110 Protecting Your Law Department for a Rainy Day

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Paradise Tarnished: Today's Sources of Liability Exposure for Corporate Counsel
http://www.acca.com/resource/v4960

SEC and Criminal Proceedings Against Inside Corporate Counsel
http://www.acca.com/resource/index.php?key=6063

Corporate Counsel Caught in the Crosshairs
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Lawyers as Whistleblowers: The Emerging Law of Retaliatory Discharge of In-house Counsel, by Lucian Pera
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In-House Counsel as Targets: Fact or Fiction? (Archived Webcast)
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Speech by Stephen M. Cutler, then Chief of Enforcement with the SEC, at UCLA, Sept. 20, 2004 (offering insight into the SEC's expectations for in-house lawyers as "gatekeepers")
http://www.sec.gov/news/speech/spch092004smc.htm

ABA Task Force on Corporate Responsibility homepage: (examining the role of lawyers in the Post-Enron world)
http://www.abanet.org/buslaw/corporateresponsibility/

Law Department Policies on Implementing Sarbox 307 (An ACC Leading Practice Profile):
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Governance and the Role of In-House Lawyers Post Sarbox: (An ACC Leading Practices Profile)
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"INDIVIDUAL LIABILITY OF THE CORPORATE LAWYER"

This is an excerpt from Chapter 6,

"Individual Rights and Liabilities of Corporate Counsel", of

Corporate Counsel Guidelines

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SUMMARY

§ 6.01 Introduction

This chapter is devoted to analyzing the personal rights and liabilities of inside corporate counsel sometimes in matters adverse to the corporation. It reviews the potential bases of civil liability to the corporation and, as privity-based defenses crumble, to third parties including employees, shareholders, business partners and others. As the visibility and importance of corporate counsel grow, they will become more attractive targets for civil litigation much as their colleagues in private firms have been for the past several decades.

The chapter also explores the tangled and fast-developing jurisprudence governing a corporate lawyer's employment rights *vis-a-vis* her corporate employer in (i) garden-variety breach of contract cases, (ii) ethics-based disputes, and (iii) discrimination cases. It also analyzes restrictions placed on corporate lawyers' right to litigate against their former corporate employers both as counsel and as a party. We have analyzed in Chapter 3 the corporate lawyers' ability to work for competitors.

A third major focus of the chapter is government sanctions against corporate counsel including limitations on practice before federal government agencies and even criminal investigations and prosecutions of corporate lawyers.

Finally, the chapter reviews various mechanisms that can provide some protection for the corporate lawyer -- malpractice insurance and corporate indemnity.

§§ 6.02–6.04 Civil Liabilities to the Corporation, and Its Directors, Officers and Employees

Although the number of claims against corporate lawyers appear to be increasing, such claims are relatively infrequent as compared to claims against private lawyers. There are several reasons for this disparity. Most corporate employers choose not to sue their corporate counsel, even for inferior work, probably because of the possibility of disclosure of client confidences and the limited opportunity for financial recovery. Thus, for most corporations, the preferred solution is terminating the corporate lawyer's employment. Most of the claims against corporate counsel therefore come from other members of the corporate family -- employees, directors or officers -- who claim to have entered into an attorney-client relationship with

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the counsel. Five examples of such claims are described in the text.

Although there are no reported cases addressing the question whether members of a corporate counsel's office are vicariously liable for the acts of other lawyers in the office, the most likely answer is that they are not. In this way, corporate counsel are significantly different from and better off than their counterparts in private firms where all partners would ordinarily be liable for the torts of the other partners acting within their scope of employment.

As indicated above, there are very few reported decisions and presumably few instances in which corporate employers have sued their corporate counsel. The principal reasons for this are the lack of substantial assets or malpractice insurance to respond to such claims and the fear that the suit would result in disclosure is of confidential information. The concern for confidentiality is tempered for companies that are in bankruptcy or that have been taken over by a federal receiver (such as failed financial institutions) or a state court conservator (such as insolvent insurance companies). Nevertheless, even such failed corporations tend not to sue their former inside counsel because of the limited opportunities for financial recovery.

Historically a more troublesome area for corporate counsel has been claims by corporate officers and employees. Such claims usually arise out of joint representation of the corporation and a corporate officer or employee typically in civil litigation. While joint representation in criminal litigation is, if anything, much more treacherous than civil cases, most corporate counsel know to avoid that problem.

Often there is a true joint representation and the claim results from the fact that there was an unwaivable conflict, the counsel failed to explain adequately the nature of the potential conflict and obtain an informed waiver, or the individual client believed that his interests were sacrificed for the corporate good. There can also be claims arising out of situations in which the corporate counsel did not expressly agree to represent the individual but the individual believes (or at least claims) that the disclosure of confidences to corporate counsel was made pursuant to an attorney-client relationship.

Unions and union counsel face a similar problem. Union members often present claims against the employer for the union's counsel to evaluate and determine whether the claim should proceed with the union's support. During that evaluation process, union members sometimes believe that the union's

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lawyers were acting as their personal counsel, and this has led to claims against the lawyers.

The solution to all of these problems is the adoption of procedures, and strict adherence to them, that explain to corporate officers, employees and others, the scope of corporate counsel's representation. And if counsel undertakes to represent the individual, the joint representation should be preceded by a careful analysis of the likelihood of conflict, and a thorough discussion of the risks to the individual -- hopefully with a witness present.

§ 6.05 Civil Liabilities—Civil Liability to Third Parties

As privity erodes, corporate counsel have potential liability to an increasing array of third parties. Problems may arise with business partners or joint venturers where one partner's corporate counsel's office has undertaken the representation of the entire venture. The problem in these situations is that dispute may develop between counsel's corporate employer and the other business venturer or partner. As these conflicts sharpen, counsel may receive conflicting directions from, or perceive a conflict of interest between, her corporate employer and the other participants in the venture.

These problems can become insoluble and result in counsel's forced resignation at least as counsel for the venture. While careful waivers and prudential steps in segregating files and avoiding intra-venture conflict may avoid many issues, the potential for problems may convince most well-advised corporate counsel that it is unwise to represent a joint venture or partnership in which the corporation is a participant.

Another area in which there is potential liability but surprisingly few cases involves opinion letters. The widespread use of opinion letters by private counsel has spawned relatively few suits. There are also a few unusual situations in which corporate counsel may become liable to adversaries such as where the corporate lawyer makes misrepresentations as to her authority to settle a case.

A fertile ground for suits against corporate lawyers, both inside and outside, is relations with shareholders. The general rule is that a corporation's officers owe no separate duty to individual shareholders. Corporate fiduciaries (including corporate counsel) may, however, have duties and liabilities to shareholders through the corporation in a derivative action.

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Corporate counsel may also face individual liability for securities fraud. Although the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, rejected aiding and abetting liability under the federal securities laws, the lower courts have expressed their displeasure with this decision by expanding other means of holding lawyers liable. This includes holding lawyers liable as controlling persons under the securities laws and finding lawyers primarily liable.

§ 6.06 Employment Rights of Corporate Counsel—In General

The jurisprudence governing the rights of corporate counsel has developed rapidly in the past decade. The early cases likened the corporate counsel to private lawyers so that lawyers forced to resign employment for ethical reasons were afforded no legal recourse. Corporate counsel, at least those working without employment contracts, were seen as "at-will" employees who were entitled to be discharged for any reason or no reason at all. This was similar to the situation for private lawyers who ordinarily can be discharged by the client without reason or cause.

The more recent cases, however, have rejected the private lawyer paradigm and have treated corporate counsel more like a special class of employees with enhanced duties of confidentiality. There has been considerable softening of the rule that a lawyer who resigns for ethical reasons is without legal recourse. More importantly, corporate counsel can bring a wide range of employment-based claims based upon federal anti-discrimination laws and even contract principles provided that adequate precautions are implemented to avoid disclosure of corporate client confidences. More leeway is shown to the lawyer who is defending against claims by the corporation than bringing them.

§§ 6.07—6.08 Ethics—Based Dismissal, Resignation and Termination of Corporate Counsel

Model Rule 1.16(a) requires that lawyers resign or withdraw if their clients intend to commit certain illegal acts or cause the lawyers to act illegally or unethically. While this rule may impose some hardship on a private lawyer in losing a client, the effect on the corporate counsel may be a career-ending decision. This is particularly harsh when one considers that it is the *client's* proposed misconduct that triggered the lawyer's ethical duties.

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That said, the landmark decision is *Balla v. Gambro, Inc.,* held that corporate counsel who objected to his corporate employer selling kidney dialysis machines that would allegedly be dangerous to patients, reported the matter to the FDA, and was fired, had no claim for "retaliatory discharge." Reasoning that such a tort action would undermine the lawyer-client relationship, in which the client historically could discharge counsel for any reason, the Illinois Supreme Court found against the lawyer.

Balla v. Gambro was at first followed by several courts and then the California Supreme Court held in *General Dynamics Corp. v. Superior Court*, that a corporate lawyer should be able to sue in situations where other corporate employees could sue provided that there are no sensitive confidentiality issues implicated or, if they arose, confidentiality could be safeguarded.

