements for the Application of Solicitor-Client Privilege

In order for solicitor-client privilege to apply, the following requirements must be met:[23]

(a) The communication is between counsel and client;

(b) The communication is for the purpose of seeking or giving legal advice; and

(c) The communication is intended to be confidential.

Generally, solicitor-client privilege will apply as long as the communication falls within the ordinary scope of the professional relationship. Once the privilege is established, it is broad and encompassing. As stated in *Descoteaux v. Mierzwinski*[24], privilege attaches to all communications made within the solicitor-client relationship which arises as soon as the potential client steps into the door and even before a formal retainer is signed.

Despite its importance, the Rule is not absolute. Case law has carved out the following principled exceptions:[25]

(a) Constitutional exception: a claim of privilege which would otherwise impair an accused's ability to make a full answer and defence will in certain circumstances require disclosure despite one's right to privilege.[26]

(b) Criminal/fraud exception: communications will not be privileged where they are in themselves criminal or they are made with the purpose of obtaining legal advice to facilitate the commission of a crime.[27]

(c) Public safety exception: communications will not be privileged where to honour the privilege would put the safety of the public at risk. In circumstances where it can be demonstrated that there is an imminent risk of serious bodily harm or death to an identifiable person or group, the privilege will be set aside.[28]

III. The Duty of Confidentiality as Distinct from the Rule of Privilege

Though the distinction between solicitor-client privilege and the lawyer's duty of confidentiality is often blurred, it is important to understand that privilege and confidentiality stem from two different principles. Whereas the duty of confidentiality is an ethical rule of

[23] *Pritchard v. Ontario (HRC)* 2004 SCC 31 at para.15.
[24] [1982] 1 S.C.R. 860
[25] Ken B. Mills, "Privilege and In-House Counsel" (2003) 41 Alta. L. Rev. para. 3 (QL).
[26] *R. v. Stinchcombe,* [1991] 3 S.C.R.326 at 340.
[27] *Supra* note 25 at para.3.
[28] *Smith v. Jones,* [1999] 1 S.C.R. 455 at para 19.

professional conduct, the rule of solicitor-client privilege developed as an evidentiary rule, with the purpose of preventing a lawyer from being compelled to produce client related evidence. This distinction is stated in the Commentary to Rule 2.03 of the Rules of Professional Conduct[29]:

> This rule (of confidentiality) must be distinguished from the evidentiary rule of lawyer and client privilege concerning oral or documentary communications passing between the client and the lawyer.

The Commentary also states that the ethical duty of confidentiality is wider than the evidentiary rule of solicitor-client privilege for the following reasons:[30]

(a) The rule of confidentiality requires lawyers to maintain all information with respect to the client in confidence, whereas the privilege merely prevents the introduction of confidential information into evidence.

(b) The rule of confidentiality applies not only to confidential communications between clients and lawyers that are exchanged for the purpose of obtaining legal advice, but to all information concerning the clients' affairs acquired from any source during the course of the professional relationship.

(c) The rule of confidentiality applies even though others may share the lawyer's knowledge. In contrast, privilege applies to the communication itself, and does not bar the production of evidence pertaining to the facts communicated if obtained from another source. Privilege is also often lost where other parties are present during the communication.

IV. Waivers of Privilege

Solicitor-client privilege is the right of the client and not of the solicitor.[31] Generally, only the client may waive the privilege. However, case law demonstrates that privilege may be waived by the client's agent[32] or in specific instances, by someone other than the solicitor or client. For example, where an organization elects to answer through a particular employee, any waiver made will likely bind the organization.[33]

Waiver of privilege is established when it is shown the possessor of privilege:[34]

[29] *Supra* note 1 rule 2.03
[30] *Supra* note 7 at p.3-3.
[31] J. Sopinka, S.N. Lederman & A.W. Bryant, The Law of Evidence in Canada, 2d ed. (Toronto: Butterworths, 1999) at 756 [Sopinka], citing *Geffen v. Goodman Estate*, [1991] 2 S.C.R. 353.
[32] *Syncrude Canada Ltd. V. Canadian Bechtel Ltd.* (1992), 10 C.P.C. (3d) 388 (Alta. C.A.).
[33] R.D. Manes & M.P. Silver, Solicitor-client privilege in Canadian Law (Toronto: Butterworths, 1993) at 206
[34] *Hartford Accident and Indemnity Company v. Maritime Life Assurance Company,* (1996) 9 C.P.C. 4th.cited in para. 105 of *National Bank Financial Ltd. V. Potter* [2005] N.S.J. No.186.

(a) Knows of the existence of the privilege

(b) Demonstrates a clear intention to forego the privilege.

From the case law it appears that there are two main instances where the solicitor-client privilege can be waived:

1. Express waiver

Express waiver of privilege occurs where the client voluntarily discloses confidential communications with his or her solicitor.[35] For example, in *Smith v. Smith*[36], the client was held to expressly waive solicitor-client privilege where he filed an affidavit which set out the substance of the confidential solicitor-client communications.

2. Unintentional waiver

Unintentional waiver has been divided into two categories:

(a) Implied waiver

Generally, waiver is held to be implied where the court finds that an objective consideration of the client's conduct demonstrates an intention to waive privilege.[37] While waiver of privilege normally requires knowledge of the privilege and voluntary intention to waive that privilege, it may occur in the absence of an intention to waive, where fairness and consistency require, such as in a case where a party has taken a position which would make it inconsistent to maintain the privilege. In *R. v. Campbell*[38], the R.C.M.P. put in issue its belief in the legality of a reverse sting operation and asserted its reliance upon advice from Department of Justice lawyers to support its position. The Supreme Court of Canada held that the R.C.M.P. had waived the right to privilege of the contents of the advice which was relied upon. Similarly, if a client denies that he or she gave instructions to his lawyer to settle a debt, the other party who is seeking to enforce the settlement has the right to examine the lawyer on what was said between the lawyer and the client.[39]

(b) Inadvertent disclosure of privileged communications

Disclosure of privileged communications may sometimes be completely accidental without any intention to waive, express or implied. Recent Canadian cases have chosen not to adopt the traditional principle in *Calcraft v. Guest,*[40] that

[35] *Supra* note 33 at 189.
[36] [1958] O.W.N. 135 (H.C.J)
[37] *Supra* note 33 at 191.
[38] [1999] S.C. J. No.16.
[39] *Newman v. Newman* (1979), 8 C.P.C. 229 (Ont. H.C.J.).
[40] [1898] 1 Q.B. 759

mere loss of confidentiality either by accident or by design results in a waiver of privilege. With the liberal production and exchange of large quantities of documents today between counsel, accidental disclosure is bound to occur. A judge should have the discretion to determine whether in each circumstance, the privilege has been waived.[41] According to Sopinka, factors to be taken into account should include whether the error is excusable, whether an immediate attempt has been made to retrieve the information and whether preservation of the privilege in circumstances will cause unfairness to the opponent.

This modern approach to inadvertent disclosure appears to have been consistently adopted by Canadian courts. In *Royal Bank of Canada v. Lee*[42], it was held that there was no loss of privilege because the disclosure was entirely accidental. Similarly, in the recent case of *National Bank Financial Ltd. v. Potter*[43] it was implied that some form of intention was required to waive privilege,

> "…even in the case of inadvertent loss of possession the Courts do not consider loss of possession as a result of the actions of the holders of the privilege to be demonstrative of a clear intention to forego privilege."

Ultimately, Canadian courts will generally favour upholding privilege over production of the documents.[44]

(c) Inadvertent disclosure in the United States

In contrast, there does not appear to be a consistent approach to the treatment of inadvertent disclosure in the United States. U.S. cases have adopted the following three approaches to the treatment of inadvertent disclosure:[45]:

A. A traditional view where mistaken disclosure of privileged material to the opponent constitutes waiver.[46]

B. An approach where privilege will only be held to be waived where there is evidence of the client's intention to waive privilege.[47]

[41] *Supra* note 31 at 764.
[42] (1992), 127 A.R. 236 (C.A.).
[43] [2005] N.S.J. No.186 at para.103.
[44] Supra note 25 at para. 36.
[45] John K. Villa, "Inadvertent Disclosure of Privileged Material: What is the Effect on the Privilege and the Duty of Receiving Counsel?" *ACC Docket* 22, no. 9 (October 2004): 108-115
[46] *FDIC v. Singh* 140 F.R.D. 252
[47] *Berg Electronics Inc. v. Molex Inc.* 875 F. Supp. 261, 263 (D. Del.1995).