§§ 6.09–6.10 Discrimination–Based Employment Suits by Inside Counsel

Suits by corporate counsel alleging discrimination in employment have been better received by the courts. The courts begin with the unspoken presumption that an employee can pursue such litigation and that there are adequate safeguards for confidentiality. This applies to claims of discrimination under Title VII including those based upon race, age, and sex.

Corporate counsel, of course, have the right to bring straight breach of contract claims if justified by their employment contracts and the applicable state law.

§ 6.11 State and Federal Whistle–Blower Protection Statutes

A few corporate counsel have also attempted to invoke the protection of federal and state "whistle-blower" statutes that protect employees from retaliatory discharge after disclosing their employers' wrongdoing. The extent to which such statutes will provide protection to the corporate lawyer remains unresolved.

§ 6.12 Restricting Lawyers from Practice Before Federal Agencies

Another sanction that can be levied upon corporate counsel is a limitation of the right to provide legal advice to a class of regulated businesses or to practice before a federal regulatory agency. The SEC and the federal banking agencies have the statutory authority to impose cease-and-desist orders that broadly restrict a lawyer's ability to provide legal services to

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entities subject to their regulation. While seldom used, these sanctions have potentially devastating impact.

Better known than the cease-and-desist orders is the regulatory agencies' authority to restrict those who practice before them. Perhaps the best known such procedure is the SEC's 2(e) proceedings; other federal agencies have analogous rules. The SEC's 2(e) proceedings have been the subject of ongoing judicial challenges and their validity has been in serious question. *Checkosky v. SEC*, 139 F. 3d 221 (D.C.Cir. 1998).

While the 2(e) procedure can have a major impact on counsel (and other professionals), its principal importance for corporate counsel may be that it has been a platform for the SEC to express its views about the appropriate role of corporate and securities lawyers. Thus, the most famous lawyers' 2(e) case is probably *In re Carter and Johnson,* a decision in which the SEC declined to impose sanctions but broadly stated what it expected of securities lawyers whose corporate clients fail to follow the lawyer's advice on disclosure issues. Similarly, another SEC report, not premised on 2(e), discusses the obligations of corporate counsel where there is knowledge of corporate wrongdoing and insufficient corrective action. This is the famous Salomon Brothers' bond-trading scandal that rocked Wall Street in the early 1990's. *In re Gutfreund*.

§ 6.13 Malpractice Insurance

With the rapid development of the corporate bar and the increased recognition of the risks of corporate practice has come malpractice insurance policies designed for the inside corporate counsel. While there may be some question about the need for such policies for every corporate lawyer, there are clearly some industries and some situations in which corporate counsel may find the availability of insurance reassuring and even helpful. The principal areas where corporate counsel are rightly concerned are where (i) the company may not be in existence to indemnify counsel because it is a start-up company or is in dire financial condition, (ii) the company is in an industry where failure frequently results in suits against directors and officers and lawyers (*i.e.*, banks and insurance companies), (iii) the company is in a highly volatile market that spawns shareholder litigation, (iv) the company is involved in joint ventures, and (v) corporate counsel often gives legal advice to third parties such as corporate insiders, pro bono clients or others. Insurance may be valuable in these situations, as well as in any case where the corporate counsel has significant personal assets.

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A significant issue with corporate lawyer's malpractice coverage is the possible overlap with directors' and officers' liability insurance (if counsel is also a director or officer). The overlap often provokes disputes between the carriers that paralyzes both carriers as they both invoke the "other insurance" clauses to decline coverage. Thus, careful integration of the two policies is essential.

The malpractice liability policy for corporate lawyers, often referred to as "employed lawyers coverage," is based on the familiar model of the classic directors' and officers' liability insurance policy. This includes what is known as "Part A" and "Part B" coverage for the situations where the corporation is not indemnifying the corporate counsel so the carrier makes direct payments to the corporate lawyer or her counsel (Part A coverage) and where the corporation is paying for the lawyer's defense costs and liability, and then obtains reimbursement from the carrier (Part B coverage). The major difference between d & o insurance and employed lawyers' insurance is that for the lawyer the liability insured against must result from "legal services."

The text of Chapter 6 reviews in detail one of the most popular employed lawyers' policies -- the Executive Risk policy which is endorsed by ACCA. One significant aspect of that policy is the exclusion for claims by the corporation against its own corporate counsel. Thus, corporate counsel sued by her own corporation will have coverage for legal expenses to defend the case (the "defense sublimit") but no coverage for liability. This structure should discourage suits by the corporation against its own counsel in order to collect on the insurance. A somewhat similar provision -- generally referred to as the "insured v. insured exclusion" -- is commonplace in d & o policies. Other exclusions that are often found in d & o policies are also present in employed lawyers' coverage include those for dishonesty, personal gain, etc.

§ 6.14 Corporate Indemnity and Limitations of Corporate Counsel's Liability

Although prospective limitations on liability are accepted tools in the corporate world to attract directors and other corporate fiduciaries, they are probably prohibited for corporate lawyers by Model Rule 1.8(h). Indeed, there is a split of authority among bar associations as to whether a corporation and its inside counsel can agree to liability limitations. There is no doubt, however, that a corporation and its former lawyer

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can release claims for past conduct as part of a settlement or otherwise. And a lawyer who successfully defends a case against him is entitled to corporate indemnity under Delaware law and the law of most states.

§ 6.15 Limitations on Litigating Against the Company

The ethical rules governing confidentiality of information gleaned during the attorney-client relationship limit corporate counsel's ability to work for competitors as we have seen in § 3.34 *supra*. The same confidentiality concerns impose restrictions on corporate counsel's ability to litigate against her former employer. While this does not prohibit corporate counsel from filing suit as a party against the former corporate employer, it may preclude her from acting as counsel in litigation against the corporation or even joining a class of former employees suing the corporation. The concern in all of these cases is balancing the former corporate counsel's right to enforce her rights against placing former corporate counsel in a position to, in effect, graymail her employer with the threat of disclosure of the confidences she has gained. A Solomonic compromise, adopted by some courts, is to permit the former corporate lawyer only to sue individually (which may be financially burdensome) rather than as part of a class so that the public disclosure of corporate client confidences can be more easily controlled. There is substantial authority that the court can monitor the disclosures of former corporate counsel even to her own counsel through *in camera* procedures or by sealing the records. Courts are becoming less tolerant of any attempts by former corporate counsel to use the threat of unveiling corporate confidences as a weapon in litigation against the corporation, and lawyers who have played this card are being rebuked.

§ 6.16 Taking Documents from Corporations

The general rule is that corporate documents belong to the corporation and employees can take neither the originals nor copies when they leave the corporation's employ. This obligation would appear heightened by the fact that corporate counsel's documents contain confidential information that the lawyer could seldom, if ever, ethically use after employment. The one instance in which a former corporate counsel may ethically be permitted to use confidential information from her corporate employment is under Model Rule 1.6(b)(2) in order to establish a claim or defense against the corporate client. Whether that possibility would permit removal of confidential corporate documents is questionable but one court has entertained such an

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argument seriously. In *X Corp. v. Doe*, a district court appeared to approve of a departing corporate counsel taking confidential information and documents if a reasonable attorney could conclude that the documents clearly established a client-employer's crime or fraud. Although the court later held that the documents did not meet that test and ordered them returned to the corporation, the initial decision was nonetheless surprising in that it appeared to encourage corporate lawyers to remove files on their departure.

§ 6.17 Qui Tam Suits

While there is no per se prohibition on corporate counsel acting as qui tam relators, this does not mean that their duties of confidentiality are in any way diluted. Indeed, a former corporate counsel who improperly utilizes confidential information may not serve as a qui tam relator.

§§ 6.18–6.22 Criminal Exposure for Corporate Counsel

Corporate counsel, as well as all other lawyers, are becoming more attractive as targets for law enforcement than at any time in the past. They are valued because of their visibility, stature and the fact that they may be able to be pressured into providing unusually valuable information on other targets (including the corporation). Their trophy status and their potential benefit to prosecutors is enhanced by their vulnerability to pressure: knowing that any criminal charge is likely to lead to disbarment, they are often highly motivated to cooperate with law enforcement.

As a result, law enforcement has been increasingly attracted to lawyers as witnesses and targets. By placing pressure on corporate counsel, the prosecutors may be able to neutralize an "advice of counsel" defense, disrupt the corporation's defense and possibly obtain vital or even privileged information. Corporate counsel who sees herself being cast as a suspect or target in a criminal investigation which also involves the corporation must be cognizant of the ethical restrictions governing her conduct.

The basic principles are embodied in Model Rule 1.7 governing conflicts of interest and Model Rule 1.6 governing confidentiality of information. Thus, if the corporate lawyer is either a subject or target of the investigation, or has reason to believe that she will eventually become one, there is a very serious question as to whether she may continue giving advice to the corporation regarding the handling of the investigation.

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Model Rule 1.7(b) renders it a conflict if the lawyer's own interests interfere with her responsibilities to the client unless waived by the client after consultation. A criminal investigation focussing partially on the lawyer would appear to trigger a Model Rule 1.7 analysis.

Apart from the potential conflict issues in Model Rule 1.7, the corporate counsel must carefully weigh the confidentiality restrictions in Model Rule 1.6 against her desire to vindicate her own conduct. While Model Rule 1.6(b)(2) allows a lawyer to disclose otherwise confidential information "to establish a defense to a criminal charge," this does not authorize wholesale revelation of privileged information. Careful examination of the application of Model Rule 1.6 is necessary for the lawyer who is concerned about compliance with the ethical rules. Of course, a lawyer who has engaged in illegal acts may be more concerned with fending off a criminal prosecution than compliance with ethical norms.

The ethical rules can provide a defense to lawyers charged with criminal conduct because they can show that their silence was not in furtherance of a crime but required by the legal ethics.

§ 6.23 Attorney–Director

We examined in Chapter 3 the ethical issues confronting the attorney-director and concluded that, for the most part, they were theoretically subject to solution. See § 3.32 supra. As we observed in that section, and as we reiterate here, the attorney-director has become such a lightning rod for litigation, the risks may effectively moot the analytical.

There are basically two risks to the attorney-director. The first risk is that she fails to explain the conflicts issues that her dual capacity presents and/or fails to clarify what "hat" she is wearing at all times. This problem can be solved through strict adherence to the rules discussed in § 3.32. A more substantive concern arises from the enhanced standard of care that a few courts have imposed on the attorney-director. Extrapolating from *Escott v. Barchris*, a few cases have opined that an attorney-director may be held to a higher standard than another (in that case outside) director. This heightened standard of care became a rallying cry for the FDIC, FSLIC and RTC in the failed bank and thrift cases and it elevated the lawyer-director to the target of choice in those cases. The notion continues today and the lawyer-director can expect to be subjected to greater scrutiny and exposed to more claims than

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the other directors -- not necessarily for good reason. This new reality, however, may be more important than the theoretical defenses of the attorney-director in assessing the wisdom of this course.

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"INDIVIDUAL LIABILITY OF THE CORPORATE LAWYER"

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§ 6.06 Employment Rights of Corporate Counsel—In General

Although a lawyer is required to abide by the ethics rules or face professional discipline, the first reported decisions construing corporate counsel's rights against the company when he has taken a stand purportedly based upon, or even required by, ethical rules, were surprisingly harsh toward the lawyer. The law, however, is evolving in a direction that is more favorable for the corporate counsel. The early cases involving corporate counsel followed the time-honored rule for private lawyers that the client could discharge the lawyer at any time with or without a reason and the client is liable only for the work performed (and quantum meruit in a contingent or deferred fee case). Those cases held that if the corporate counsel is an employee-at-will, *i.e.* one without an agreed-upon term of employment, the corporate counsel may be discharged for any reason -- including the fact that the lawyer believed himself to be ethically required to disregard the orders of senior management.[1] Likewise, a corporate counsel who resigned rather than perform what he believed was an unethical act could not collect for any work not performed.

The more recent cases eschew the private lawyer/discharge-at-will-for-any-reason paradigm and move far along the spectrum toward viewing corporate counsel as an employee who has enhanced duties of confidentiality and loyalty. In a number of jurisdictions, corporate counsel can assert all or most of the employment claims of other employees -- especially all manner of federal discrimination claims -- except to the extent that to do so would wholly undermine the lawyer's duties to former clients of confidentiality and loyalty. Moreover, some courts are devising imaginative ways of preserving confidentiality that would permit nearly every such case to proceed.

[1]In some large corporate counsel's office, it may be theoretically possible for the lawyer to decline to participate in the problematic act by having the task reassigned to another lawyer in the office. While this may avoid the dilemma posed by Model Rule 8.4(a), which prohibits a lawyer's personal involvement in activities that he regards as a violation of the ethical rules, it may, as a practical matter be as damaging to the lawyer's career as resignation. Furthermore, if the lawyer is convinced that the problematic act would violate the ethics rules, he may be obligated to "inform the appropriate professional authority" if the lawyer to whom the case is reassigned performs the act. *See* Model Rule 8.3(a).

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Courts draw the line where the lawyer who was *defending* employment claims for the company now wants to join other employees in *bringing* such claims. The courts frequently prohibit the former corporate counsel's joining, or leading, a class action because it would result in disclosing privileged information to the company's adversaries. In a Solomonic compromise, former corporate counsel who were involved in employment matters are forbidden from participation in the employee class action, and are required to pursue an individual suit.

§ 6.07 Employment Rights of Corporate Counsel—Dismissal and Wrongful Termination of At Will Corporate Counsel

We have discussed at some length the issue whether counsel may or must resign because of ethical violations. See § 3.20 *supra*. That section must be reviewed with care before beginning the analysis of corporate counsel's employment rights against the corporation.

Model Rule 1.16(a) was obviously developed with the private lawyer in mind. Resignation would end the representation of that client but not leave the lawyer unemployed. There is a significant policy question whether inside counsel should be required to resign if that means no longer being employed since that can impose a crushing financial hardship on the inside lawyer for the misconduct of the corporate client. Philosophical musings, however, are beyond the scope of this treatise and the inside corporate lawyer is now, and probably always will be, subject to the standards of Model Rule 1.16(a) to the same extent as private counsel.

The distinction between ethically-required (Model Rule 1.16(a)) and ethically-permissible (Model Rule 1.16(b)) withdrawal and termination of employment is essential to evaluating the contract rights of inside counsel. While inside counsel may rely upon a public policy exception to provide rights against the corporate employer where the lawyer is ethically required to resign because of the employer's misconduct, it is doubtful that he will have equal rights where the resignation is only permitted by the ethical rules.

§ 6.08 Employment Rights of Corporate Counsel—At—Will Counsel's Legal Rights for Ethics—Based Discharge

The traditional rule is that an at-will employee -- including a lawyer -- can be fired for cause or for no cause at

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all.[2] Most jurisdictions, however, recognize a "retaliatory discharge" or "wrongful discharge" exception to this rule.[3] In those situations in which the exception is recognized, it is typically justified by some public policy.[4] The first cases that addressed this issue did *not* recognize a "wrongful discharge" exception for lawyers for ethics-based concerns,[5] although the jurisprudence seems to be in transition in those cases in which the disposition of the suit would not raise confidentiality concerns.

In a leading case in this area, *Balla v. Gambro, Inc.*,[6] a dismissed corporate counsel sued his former employer, a marketer and distributor of kidney dialysis machines. Plaintiff had been responsible for all the entity's legal matters, including regulatory affairs and governmental compliance issues. Counsel obtained from the corporate parent a letter indicating that certain machines would be dangerous to dialysis patients and not in compliance with applicable FDA regulations, and advised company officials to reject the machines for noncompliance with applicable FDA regulations, and because they could be potentially dangerous to users.

The Gambro president announced an intention to sell the machines and counsel informed the company president of his intent to stop that sale. The president fired corporate counsel (Balla) who then reported the defective machines to the FDA, which seized the machines before they could be distributed. Balla brought a retaliatory discharge claim against the company for the firing, alleging contravention of a fundamental public policy by his corporate employer. Affirming summary judgment for the employer, the Illinois Supreme Court ruled that no retaliatory discharge cause of action was available for in-house corporate attorneys, because they were not just employees, but

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[2]*See generally* Rand v. CF Industries, Inc., 797 F.Supp. 643 (N.D.Ill.1992).

[3]*See In House Counsel's Right to Sue for Retaliatory Discharge*, 92 Colum.L. Rev. 389, 394 (1992).

[4]*But see* General Dynamics Corp. v. Superior Court, 7 Cal.4th 1164, 32 Cal.Rptr.2d 1, 876 P.2d 487 (Cal. 1994), discussed *infra*, in which the court's allowance of a retaliatory discharge claim by in-house counsel turned upon a simple analogy: if a non-attorney employee can sue for wrongful discharge, so, too, can in-house attorney employees, so long as the attorney-client relationship is not breached. *Id.* at 490.

[5]Patricia Leigh Odell, *Retaliatory Discharge: Corporate Counsel in a Catch-22 (Note)*, 44 Ala. L. Rev. 573, 576 (1993).

[6]145 Ill.2d 492, 164 Ill.Dec. 892, 584 N.E.2d 104 (Ill. 1991)

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also general counsel. The court found that the allowance of such a tort action would undermine the attorney-client relationship.[7]

Balla v. Gambro is consistent with *Willy v. Coastal Corporation*,[8] where corporate counsel alleged that he had been terminated for insisting that the company comply with environmental and securities reporting obligations. The court interpreted Texas law to preclude assertion of a "wrongful discharge" tort by corporate counsel, noting that there existed an established course of behavior for attorneys in the position alleged -- serve the client or withdraw -- and that those were the options available to corporate counsel.[9]

The *Balla v. Gambro* rule was too harsh to survive for long, and courts are now recognizing a right to sue where the corporate counsel is acting on ethical considerations. In a leading decision, *General Dynamics Corp. v. Superior Court*,[10] the California Supreme Court challenged the basic thesis of the *Balla v. Gambro* line of cases. The court held that a lawyer should be entitled to the rights of a non-lawyer to sue where no sensitive confidentiality concerns are implicated or, if they exist, confidentiality can be adequately safeguarded. It

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[7]*Id.* at 109-110. The Illinois Supreme Court expressed some concern that allowing such a suit, even on public policy grounds, would cause employers to be less than candid with in-house counsel in many situations, including instances of questionable conduct.