C. An intermediate approach which focuses on the reasonableness of the precautions taken to preserve the confidentiality of communications. Several factors considered include:[48]

I. Reasonableness of the precautions taken to prevent inadvertent disclosure in view of the extent of the document productions

II. The number of inadvertent disclosures

III. Extent of the disclosure

IV. Any delay and measure taken to rectify the disclosures

V. Whether the overriding interests of justice would or would not be served by relieving a party of its error

(d) Inadvertent disclosure in the U.S. and in-house counsel: The case of *Jasmine Networks v. Marvell Semi Conductor Inc.*

While different jurisdictions in the U.S. have adopted different approaches to waiver and inadvertent disclosure, there is one recent case notable for the controversy it has caused in the United States and in Canada in relation to the issue of inadvertent disclosure and in-house counsel. In the case of *Jasmine Networks v. Marvell Semi Conductor Inc*[49], a voicemail system kept recording after Mr. Gloss, in-house counsel and vice-president of corporate affairs for Marvell, Marvell's in-house patent attorney and its vice-president of engineering thought they had hung up the phone. The voicemail recorded their discussion on plans to steal Jasmine's trade secrets, hire away key employees and speculation on who might go to jail if they got caught. The issue presented to the Court of Appeal was whether the recorded conversation was protected by solicitor-client privilege.

According to the *Evidence Code s.912, subdivision A* of California, privilege may be waived in one of two ways: 1) By the privilege holder making an uncoerced disclosure of the information or 2) By the holder intentionally consenting to disclosure by a third party.

While Jasmine and Marvell both agreed any waiver must result from uncoerced disclosure, Marvell argued that the disclosure must also be

[48] *Amgen Inc. V. Hoechst Marion Roussel Inc.* 190 F.R.D. 287, 291.
[49] [2004] Cal App. LEXIS *476*

intentional. The Court of Appeal held in favour of Jasmine stating, "the weight of authority supports the conclusion that intent to disclose is not required in order for the holder to waive privilege through uncoerced disclosure."[50]

The Court of Appeal agreed with the longstanding principle that lawyers generally do not have the right to waive their client's privilege without their consent. The case at hand presented unique circumstances because of Mr.Gloss' dual role as in-house counsel and vice president. The Court held that Marvell had inadvertently waived privilege because Mr. Gloss was not only acting as in-house counsel but also as vice president of Marvell during the recorded discussion.

The implication of the *Jasmine* decision is that it makes it difficult for general counsel who are also senior executives to assert privilege in cases of inadvertent disclosure. However, subsequent to the Court of Appeal decision, the case was reviewed by the Supreme Court of California and depublished. Therefore, the decision is of no force as a precedent. In response to the Court of Appeal decision, the California legislature drafted Bill 1133 (Harman), proposing to change the state's law on evidence to make it clear that privilege can only be waived intentionally.

While there has not been any case in Canada where general counsel's dual role has called privilege into question, it is unlikely that a Canadian Court would rule the same way given the recent decisions in *Royal Bank* and *National Bank Financial*.

V. The Application of the Rule of Privilege to In-House Counsel

The English Court of Appeal in *Alfred Crompton Amusement Machines v. Customs and Excise Commissioners (No.2*[51]*)*, described the role of in-house counsel as follows:

> "Many barristers and solicitors are employed as legal advisers, full time, by a single employer… They are regarded by the law as, in every respect in the same position as those who practice on their own account…. They must uphold the same standards of honour and etiquette. They are subject to the same duties to their client and to the court. They must respect the same confidences. They and their clients have the same privileges. I speak, of course of the communications in the capacity of legal adviser."

This statement has been repeated and affirmed numerous times by Canadian Courts.[52] As such, it is clear that Canadian Courts hold that in-house counsel are governed by

[50] *Ibid* at p.4.
[51] [1972] 2 all E.R. 353 (C.A)

the same rules as outside counsel. However, in practice, unique problems are encountered by in-house counsel in the application of these rules. In this section of the paper, I summarize some of common issues and difficulties that arise in the application of the rule of privilege to in house counsel.

1. The Client is the Corporation

It is important to determine who the client is in order to understand when communications are privileged and by whom privilege can be waived. Where a lawyer is employed in-house, it is the organization that is the client and not the employees or officers of the organization. This distinction is highlighted under rule 2.02(1.1) of the Law Society of Upper Canada's Rules of Professional Conduct:[53]

> "Notwithstanding that the instructions may be received from an officer, employee, agent, or representative, when a lawyer is employed by an organization including a corporation, in exercising his or her duties and in providing professional services, the lawyer shall act for the organization."