[8]647 F.Supp. 116 (S.D.Tex.1986), *rev'd in part on other grounds*, 855 F.2d 1160 (5th Cir.1988). *See also McGonagle v. Union Fidelity Corp.*, 383 Pa.Super. 223, 556 A.2d 878 (Pa.Super.1989).

[9]*Id.* at 118. As one commentator has stated, "*Willy's* logic is neither clear nor convincing ... [since] logic hardly dictates that the rules must go unsupplemented by wrongful discharge protection for house counsel." Ted Schneyer, Professionalism and Public Policy: The Case of House Counsel, 2 Geo. J. Legal Ethics 449, 470-71 (1988). *See also Herbster v. North American Co.for Life & Health Insurance*, 150 Ill.App.3d 21, 103 Ill.Dec. 322, 501 N.E.2d 343 (Ill. App. 1986), *cert.denied*, 484 U.S. 850, 108 S.Ct. 150, 98 L.Ed.2d 105(1987)(plaintiff lawyer was unsuccessful in claim of retaliatory discharge, when fired for refusal to act in violation of ethics rules and other laws, because attorneys occupy what the court calls a special place in our society).

[10]7 Cal.4th 1164, 32 Cal.Rptr.2d 1, 876 P.2d 487 (Cal. 1994)

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rejected the notion that inside counsel's only choices were to resign or commit an ethical breach.[11]

The *General Dynamics* case was followed by *GTE v. Stewart*,[12] where the court recognized the right of an in-house attorney to file suit for retaliatory discharge for ethics-based reasons. It also suggested that this could be accomplished without disclosing confidential information.

Thus, since *Balla v. Gambro*, the pendulum is beginning to swing back toward the corporate counsel. Of chief concern to courts, as seen in the *General Dynamics* case, is the issue of protection of client confidentiality. Current or former in-house lawyers who improperly disclose or seek to disclose client confidences to further their claims have received a chilly reception by the courts.[13] Corporate counsel now appear to have a chance to redress a true retaliatory discharge, and an additional avenue to pursue, other than resignation as a matter of professional responsibility.

§ 6.09 Employment Rights of Corporate Counsel—Discrimination—Based Employment Suits by Inside Counsel

A different rule is emerging for suits based upon federal antidiscrimination laws -- at least to the extent that there is little risk of disclosure of confidential information. In *Kachmar v. Sungard Data Systems, Inc.*,[14] the Third Circuit, confronting a situation in which discharged counsel asserted a non-ethics based Title VII claim, adopted a significantly more permissive view than *Balla* in allowing a retaliatory discharge claim to go forward. *Kachmar* involved a suit by former in-house counsel fired after a series of disputes with top corporate officials. She brought both Title VII and pendent state law

[11]In its discussions, the court considered the similar plight of in-house attorneys and their non-attorney colleagues, and noted that similarities of circumstance dictate analogous courses of action, *i.e.*, availability of the right to sue for wrongful discharge. *Id.* At 489-490. Note, however, that the court also stated, in strong language, that where a retaliatory discharge claim cannot be completely resolved "without breaching the attorney-client privilege, the suit *may not proceed*." *Id.* at 490 (emphasis added).

[12]421 Mass. 22, 653 N.E.2d 161 (Mass. 1995).

[13]*See e.g.*, Douglas v. DynMcDermott Petroleum Operations Co., 144 F.3d 364 (5th Cir.1998); Siedle v. Putnam Investments, 147 F.3d 7 (1st Cir.1998).

[14]109 F.3d 173 (3d Cir.1997).

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TAKING THE LEAD: STRATEGIES FOR THE CORPORATE ADVOCATE ACCA'S 1999 ANNUAL MEETING

claims. The district court "alluded to" the notion that maintenance of a retaliatory discharge claim would improperly implicate communications subject to the attorney-client privilege and/or information relating to Kachmar's representation of Sungard.

The Third Circuit first noted that other federal courts confronting this question had upheld the right of discharged in-house counsel to proceed under Title VII and related statutes.[15] It then pointed out that the policies underlying the federal antidiscrimination laws took precedence over state law at-will discharge principles. The court then found that the concerns for disclosure of client confidences, although reasonable, were not enough to "warrant dismissing a plaintiff's case, especially where there are other means available to prevent unwarranted disclosure of confidential information." The court enumerated a range of judicial measures, including "the use of sealing and protective orders, limited availability of evidence, orders restricting the use of testimony in successive proceedings, and, where appropriate, in camera proceedings." The court reversed and remanded for the trial judge to frame a procedure permitting vindication of retaliatory discharge claims while still "preserving the core values of the attorney-client relationship."[16] *Kachmar* suggests that those corporate counsel who claim the protection of federal anti-discrimination (or other employee-protective) law have a stronger hand in responding to dismissal.[17]

At the other end of the spectrum, at least one court has held that disclosure of client confidences by an inside counsel as a matter of law *may not* constitute "protected activity" under federal discrimination laws, and that termination of the counsel/employee was permissible. In *Douglas v. Dyn McDermott Petroleum Operations*,[18] the court held that an inside lawyer's disclosure of information about alleged discrimination in the corporate work place to a federal agency amounted to a violation

[15]*Id.*

[16]*Id.* at 182.

[17]The Association of the Bar of the City of New York Committee on Professional and Judicial Ethics Formal Op. No 1994—1 stated that no ethical provision barred a terminated in-house counsel from pursuing a claim for employment discrimination against his former employer. The Committee did note that former in-house counsel was precluded from serving either as attorney or class representative for a proposed class action suit against his former employer. That role would create intolerable tension between the duty to represent the class zealously and the duty to protect the confidences of his former employer.

[18]163 F.3d 223 (5th Cir.1998)

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of the confidentiality provisions of Model Rule 1.6. The court dismissed as "patently implausible" Douglas' argument that she reasonably understood that the government agency was her client, along with her corporate employer. Because the inside lawyer had declined contemporaneously to term her disclosure as a "whistle-blower" complaint, the court did not need to reach the question whether the disclosure fell within the exception contained in Model Rule 1.6(b)(2) as necessary to establish a "claim or defense" by Ms. Douglas against her employer-client. The court concluded with a blistering rebuke for lawyers who violate ethical rules and the "unique position of special trust" that inside counsel enjoys.

Excepting an unusual case like *Douglas*, where the inside counsel disclosed client confidences and failed to invoke the "claim or defense" exception in Model Rule 1.6(b)(2), the rule in *Kachmar* is probably the prevailing standard, thus allowing inside counsel to sue for employment discrimination if confidences can be protected. *Kachmar* capped a series of cases that either explicitly or implicitly allowed corporate counsel to sue their current or former corporate employers for employment discrimination prohibited by federal law.[19]

The limitation that the courts have imposed on these federal discrimination suits by corporate counsel are: (i) protective orders and other devices to prevent unwarranted disclosure *and* (ii) the lawyers may not be able to start or join a class of other employees *if* the corporate counsel had participated in the defense of such claims.[20]

§ 6.10 Employment Rights of Corporate Counsel—Breach—of—Contract Claims by Inside Counsel

Dismissed corporate counsel may have other options, such as a breach of contract action[21], an action for violation of an

[19]Whittlesey v. Union Carbide Corp., 742 F.2d 724 (2d Cir.1984) (age discrimination); Stinneford v. Spiegel, Inc., 845 F.Supp. 1243 (N.D.Ill.1994) (age discrimination); Golightly—Howell v. Oil, Chemical and Atomic Workers, 806 F.Supp. 921 (D.Colo.1992) (race or sex discrimination); Rand v. C.F. Industries, Inc., 797 F.Supp. 643 (N.D.Ill.1992) (age discrimination); Hoskins v. Droke, 1995 WL 318817 (N.D.Ill.1995) (Title VII); Vanek v. Nutrasweet, 1993 WL 535209 (N.D.Ill.1993) (sex discrimination); Verney v. Pa. Turnpike Commission, 903 F.Supp. 826 (M.D.Pa.1995) (Title VII—retaliation).
[20]*See e.g.*, Doe v. A Corp., 709 F.2d 1043 (5th Cir. 1983); Hull v. Celanese, 513 F.2d 568 (2d Cir.1975); New York City Bar Ethics Op. 1994-1.
[21]*See Nordling v. Northern States Power Co.*, 478 N.W.2d 498 (Minn.1991) (affirming dismissal of retaliatory discharge tort

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applicable whistle-blower statute,[22] or a breach of an implied-in-fact dismissal-for-cause-only agreement arising from company manuals or hand-outs.[23] The availability of these avenues is relatively sparse, state-specific, and of limited usefulness as an *ex ante* protection against retaliatory dismissal.

§ 6.11 Employment Rights of Corporate Counsel—State and Federal Whistle—Blower Protection Statutes

Although the Anglo-American endorsement of the common law doctrine of employment-at-will still reigns over the world of free enterprise, including the area of employment of corporate counsel, employees in some fields have been successful in challenging retaliatory discharge, also known as firing after "whistleblowing." Under federal and state law provisions which protect whistleblowers from retaliatory discharge, in-house counsel are attempting to prove in court that they, too, are protected "employees" under the terms of most whistleblowing statutes.[24]

To date, only one judicial decision has extended state statutory whistleblower protection specifically to corporate counsel.[25] Of the approximately 33 states that have enacted

claim but reversing lower court and allowing breach of contract action for in-house attorney).
[22]*See*, *e.g.*, *Parker v. M & T Chemicals*, 236 N.J.Super. 451, 566 A.2d 215 (N.J.Super.Ct.App.Div.1989)(in suit filed under N.J. whistleblower statute, court rejected employer's defense that a client, even a corporation, can end the lawyer-client relationship despite the provisions of the whistleblowing statute).
[23]*Mourad v. Automobile Club Ins. Ass'n*, 186 Mich.App. 715, 465 N.W.2d 395 (Mich.Ct.App.1991).
[24]*See generally* John L. Howard, *Current Developments in Whistleblower Protection*, 39 Labor L. J. 67,69 (1988). A typical state whistleblowing statute, for example, provides that employees may not be discharged for reporting company wrongdoing and related actions. The term "employee" generally is defined as an individual who performs services under the control and direction of an employer, and receives wages or other remuneration for such activities. This broad definition would not preclude, on its face, employees of corporate general counsel's office.
[25]*See* Parker v. M & T Chemicals, 236 N.J.Super. 451, 566 A.2d 215 (N.J.Super.Ct.App.Div.1989) (recognizing that in-house attorneys are employees within the meaning of the New Jersey Whistleblower statute and can, therefore, sue an employer for retaliatory discharge).

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whistleblowing statutes, less than half extend such protection to private sector employees.[26] Even among those states that create a cause of action for private employees, none explicitly addresses the issues facing in-house counsel. Moreover, some whistleblower statutes contain restrictions that severely restrict in-house counsel's ability to invoke statutory protection. For example, in *Wieder v. Skala*,[27] the court held that the whistleblower statute did not apply to a retaliatory discharge claim by a law firm associate based upon the attorney's efforts to have the firm comply with disciplinary rules, because the statute was not pleaded in the complaint and because the whistleblower statute is expressly limited to "activity, policy or practice of the employer ... which ... presents a substantial and specific danger to the public health or safety."[28]

Other state courts have left open the possibility that an attorney could sue under the applicable whistleblower statute but have denied protection on the specific facts before them.[29]

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[26]John Jacob Kobus, Jr., Note, *Establishing Corporate Counsel's Right to Sue*, 29 Val. U. L. Rev. 1343,1401 (1995). The majority of the whistleblower statutes only apply to public sector whistleblowers, and only a few extend protection to private sector whistleblowers. *Id.*

[27]144 Misc.2d 346, 544 N.Y.S.2d 971 (N.Y. 1989)

[28]*Id.* At 973.

[29]*See* Chilingirian v. City of Fraser, 194 Mich.App. 65, 486 N.W.2d 347 (Mich.Ct.App.1992) (private attorney could not recover for wrongful termination as city attorney under state Whistleblower Protection Act because attorney was an independent contractor rather than an employee; "it is clear that plaintiff was not 'in-house' counsel for the city"), *aff'd* 200 Mich.App. 198, 504 N.W.2d 1 (1993); Contreras v. Ferro Corporation, 1993 WL 437585 (Ohio App.1993) (in-house counsel, although an employee under the whistleblower statute, could not invoke the act's protection because he failed to follow procedures for internal notification of alleged violations before contacting outside authorities as required by the statute).

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Corporate Counsel: Caught In The Crosshairs?

ACC thanks Rebecca M. Lamberth, Mark Calloway, and Catherine Hess of Alston & Bird, LLP for their work in preparing this whitepaper.

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INTRODUCTION – THE TELEPHONE CALL YOU DREAD

You are sitting in your office, immersed in one of the several pressing issues that top your "to do" list for the day when the phone rings. Caller ID indicates that it is an outside call and when you respond you unexpectedly hear an introduction no one in the world of in-house counsel would ever welcome:

> Mr. Jones, I work with the Securities & Exchange Commission and we need to set up a date and time in the next week or so when you can come down to our offices for an interview. If you are represented by counsel, we will be glad to coordinate the details with that person …

Even as you carefully choose your words in reply, you already know that the intended subject of this requested meeting will be your company's involvement in revenue recognition issues. It's the same issue that has occupied most of your waking hours over the last six months. Those issues have already spawned an announced restatement of the company's financials and an internal investigation. Now this call. What does it mean? Why would the SEC be asking to interview YOU?

Alternatively – and, in fact, it is more likely – the call will come from either your company's general counsel or the company's outside counsel informing you that someone – the SEC, the DOJ, the U.S. Attorney or counsel engaged to conduct an internal investigation – wants to interview you. That's right, YOU. Your reaction, naturally, is to question this turn of events. You're the company's lawyer! Oh, and you are also told to collect all your notes and files related to the investigation and the underlying issues or events. Much of what you know and some of what you possess is privileged … or, at least, you think it is. So this request for an interview MUST be a mistake! Right?

The answer, increasingly, is "not necessarily" or perhaps, "not for long." In the current complex and highly charged business world, corporations are more closely scrutinized than ever before and everyone is on the lookout for the next corporate scandal. Consequently, in-house counsel more frequently face allegations concerning their company's business or accounting practices. When that happens, in-house counsel will find themselves tasked with charting a course through potentially damaging information and other fact gathering. A growing twist on this trend is the fact that counsel are also increasingly being asked to provide such information directly to third parties, including government regulators, and thereby waiving the applicable privileges, potentially making such information fair game for plaintiffs' lawyers.

This paper provides a broad overview of issues such situations present for in-house counsel. It is impossible either to predict or to discuss every issue that may arise in the context of a request to testify or disclose confidential corporate information. It is our hope, however, to present a resource to guide you through the issues that typically arise.[1]

HOW DID YOU END UP HERE?

When evidence or allegations of potential corporate misconduct surface, the central role of in-house counsel in advising and, ultimately, directing the company's response is obvious and necessary. The company must be advised regarding the law governing its legal rights and obligations, as well as those of its various involved constituencies – including management, the Board of Directors and those involved in the underlying events. Determinations must be made regarding how best to identify all knowledgeable persons, to gather the relevant facts and to demonstrate either the groundless nature of the allegations or the limited nature of any wrongful conduct.

As such, in-house counsel will often be inclined to "roll up their sleeves and jump in," personally managing the often complex series of efforts and decisions that must be made rapidly. It remains true that internal corporate investigations are frequently conducted by members of the in-house legal department, including interviews of critical witnesses, the collection of relevant documents and electronic data and the analysis of allegations against all such collected evidence. After all, such an exercise inevitably involves confidential information and is itself best kept confidential for at least some period of time.[2] Unless thoughtful care is exercised at this initial juncture, however, in-house counsel will likely become the single greatest repository of information critical to the company's culpability or that of its representatives or agents.

> Practical Note: That initial urge for members of the company's legal department instinctually to "dive in" should be tempered by reasoned analysis of the available avenues for investigation and the best manner in which to appropriately maintain the privileged nature of the company's legal deliberations.

Until recently, respect for the privileged nature of much of the information and analysis possessed by in-house counsel minimized any real threat that those conducting either criminal or civil inquiries into the potential wrongdoing would pursue making such inquiries directly of the company's lawyers. With the "corporate cooperation" rules outlined in the Department of Justice's Principles of Federal Prosecution of Business Organizations,[3] also referred to as the "Thompson Memo," the potential for waiver of the corporate privilege – either voluntarily or following a request that this occur from one or more government regulators or enforcement agencies – has increased exponentially. As a result, that initial urge for members of the company's legal department instinctually to "dive in" should be tempered by reasoned analysis of the available avenues for investigation and the best manner in which to appropriately maintain the privileged nature of the company's legal deliberations.

So, armed with a clear understanding that "lawyer as witness" is not a laudable goal when arrived at via the lawyer's function as counselor to the corporation – as opposed to participant in the underlying events – let's consider both the legal and factual parameters that often come into play, as well as some practical advice about how to navigate these perilous waters. Along with and following our discussion of the form, logistics and consequences of how and why in-house counsel may be

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[1] The state of the law discussed in this paper is general in nature, and thus non-jurisdictional. As such, it should serve as a guide for exploring unique situations both within your legal department and with outside counsel, and not as a substitute for obtaining legal advice.