A lawyer acting for an organization must remember that an organizational client has a legal personality distinct from its shareholders, officers, directors, and employees. While the organization will give instructions through its officers, directors or employees, the lawyer must ensure that it is the interests of the organization that are served.[54] The distinction between an organization and its officers and shareholders raises significant potential conflict of interest issues that in-house counsel must be wary of.[55]

In-house counsel of a parent corporation often also have the responsibility for advising wholly owned subsidiaries. Most Canadian courts have extended the definition of a client corporation to include the corporation's subsidiaries, affording them the same privilege and confidentiality protections as the parent. In *Mutual Life Assurance Co. of Canada v. Deputy Attorney General of Canada,*[56] Saunders J. concluded that it was not in line with the purpose behind privilege to treat wholly owned subsidiaries as independent third parties because they are separate legal entities.

Another question that has arisen in the context of the client as an organization is how to determine which individuals in the organization have the right to speak for the organization for the purposes of determining whose communications are protected by solicitor-client privilege. While Canadian courts have not had to address this issue, academics and

[52] See *R v. Campbell, [1999*] 1 S.C.R. 565*, Canary v. Vested EstatesLtd,* [1930] W.W.R. 996, at 997-998.
[53] *Supra* note 1 at. rule 2.02(1.1)
[54] *Supra* note 1 at Commentary under rule 2.02(1.1)
[55] Mahmud Jamal ,"In-House Counsel and Solicitor-Client Privilege" (Ontario Bar Association, May 2004)
[56] *Mutual life assurance co. of Canada v. Deputy Attorney General of Canada (1988*) 28 C.P.C. (2d) 101 at p. 103 *(ont. H.C.J.*) per Saunders J.

experts have often turned to the leading American case of *Upjohn v. United States* for guidance.[57]

In *Upjohn,* a pharmaceutical corporation was subject to an internal investigation into "questionable payments" made to secure government contracts abroad. General counsel of Upjohn sent a questionnaire to all foreign and general area managers seeking information concerning the payments. Internal Revenue Services demanded production of the questionnaires to investigate the tax consequences of the transaction. Upjohn refused claiming attorney client privilege. In adopting the 'control group' test[58], the Sixth Court of Appeals held that the communications between the general managers and in-house counsel were not subject to attorney client privilege.[59]

The Supreme Court of the United States reversed the Court of Appeal decision. According to Rehnquist J., the control group test "frustrates the very purpose of the privilege by discouraging the communication of relevant information by employees of the client to attorneys seeking to render legal advice to the client corporation." While the Supreme Court did not articulate a specific test for identifying when privilege should apply to employees of a corporation, some of the factors the Supreme Court examined in coming to its decision to grant privilege in this case were the confidentiality of the questionnaires, the fact that the communications concerned matters within the scope of the employees' corporate duties and the fact that employees were aware that they were being questioned in order for the corporation to obtain legal advice.[60]

In Canada, the *Upjohn* decision has been viewed favourably. There has been broad protection for confidential communications emanating from an employee, regardless of position in the organizational hierarchy, provided the objective of the communication is to obtain legal advice and the statement is made within the scope of the employee's duties. The issue has been treated by Canadian courts as one coming under the agency theory of privilege; that is any employee can be engaged by the corporate client to pass on information to the solicitors for the purpose of receiving legal advice [61]

2. The Distinction between Legal and Business Advice

Solicitor-client privilege applies only to legal advice and not advice on purely business matters even when provided by a lawyer.[62] Due to the fact that in-house counsel often have both legal and non-legal responsibilities, each situation must be assessed on a case by case basis to determine if it is protected by solicitor-client privilege.[63] While Lord Denning did state in *Alfred Crompton Amusement Machines Ltd.* that the rule of solicitor-client privilege applies

[57] *Upjohn Co. v. United States* 1981 U.S. *LEXIS* 56.
[58] Definition of control group test: Only communications between employees who are in a position to control or direct corporate actions and a lawyer will be protected by privilege.
[59] *Supra* note 57 at 1.
[60] *Supra* note 57 at 5.
[61] *Supra* note 31 at 744.
[62] *supra* note 55 at 5.
[63] *Supra* note 55 at 5.

equally to in-house counsel, he immediately added that only communications made in the capacity of legal advisor are privileged and not work done in any other capacity. He warned that "in house counsel must be scrupulous to make the distinction."