[2] This is not to say one should, or even can (as discussed *infra*), endeavor to cloak underlying facts uncovered in the investigation of potential corporate wrongdoing in privilege or otherwise attempt to shield them from any and all outside scrutiny. On the other hand, however, the critical role of the privilege in enabling open and frank discussion between in-house counsel and corporate representatives cannot be ignored. If the role of in-house counsel in the context of a company crisis is permitted to erode to that of anticipated whistleblower, there will be no winners.

[3] Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Dep't of Justice, to Heads of Department Components, United States Attorneys, § II (Jan. 20, 2003) (hereinafter "Thompson Memo").

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whether as risk manager, compliance officer or in some other capacity – in relation to the underlying events.

For the unsuspecting, the potential consequences of turning in-house counsel into a witness may not become evident immediately. The fact that a formal investigation may begin with outside lawyers interviewing in-house counsel can appear seemingly trivial – to those who have not anticipated likely problems down the road discussed herein. Immediately, however, the in-house counsel interviewed will almost certainly lose his or her ability to function as a lawyer for that matter. Quite possibly, that in-house attorney will become a primary witness with regard to evidence of the potential corporate wrongdoing.

Such consequences may be triggered for various reasons. Either outside counsel or the committee to whom they must answer may not be willing to re-plow the evidence previously collected by in-house counsel. Insufficient thought may be given to the potential ramifications of making in-house counsel a primary witness until much too late in the process. Depending on the age of available evidence, the availability and continued memory of critical witnesses and numerous other factors, outside counsel retained to conduct a formal investigation may determine that it is important to interview in-house counsel as one of the most knowledgeable persons concerning the underlying events or management's response thereto – despite the fact that person is a lawyer for the company. In the event such a conclusion is reached, outside counsel may almost certainly comb through in-house counsel's files, including potentially – or even clearly – privileged notes and other privileged information.

In such instances, the ability of the in-house lawyer to function in a legal counselor role for the company may have been compromised given his or her central role as witness. What's more, the scope of those effects may extend beyond the boundaries of the investigation. Certainly, that lawyer will be a focus of interest for additional inquiry from other third parties who arrive at the company's doorstep – such as the SEC, DOJ or other governmental agencies, thereby suggesting that in-house counsel refrain from future steps in the investigation. Moreover, to the extent in-house counsel is needed as a witness in future litigation on the matter, privileged information is now co-mingled with factual information, thereby complicating the company's ability to divide out discoverable and non-discoverable information. Finally, as the in-house counsel's own personal interests as a witness increase, her ability to act as legal counsel for the company in any respect may be compromised as a conflict can develop between the interests of the lawyer and that of her client.

Practical Note: Decrease the likelihood that you will have to testify. Thougtfully involve a non-lawyer who can act a witness, should that become necessary.

Interviews by Public Regulators and Law Enforcement

In recent years the SEC has encouraged companies to cooperate with its investigations by emphasizing its "willingness to credit such behavior in deciding whether and how to take enforcement action…"[4] The DOJ also emphasizes cooperation in deciding whether to pursue or forgo criminal charges. As part of these "cooperation" efforts, government investigators routinely seek the waiver of the attorney-client privilege, as well as work product protection. In these instances, in-house counsel who participated in an underlying internal investigation may be called required to disclose corporate information, we will consider more specifically ways to avoid or mitigate such situations.

Practical Note: Of course, in-house counsel's role in the context of an internal investigation is not the only manner in which he or she may become a witness. It is, however, a common avenue and one that can be mitigated through thoughtful practices. David Brodsky's role in the obstruction of justice trial of Frank Quattrone is a widely-publicized example of "lawyer as witness for the prosecution" arising in a different – and less predictable – context. As former General Counsel for Credit Suisse First Boston, Mr. Brodsky became a critical government witness after CSFB agreed to waive the attorney client privilege and thus was required to testify about a key communication with Mr. Quattrone.

HOW CAN YOU BE ASKED TO TESTIFY AGAINST YOUR CLIENT?

The post-WorldCom, Enron and Global Crossing environment in which we and our corporate clients operate has indisputably resulted in increased scrutiny, more rigorous enforcement conduct by the Securities and Exchange Commission ("SEC"), the Department of Justice ("DOJ") and other governmental enforcement efforts and ever more aggressive approaches by the plaintiffs' bar in civil litigation filed against corporate defendants. Absent participation by in-house counsel in the underlying events, the more common circumstances under which counsel may unwittingly become the target of a third party's efforts to turn the lawyer into a witness occurs when counsel plays a central role as principal "investigator" into the events underlying allegations of corporate wrongdoing. Thus, any type of internal corporate investigation – whether formal or informal – should be designed to avoid making a member of the in-house legal department the only repository of the company's collective knowledge and information gained via the investigatory process. When an internal investigation is conducted by in-house counsel without consideration of the potential for becoming a direct target of third parties' subsequent fact-gathering efforts, the results can be unfortunate (or worse).

Thus, in the context of the internal investigation, and indeed in many other situations in which in-house counsel is called upon to advise the company, the critical role of the applicable legal privileges – the attorney-client communication privilege and the attorney work product doctrine – that enable the open and frank discussion between in-house counsel and corporate representatives cannot be ignored. If the role of in-house counsel in the context of a company crisis is permitted to erode to that of anticipated whistleblower there will be no winners. In today's environment, however, there are numerous avenues that can turn in-house counsel into a witness against the company.

Interviews by Outside Counsel

The earliest manifestation of problems attendant to "lawyer becoming witness" can occur if and when the Board of Directors, Audit Committee or other independent Board committee hires outside counsel to conduct a formal investigation of the facts underlying concerns regarding potential corporate wrongdoing and, perhaps, management's response thereto. In-house counsel may have conducted a prior internal investigation in a manner that turned the lawyer into the only source of collected information. If this has occurred with no consideration of whether or how relevant, non-privileged factual information could ever be provided on the company's behalf to third parties – whether in the context of civil litigation or in the form of government regulators or enforcement agencies – the foundation for problems going forward will already been laid. Alternatively, the potential need to interview in-house counsel may arise based on his or her role –

[4] Report of Investigation Pursuant to Section 21(a) of the Securities and Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 76 SEC Docket 220, at 2 (Oct. 23, 2001) (the "Seaboard 21(a) Report"); *see also* Thompson Memo.

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upon for interviews with the relevant government investigators, as well as to turn over privileged written materials.

For example, the Thompson Memo, which is intended to guide federal prosecutors in their decisions regarding potential prosecution of corporations and other business organizations, states that waiver is an important factor in the prosecutor's evaluation of the company's cooperation with the government. Specifically, the Thompson Memo states:

> In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection.[5]
>
> * * *
>
> One factor the prosecutor may weigh in assessing the adequacy of a corporation's cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors and employees and counsel. Such waivers permit the government to obtain statements of possible witnesses, subjects, and targets, without having to negotiate individual cooperation or immunity agreements. In addition, they are often critical in enabling the government to evaluate the completeness of a corporation's voluntary disclosure and cooperation. Prosecutors may, therefore, request a waiver in appropriate circumstances. The Department does not, however, consider waiver of a corporation's attorney-client and work product protection an absolute requirement, and prosecutors should consider the willingness of a corporation to waive such protection when necessary to provide timely and complete information as one factor in evaluating the corporation's cooperation.[6]

Although waiver of the privilege is not an absolute requirement under the Thompson Memo, the emphasis on waiver by federal prosecutors is becoming a disturbing trend, as discussed *infra*.[7]

5 The Thompson Memo recognizes, however, that business entities should not be expected to waive its privileges and protections in the context of negotiating with federal prosecutors in the contemporaneous criminal investigation. *See* Thompson Memo at n.3 ("This waiver should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue. Except in unusual circumstances, prosecutors should not seek a waiver with respect to communications and work product related to advice concerning the government's criminal investigation.").

6 Thompson Memo at § VI, A-B.

7 *See also* Comments of Susan Hackett, Senior Vice President and General Counsel, Association of Corporate Counsel, to the ABA Attorney-Client Privilege Task Force Hearings (April 21, 2005), available at http://www.acca.com; *Association of Corporate Counsel Survey: Is the Attorney-Client Privilege Under Attack?* (Apr. 6, 2005), available at http://www.acca.com.

Whether and at what point a company should consent to the interview of in-house counsel depends upon the direct and indirect benefits and consequences, as discussed herein, that could flow from the statements made. Regardless, cooperation under the Thompson Memo is voluntary and a company could refuse the interview requests if willing to risk the consequences of such a refusal.

As for the SEC, the Seaboard 21(a) Report identifies four factors used to measure a company's cooperation in the context of SEC investigations: self-policing, self-reporting, remediation and cooperation with enforcement authorities. The Seaboard 21(a) Report sets forth some of the criteria the SEC will consider in determining how much to credit a company's self-policing, self-reporting, remediation and cooperation. Credit for such cooperative actions by a company may range from the SEC deciding to take no enforcement action to filing reduced charges, seeking lighter sanctions or including mitigating language in documents it uses to announce and resolve enforcement actions.[8] In particular, the SEC lists the following among the criteria:

> Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?[9]

The SEC discussed the issue of privilege in a footnote to the Seaboard 21(a) Report:

> In some cases, the desire to provide information to the Commission staff may cause companies to consider choosing not to assert the attorney-client privilege, the work product protection and other privileges, protections and exemptions with respect to the Commission. The Commission recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff. Thus, the Commission recently filed an *amicus* brief arguing that the provision of privileged information to the Commission staff pursuant to a confidentiality agreement did not necessarily waive the privilege as to third parties. *Brief of SEC as Amicus Curiae, McKesson HBOC, Inc.,* No. 99-C-7980-3 (Ga. Ct. App. Filed May 13, 2001). Moreover, in certain circumstances, the Commission staff has agreed that a witness' production of privileged information would not constitute a subject matter waiver that would entitle the staff to receive further privileged information.[10]

Although the Seaboard 21(a) Report does not explicitly require waiver of the attorney-client privilege and work-product protection, the SEC has pushed for such waivers. In a press release regarding the Seaboard 21(a) Report, the SEC stated that the concept of cooperation with law

8 *See* Seaboard 21(a) Report at 2.

9 Seaboard 21(a) Report at 3-4.

10 Seaboard 21(a) Report at Footnote 3.

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enforcement authorities included providing the SEC staff with all information relevant to the underlying violations and the company's remedial efforts.[11]

In practice, the SEC has increased its focus on cooperation. According to Steven Cutler, former Director of Enforcement at the SEC, "the Commission is placing a greater emphasis than ever before on assessing and weighing cooperation when making charging and sanctioning decisions…. the Commission no longer begins and ends its assessment by asking, "did this party cooperate, yes or no?" Now, it routinely goes on to consider, if the party did cooperate, how much? How often? You should expect that we will seek to reflect the answers to these sorts of questions when we resolve investigations and actions."[12] This increased emphasis on cooperation heightens the importance of in-house counsel's testimony and forces companies to weigh the benefits and risks – including collateral consequences – of waiving the attorney-client privilege and work product protection in an effort to provide full cooperation.[13]

Civil Litigation – Depositions and Other Forms of Discovery

In the context of civil litigation, whether by government regulators or private third parties, the Federal Rules of Civil Procedure ("FRCP") and their state law counterparts contain no *per se* prohibition against deposing attorneys, including in-house counsel. Specifically, Rule 30(a) permits the deposition "of *any* person, including a party." Such a deposition may often genuinely be opposed as a form of harassment, and even if permitted, is generally limited to non-privileged information absent a waiver. *See* Fed. R. Civ. P. 26(b)(1). The attorney-client privilege or work product doctrine, absent waiver, however, supply grounds for a refusal to answer some or all of the questions directed at in-house counsel by someone other than a corporate representative. Thus, should in-house counsel prove to be the only corporate representative possessing knowledge or information on a relevant subject, he or she may become a witness as to those matters but may still assert applicable privileges on behalf of the company. *See* Fed. R. Civ. P. 30(b)(6).

In many instances, the company can seek to quash efforts to depose its in-house counsel. Until recently, deposition of opposing attorneys – including corporate counsel – was a disfavored practice and required the desiring party to meet a threshold before a court would allow the testimony. In the seminal case on the subject, *Shelton v. American Motors Corp.*, 805 F.2d 1323 (8th Cir. 1986), the Eighth Circuit concluded that depositions of opposing counsel should be limited to situations when "(1) no other means exist to obtain the information than to depose opposing counsel; (2) the information sought is relevant and nonprivileged; and (3) the information is crucial to the preparation of the case."[14] In so holding, the court recognized the negative impact the trend in deposing counsel had:

> In recent years, the boundaries of discovery have steadily expanded, and it appears that the practice of taking the deposition of opposing counsel has become an increasingly popular vehicle of discovery. To be sure, the Federal Rules of Civil Procedure do not specifically prohibit the taking of opposing counsel's deposition. We view the increasing practice of taking opposing counsel's deposition as a negative development in the area of litigation, and one that should be employed only in limited circumstances.
>
> * * *
>
> Taking the deposition of opposing counsel not only disrupts the adversarial system and lowers the standards of the profession, but it also adds to the already burdensome time and costs of litigation. It is not hard to imagine additional pretrial delays to resolve work-product and attorney-client objections, as well as delays to resolve collateral issues raised by the attorney's testimony. Finally, the practice of deposing opposing counsel detracts from the quality of client representation. Counsel should be free to devote his or her time and efforts to preparing the client's case without fear of being interrogated by his or her opponent. Moreover, the "chilling effect" that such practice will have on the truthful communications from the client to the attorney is obvious.[15]

In 2002, the Eighth Circuit "clarified" the application of the *Shelton* test and permitted the deposition of counsel regarding a prior, completed case, holding that the *Shelton* test was intended to protect against the deposing of counsel in a pending case that could potentially lead to the disclosure of the attorney's litigation strategy. *See Pamida, Inc. v. E.S. Originals, Inc.*, 281 F.3d 726 (2002). On the heels of *Pamida*, the Federal District Court for the District of Columbia held similarly that the *Shelton* test applies to limit depositions of attorneys only in the following instances: (1) when trial or litigation counsel are being deposed, or (2) when such questioning would expose litigation strategy in the pending case. *See United States v. Philip Morris Inc.*, 209 F.R.D. 13 (D.D.C. 2002). The court in *Philip Morris* permitted the deposing of opposing counsel, in part, because the deponents, though in-house attorneys, were employees with "substantial non-legal, non-litigation responsibilities, including corporate, business, managerial, public relations, advertising, scientific, and research and development responsibilities not subject to attorney-client or work-product privilege protections." The court also noted that the testimony sought was unrelated to trial preparation or litigation strategy in that case.

Since the *Philip Morris* decision, several district courts in other circuits have followed suit, adopting similar rules regarding the deposing of in-house counsel. Although the holdings in *Pamida* and *Philip Morris* are seen by some as a mere clarification of the *Shelton* test, and by others as a departure from the protections set forth by *Shelton*, the apparent trend among courts – and the presumption under which corporate counsel should operate – is that deposing non-litigation counsel will be permitted if the deposition will not elicit privileged information regarding litigation strategy in the pending case.

> Practical Note: Consider entering an appearance in the matter so that you will be properly viewed as counsel for the matter, rather than "just another" company employee.

11 *See* Press Release, Securities ad Exchange Commission, SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion (October 23, 2001), No. 2001-117.

12 Stephen M. Cutler, Speech by SEC Staff: Remarks Before the District of Columbia Bar Association (February 11, 2004).

13 *See* discussion *infra*.

14 *Id*. at 1327.

15 *Id*.

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Grand Jury or Trial Subpoenas

In-house counsel may also receive a government request to testify in a criminal matter by way of a *subpoena ad testificandum*. "Because of the potential effects upon an attorney-client relationship that may result from the issuance of a subpoena to an attorney for information relating to the attorney's representation of a client," the Department of Justice requires prior approval for the issuance of federal subpoenas to lawyers.[16] *See* United States Attorneys' Manual ("USAM") § 9-13.410 (Guidelines for Issuing Grand Jury or Trial Subpoena to Attorneys for Information Relating to the Representation of Clients). An exception to this policy occurs when in-house counsel is subpoenaed to provide "corporate business information." *See* USAM Criminal Resource Manual § 263. In such cases, counsel is subpoenaed "his/her capacity as a corporate officer." *Id.*

Under DOJ policy, a US Attorney must make "all reasonable attempts" to obtain the information before seeking a subpoena, including seeking the information "voluntarily" from the attorney, again, unless this approach would compromise the investigation.[17] If a subpoena is requested, the Assistant Attorney General of the Criminal Division applies the following standard to requests for subpoenas to be issued to a client's attorney:

- The information sought shall not be protected by a valid claim of privilege.
- All reasonable attempts to obtain the information from alternative sources shall have proved to be unsuccessful.
- In a criminal investigation or prosecution, there must be reasonable grounds to believe that a crime has been or is being committed, and that the information sought is reasonably needed for the successful completion of the investigation or prosecution. The subpoena must not be used to obtain peripheral or speculative information.
- In a civil case, there must be reasonable grounds to believe that the information sought is reasonably necessary to the successful completion of the litigation.
- The need for the information must outweigh the potential adverse effects upon the attorney-client relationship. In particular, the need for the information must outweigh the risk that the attorney may be disqualified from representation of the client as a result of having to testify against the client.
- The subpoena shall be narrowly drawn and directed at material information regarding a limited subject matter and shall cover a reasonable, limited period of time.[18]

In addition to the United States Attorneys' Manual, prosecutors are typically limited by the ethical rules governing prosecutors in their respective jurisdictions, which may require prior judicial approval before a prosecutor may subpoena a client's attorney. *See, e.g., United States v. Colorado Supreme Court,* 189 F.3d 1281 (10th Cir. 1999) (discussing split of authority on enforceable of such rules under the Supremacy Clause of United States Constitution); *see also* ABA Rules of Professional Responsibility Rule 3.8(e) ("The prosecutor in a criminal case shall… not subpoena a lawyer in a grand jury or other criminal proceeding to present evidence about a past or present client unless the prosecutor reasonably believes: (1) the information sought is not protected from disclosure by any applicable privilege; (2) the evidence sought is essential to the successful completion of an ongoing investigation or prosecution; and (3) there is no other feasible alternative to obtain the information[.]").