The requirement to be scrupulous in distinguishing between legal advice and business advice has been raised to the level of an ethical duty in Ontario as demonstrated by the commentary to rule 2.01, the rule on lawyer competence in the Law Society's Rules of Professional Conduct:[64]

> "In addition to opinions on legal questions, the lawyer may be asked for…advice on non legal matters such as the business, policy or social implications involved in the question or the course the client should choose. In many instances the lawyer's experience…on non legal matters will be of real benefit to the client. The lawyer who expresses views on such matters should, where and to the extent necessary, point out any lack of experience or other qualification in the particular field and should clearly distinguish legal advice from other advice."

3. Internal Investigations, Minutes of Board Meetings and Internal Memos: Typical Situations Encountered by In-House Counsel.

(a) Internal Investigations

One of the typical situations encountered by in-house counsel is a request by the client organization to conduct internal investigations into potential civil or criminal claims involving the organization or its employees. These investigations can be protected from disclosure to third parties by solicitor-client privilege if conducted properly. Courts have ruled both ways on whether such investigations are covered by solicitor-client privilege. The determining factor appears to be whether there is a sufficient evidentiary connection established between the investigation and the seeking or obtaining of legal advice.[65]

In *Hydro-One Network Services Inc. v. Ontario (Ministry of Labour),*[66] the Court had to decide whether a report prepared by an employee at the request of in-house counsel to investigate into the causes of an accident were privileged. The Court found that the documents were privileged because they were intended to be confidential and because the purpose of the report was to enable in-house counsel to provide legal advice. In contrast, in *Prosperine v. Ottawa-Carleton (Regional Municipality)*[67] the Court held there was no solicitor-client privilege. The Corporation sought privilege over a report prepared by an outside consultant. The report had been commissioned by a municipality to investigate into a potential fraud committed by a contractor to the municipality. The municipality claimed that the report was privileged because

[64] *Supra* note 1. Commentary to Rule 2.01 "Competence".
[65] *Supra* note 55 at 7.
[66] [2002] O.J. No.4370 (O.C.J.)
[67] [2002] O.J. No. 3316 (Sup. Ct)

the consultant had been hired by in-house counsel. The Court rejected the claim for privilege because the contract between the municipality and consultant did not indicate that the purpose of the investigation was to facilitate the giving of legal advice. Rather the purpose of the report was to quantify the financial loss incurred and to identify improvements in the future.[68]

College of Physicians of British Columbia v. British Columbia (Information and Privacy Commissioner)[69] demonstrates that it is not always clear when a court will find an investigation privileged. In this case, in-house counsel for the B.C. College of Physicians obtained expert opinions to assist the College in assessing a complaint against a physician. While the Court of Appeal agreed that the lawyer was acting in her capacity as a lawyer with the objective of giving legal advice when she obtained the experts' opinions, the Court held that the reports were nevertheless not privileged. While third party communications may be privileged where the third party is performing a function on the client's behalf, serving as a channel of communication between the client and the solicitor, the Court found that in this case, the experts were retained merely to provide opinions concerning the medical basis for the complaint. While these opinions were essential to the legal problem confronting the College, the Court held that the experts' services were incidental to the seeking and obtaining of legal advice.[70]

(b) Minutes of Board Meetings

The legal advice provided by in-house counsel to the board of directors of an organization is privileged. Therefore the minutes of the board meetings containing such advice or the portion of the minutes recording that advice will be protected by solicitor-client privilege. As stated in *Canadian Pacific Ltd. v. Canada (Competition Act, Director of Investigation and Research,*[71]

> "with respect to minutes of meetings, I would be of the view that the privilege only relates to that part which specifically involves the legal advice and secondly that the function of the meeting was reasonably necessary to deal with the aspect of developing or digesting the legal advice."

(c) Internal Memos

Internal memos containing legal advice from in-house counsel to the client are generally considered to be covered by solicitor-client privilege.[72] Nevertheless, in-house counsel must still remain vigilant as to how the memos are circulated within the organization. Indiscriminate circulation can result in loss of privilege[73] For example, in *Toronto-Dominion Bank v. Leigh Instruments Ltd.*[74], the Court held that no privilege applied to a memo issued by a

[68] *Supra* note 55 at 8.
[69] [2002] B.C.J. No. 2779 (B.C.C.A.)
[70] *Supra* note 55 at 10.
[71] [1995] O.J. No. 1867 at para. 23 (Ont. Gen. Div.) per Farley J.
[72] *Supra* note 55 at. 9.
[73] *Supra* note 55 at 9.
[74] (1997), 32 O.R. (3d) 575 (Ont. Gen. Div.).

bank's general counsel to all of its branches discussing the risks associated with comfort letters. The bank's general counsel also held executive offices in the bank and it was unclear from the evidence whether he was acting in his capacity as general counsel or as an officer of the bank in sending the memo. Other factors that led to the Court's decision included the fact that the memo was a discussion of corporate policy rather than legal advice, the memo was labelled as a 'head office circular' instead of a memo from the legal department and most importantly, there was no intention to keep the memo confidential as it was widely circulated to every branch and department, with no stamp of confidentiality on the cover page.[75]

4. The Provision of Advice to Clients Outside the Jurisdiction

In-house counsel are sometimes asked to provide legal advice in jurisdictions where they are not called to the bar. A typical example of this would be where a corporation has wholly owned subsidiaries outside the jurisdiction whose legal affairs are referred to the parent corporation's in-house counsel. Case law is conflicting on the issue of whether solicitor-client privilege applies to such communications.[76] Traditionally, it was held that privilege was confined to consultation with lawyers qualified to practice in the local forum. However, the weight of authority suggests Canadian courts are moving away from that approach. As stated by Sopinka, et al. in the *Law of Evidence in Canada,*[77]

> Many years ago, the Ontario Court of Appeal held that the lawyer must be competent to practise in the jurisdiction the law of which is relevant to the issues in question. In *United States v. Mammoth Oil Co.*[78], it was held that, in circumstances where an American citizen consulted a Canadian lawyer on American law, no privilege attached to the communication, as a Canadian lawyer was not qualified to practise in the United States. This decision could create problems for a corporate counsel, particularly where the corporation is a multi-national or carries on business in more than one province. If, for example, a problem arises outside Ontario but the corporate counsel who is a member of the Ontario Bar only, is consulted at the corporation's head office in Toronto, should that communication not be privileged? More recent authority suggests that the protection should not be so limited and that, as long as one of the parties to the communication is a lawyer, though perhaps not called to the bar of the jurisdiction in which the issue arises, then the umbrella of privilege should cover the communication. At the very least, it could be said that such a consultation is preparatory to the foreign lawyer providing information or instructions to a lawyer who is in fact licensed to practise in the relevant jurisdiction.

[75] *Supra* note 55 at 9.
[76] see *Re United States of America v. Mammoth Oil Co.* (1925), 56 O.L.R. 635 (C.A), *Lawrence v. Campbell, Hartz Canada Inc. v. Colgate-Palmolive co*. (1988), 27 C.P.C. (2d) 152 (Ont. H.C.).
[77] *Supra* note 31 at 741.
[78] (1925) 56 O.L.R. 635 (C.A.)

In-house counsel should also be particularly careful in dealing with foreign subsidiaries in the European Community ('EC'). Due to the fact that in-house lawyers in many member states are employees under those countries' laws, and thus are not subject to rules of professional ethics and discipline, the EC law generally does not extend solicitor-client privilege to in-house lawyers. As a result, communications from in-house counsel in Canada that may be privileged here, may not necessarily be privileged under EC law.[79]

5. Litigation Privilege and In-House Counsel

Litigation privilege protects documents and materials created for the dominant purpose of preparing for litigation.[80] While in-house counsel are entitled to claim litigation privilege,[81]difficulties may arise in its application. For example, where damaging internal memoranda are circulated within an organization before in-house counsel is notified, discussing a possible dispute, it may not be clear whether litigation privilege can be claimed. The weight of authority supports the view that litigation privilege can still be claimed, provided that litigation was in "reasonable prospect".[82] The following considerations and authorities support this view:

(a) Several courts have held that privilege may be claimed over documents as being made in contemplation of litigation even before a lawyer has been retained at the time the documents were prepared.[83]

(b) Documents may be prepared in contemplation of litigation, in the sense of being procured as materials upon which professional advice should be taken in proceedings pending, or threatened, or anticipated, even though the party preparing the document intended to settle the matter if possible without resort to a solicitor at all[84].

(c) Numerous cases have supported the approach of claiming privilege over all documents prepared after an event on a certain date that gives reality to the prospect of litigation. After this date, the party is viewed as preparing to meet anticipated litigation.[85]

(d) In the absence of evidence to the contrary from the party opposing the claim of privilege, the claim of privilege should be sustained.[86]

[79] *Supra* note 55 at 10.
[80] *General Accident v. Chrusz* (1999), 45 O.R. (3d) 321.
[81] *Ibid.*
[82] *Supra* note 55 at 11.
[83] *Rush v.Phoenix Assurance Company of Canada* (1983), 40 C.P.C. 185 at para. 14 (H.C.J.), *R v. Westmoreland* (1984), 48 O.R. (2d) 377 (H.C.J.)
[84] *Gillespie Grain Company Grain Insurance & Guarantee Company v. Wacowich,* [1932] 1 W.W.R. 916 at 919.
[85] See for example, *Romaniuk v. Prudential Insurance Co. of America* [2000] O.J. No. 1527 at para. 20.
[86] *Watt v. Baycrest Hospital,* [1991] O.J. No.1107 at p.2.

6. Tips for In-House Counsel on How to Create and Preserve Privilege[87]

(a) Mark documents as "privileged and confidential", and "prepared for in-house counsel for the purpose of providing legal advice" and/or "prepared for in-house counsel for the purpose of preparing for litigation".

(b) Use legal department letterhead rather than general corporate letterhead for legal advice.

(c) Sign letters and memoranda containing legal advice as legal counsel.

(d) Maintain a confidential file of materials over which privilege is to be claimed. Label these files accordingly

(e) Where possible, limit circulation of legal advice within the organization. Where this is not possible or desirable, ensure recipients understand the importance of keeping advice confidential, such as by marking the documents appropriately as suggested above.

(f) When retaining outside experts, counsel should prepare a retainer letter specifically confirming that the expert is retained for the purpose of assisting counsel in providing legal advice and/or to prepare for litigation. Ensure that the expert marks his or her report accordingly and directs the report to counsel's attention.

(g) Be aware that communicating with foreign counterparts may (depending on the jurisdiction) result in loss of privilege if proceedings are commenced in the foreign jurisdiction.

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[87] *Supra* note 55 at 13.

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Top Ten Lessons Learned by CLOs about Executive Compensation From the Stock Options Crises

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From the large number of companies under scrutiny for backdating stock options we have learned many lessons, but at least two of them should assist us as we enter the challenging new land of highly regulated executive compensation. First, when in-house counsel are walled out of the full gambit of the decision-making and papering process it can make for bad results. Second, we must be willing to question practices that may be largely commonplace when undertaken, and even deemed acceptable by auditors, the SEC, and outside counsel, but which may later be challenged. As a result in-house counsel must redouble their efforts to ensure that they are at the table when sensitive issues such as executive compensation are being decided.

At its October 2006 board meeting, the ACC leadership discussed a variety of ideas to improve in-house counsel's ability to better navigate compensation concerns in light of the ongoing backdating scandals. We thought the discussion about "lessons learned" merited sharing with the membership at large.

1. New Regulation? Learn it!
With new SEC rules on compensation practices in place, lawyers can seize the initiative with management and the board by offering their assistance to ensure compliance with new and complex regulations. If you need to get help from outside counsel to do this, fine: just don't delegate informing management and the board. If you own the responsibility you'll be more likely to be consulted and included in sensitive conversations in the future.

2. Look to Other Resources for Insight.
Instruction can be garnered from other resources. Europe and Canada have taken the lead on compensation regulation and CLO practices. Some would argue they are ahead of the US market in addressing these concerns. Their practices ensure that questions and answers regarding executive compensation are filed immediately, including a "rational basis" support that can be offered in the company's annual report. There are also a number of lawsuits, regulatory actions, and public

investigations that point out where companies may have gone wrong in their compensation activities. Keeping apprised of these actions will help you to avoid becoming one of them.

3. Encourage Management to Act Preemptively
Lawyers should encourage management to work on the next proxy statement year round, rather than waiting until the month before it's due. And they should participate in the process. It will help lawyers show the complete picture, not a once a year snapshot, on the compensation systems and "health" of the compensation process. Moreover, when decisions are made in an environment that isn't suffering from looming deadlines it helps promote deeper conversations that leave everyone better informed and more comfortable that process is being considered. It also allows time for problems to be surfaced, addressed, and resolved in a thoughtful way. Finally, it provides time for appropriate documentation to be created and executed.

4. Establish Appropriate Processes and Procedures for the Corporate Secretary
Lawyers often either serve as the corporate secretary to their company or provide legal advice to the corporate secretary. Lawyers working in either role should take steps to assure that the processes and procedures of the corporate secretary are appropriate and that board and committee decisions are adequately documented. Too often the kind of recordation that goes on in this area is sloppy; that's a recipe for disaster and sends all the wrong messages about how seriously you take these issues and the attention they're given (or not).

5. Play an Appropriate Role in Working with Consultants
Lawyers should participate in work done by the independent compensation consultants who work with the board and/or management. Regulators have been critical of the board's use of management supplied consultants. The board may be well advised to consider securing its own consultants. Compensation experts who play golf with the CEO every weekend or who live next door to the CFO may not be the best choice or their use may require second, more independent opinions. Conflicts questions increasingly arise in the realm of questionable personal relationships between consultants and management, even if there is independence vis-à-vis management's financial connections to the consultant, and even if they are acknowledged as the top in their field.

6. Help Your Directors Make Realistic Decisions
While lawyers aren't necessarily trained as compensation experts, their real world experience, role in having to defend the company, and (let's face it) often cynical approach to life generally, enables them to provide directors with a useful perspective on how compensation decisions should be made and how the decisions reached in that process may be viewed by others. Lawyers make great devil's advocates--they can help ensure a depth and comprehensiveness of the board's conversation that might otherwise be lacking. Don't be afraid to play that role; ask board members how comfortable they'd be explaining their decisions on a nationally-syndicated radio talk show. Will everyday folk think it's reasonable? There's a reason why they should.

7. Help Bring All Stakeholders to the Table
There are numerous stakeholders in the company who may have a substantive contribution to the compensation process. Compensation decisions may benefit from not only HR and the CLO's input but also that of internal audit, the ethics officer, and so on. What appears reasonable to one person in the company may appear entirely differently to someone with a dissimilar perspective. This is invaluable information to guide your decision-making and the process should contemplate how it will be secured.

8. Consider the Possible Long Term Impact of Immediate Comp Decisions
What may be reasonable as a yearly benefit (viewed as an individual or segregated payment) may be viewed as excessive if paid out over ten years and discussed as a cumulative package. This is true given compensation is usually retrospectively reviewed and often when the person in question is no longer in favor with the board, management, or the company's shareholders.

9. Be Active in Creating Appropriate Descriptors/Narratives Justifying Compensation Decisions
Narratives written now will serve as the basis of your decision later when your company's decisions may be under fire. Accordingly, there should be an increasing focus on the narrative accompanying compensation decisions, and lawyers should be at the center of that practice. Consider how you might have to use today's narration next year when discussing the particulars of your company's compensation practices with a regulator or your largest shareholder. Make sure that you are involved in writing the narratives that explain compensation decisions so that you can objectively look at the result and see if it is persuasive and survives the rational basis test. If they don't, consider not only the rhetoric itself but whether the problem is with the underlying decisions that were made.

10. Set the Stage Appropriately for your Own Participation
If you are coming on as a new CLO or it is that time of year again and you are rewriting your goals--- make sure that the written scope of your job gives you the authority and place at the table that you need to do your job well. Gone is the time when a lawyer can simply draw a bright line in the sand representing the appropriate legal considerations and then defer to his/her business partners for everything else. Many activities can be "legal" in the pristine sense and yet create other liability for the company because they are just plain ill-advised or create unnecessary reputational risks. Make sure that the scope of your written authority—as understood in a practical operational everyday sense, preferably with your CEO's back-up—gives you the tools that you need to make a full contribution. Even when something (like backdating) is commonplace practice—condoned by auditors and outside counsel—if the in-house lawyer thinks it is questionable, then the company should be so advised. "Legal, but questionable" problems arise all the time in modern corporations; the difference is that in today's environment, there is significantly less tolerance for companies who rely on that excuse.

Additional Resources

Hot SOX: Executive Compensation and other Sarbanes-Oxley Developments (ACC Webcast)
http://acc.com/resource/v6761 (Transcript: http://acc.com/resource/v7089)

SEC's Proposed Rules on Executive Compensation (ACC Webcast)
http://acc.com/resource/v6712 (Transcript: http://acc.com/resource/v6820)

Backdating Stock Options (ACC Webcast)
http://acc.com/resource/v7479 (Transcript: http://acc.com/resource/v7611)

Once Bitten, Twice Shy: The Impact of the SEC's Proposed Rules on Executive Compensation (Article 2006) http://acc.com/resource/v7293