Importantly, regardless of whether in-house counsel is subpoenaed, the grand jury does not have a right to privileged information and a valid assertion of the privilege must be honored absent a court order otherwise.

Sentencing Guidelines

In addition to "front-end" credit – whether the company will be prosecuted – cooperation and waiver of the attorney client privilege can provide "back end" credit under the United States Sentencing Guidelines ("USSG") if a company is ultimately convicted.[19] In this regard, testimony by corporate counsel, particularly when such testimony can assist the government in identifying the full nature and scope of the criminal activity by the company, can save the company significant penalties.[20]

Under Chapter 8 of the U.S. Sentencing Guidelines Manual, which governs the sentencing of organizations, a company's culpability score can be reduced by two or five points if it "fully cooperated in the investigation" of its wrongdoing, among other factors.[21] Importantly, Application

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[16] DOJ maintains that these principles cannot be used defensively. Specifically, the USAM states that the guidelines are simply that – guidelines. They cannot be relied upon to create "any rights, substantive or procedural, enforceable at law by any party in any matter, civil or criminal," nor do they place limitations on "otherwise lawful investigative or litigative prerogatives" of the DOJ. *See* USAM § 9-13.410(E). Nevertheless, these guidelines are useful in fending off an attempt by the government to make in-house counsel a witness against the company.

[17] USAM § 9-13.410(B).

[18] USAM § 9-13.410(C).

[19] Although the United States Supreme Court held that the Sentencing Guidelines violate a defendant's Sixth Amendment rights to the extent that they allow judicial, rather than jury, fact-finding to form the basis for sentencing, the Court has allowed the Guidelines to remain in place as "advisory" sentencing ranges, as opposed to the previously mandatory ranges, that courts should consider when sentencing criminal defendants. *See United States v. Booker*, 125 S.Ct. 738 (2005). As such, the Guidelines will still provide a great influence in a prosecutor's evaluation of a corporation's cooperation with investigators.

[20] Because business organizations act through their agents, under the doctrine of *respondeat superior*, the government may, under certain circumstances, prosecute both the agents *and* the company for an agent's wrongdoing. *See, e.g., United States v. Automated Medical Laboratories, Inc.*, 770 F.2d 399, 406 (4th Cir. 1985) ("a corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation *even if … such acts were against corporate policy or express instructions*.") (emphasis added).

[21] *See* U.S. Sentencing Guidelines Manual § 8C2.5(g). For example, if the company fully cooperated with prosecutors and disclosed the existence of the offense prior to "imminent threat of disclosure of government investigation," the company may receive a five point reduction, whereas

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Note 12 states "[w]aiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in the culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization." To be timely, the organization must begin to cooperate at the same time it becomes officially notified of a criminal investigation.[22] To be thorough, this cooperation should include the "disclosure of all pertinent information" known by the organization such that law enforcement personnel can identify the nature and extent of the offense as well as the individuals responsible for the criminal conduct.[23]

SCOPE OF TESTIMONY OR OTHER COMPELLED DISCLOSURE

As we know, the attorney-client privilege and work product privilege are evidentiary rules that prohibit disclosure of certain confidential information when the elements of either protection are met.[24] A lawyer's ethical duty of confidentiality, however, is "far broader" than these testimonial privileges.[25] Regardless, whether the issue is disclosure of confidential information to, for example, government regulators or efforts to compel testimony during litigation on the more narrow category of privileged matters, efforts to force in-house counsel to disclose confidential corporate information can take several forms.

In-house lawyers provide a multitude of functions to their corporate clients. Whether the hats an in-house lawyer wears include those of compliance officer, providing business advice, handling government relations, risk management or litigation management, not all information disclosed to or possessed by corporate counsel is privileged and thus may be discoverable if that lawyer is called to testify as a fact witness.

Because of their unique role, particularly for those in smaller legal departments, corporate counsel are often called upon to provide advice that may not be purely legal in form. For example, in-house counsel are frequently called on to provide "business advice." An example includes consultation with in-house counsel for his or her opinion on whether, in light of term changes via negotiations, a deal has deviated too far from its original objectives to be worthwhile for the company or requests that counsel weigh in on the cost-benefit analysis of certain compliance steps.

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non-disclosure of the offense is a two point reduction. *Id.* The company must also "clearly demonstrat[e] recognition and affirmative acceptance of responsibility for its criminal conduct" to receive credit under either provision of section 8C2.5(g). *Id.*

22 U.S. Sentencing Guidelines Manual § 8C2.5 n.12.

23 *Id.*

24 *See, e.g.,* Restatement (Third) of The Law Governing Lawyers § 68 cmt. b (2000) (The attorney client privilege applies when "(1) a communication (2) [is] made between privileged persons (3) in confidence (4) for the purpose of obtaining or providing legal assistance for the client."); Restatement (Third) of The Law Governing Lawyers § 87 ("Work product consists of tangible material or its intangible equivalent in unwritten or oral form, other than underlying facts, prepared by a lawyer for litigation then in progress or in reasonable anticipation of future litigation.").

25 Edna Selan Epstein, *The Attorney-Client Privilege and the Work Product Doctrine* 15 (4th ed. 2001); *see also* 2 John K. Villa, *Corporate Counsel Guidelines* § 6.21 (2005).

The precise scope of testimony or disclosure is necessarily dictated by the matter at issue, although there generally are two approaches – limiting disclosure to non-privileged information or providing disclosure about privileged information if an exception or waiver is found.

Practical Note: Take care not to blur legal and business functions for in-house counsel. If possible, structure the department to keep compliance, government affairs and other quasi-legal duties in the hands of persons other than the general counsel.

Non-Privileged Information Subject to Discovery

The attorney-client privilege protects from disclosure communications between a client and its attorney that were made in confidence and for the purpose of securing legal advice.[26] In the corporate context, the privilege generally exists when the communications at issue are made by employees of the corporate client to counsel at the direction of corporate superiors in order for the corporation to obtain legal advice from counsel. This protection covers communications between the client and both corporate and outside attorneys. The existence and judicial recognition of the attorney-client privilege is based on a policy decision to encourage full, candid and complete discussions between the attorney and the client, so that the attorney can provide sound, accurate and candid legal advice.

For in-house counsel, it is important to note that the attorney-client privilege protects *communications* but not the underlying facts known by those who communicated with counsel.[27] Thus, for example, if corporate counsel is asked during a deposition, a grand jury appearance or interview by government regulators to discuss the contents of documents germane to the events under scrutiny, his or her knowledge of the facts will frequently be subject to inquiry. In short, providing the underlying facts of the matter at issue to an in-house attorney will not cloak the entire matter in privilege.

Courts have also made clear that ordinary business records do not reflect upon the content of privileged communications or counsel's work product. Under modern work product analysis, it is the motivation behind a document's preparation that is at issue.[28] Thus, where "materials [are] prepared in the ordinary course of business or pursuant to regulatory requirements or for other non-litigation purposes" these documents are not prepared in anticipation of litigation and are thus unworthy of the work product protection. Thus, communications between employees and corporate counsel for non-legal purposes, e.g., an opinion

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26 *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981).

27 *Upjohn, 449 U.S.* at 395-96. One federal district court has explained that privileged communications often contain non-privileged underlying factual details that can be shared without waiving the privilege: "The response to the EEOC charge does not contain matters which constitute an intentional disclosure of statements and notes taken during the [outside counsel's] investigation. What is contained therein is what the [client] presented to the EEOC as a statement of its understanding of the facts and circumstances surrounding plaintiff's sexual harassment claim. Although the response is based on statements taken from various witnesses, the actual communications between the attorneys for the [client] and the witnesses are what is privileged, not the underlying facts." *See Boling v. First Util. Dist.*, 1998 WL 34023311 (E.D.Tenn. Oct. 28, 1998).

28 *Nat'l Union Fire Ins. Co. v. Murray Sheet Metal Co.,* 967 F.2d 980, 984 (4th Cir. 1992) ("The document must be prepared *because* of the prospect of litigation when the preparer faces an actual claim or a potential claim following an actual event or series of events that reasonably could result in litigation.").

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concerning a purely business matter, fall outside the purview of the attorney-client privilege and work product protection and are not protected from discovery if corporate counsel must testify.[29] Moreover, some courts have held that general, conclusory statements about counsel's recommendations do not waive the attorney-client privilege. For example, one court held that a statement to government investigators that the client's attorneys "'had thoroughly reviewed the decision . . . after . . . looking at the matter from nine different ways'" was an "undetailed assertion" and thus was insufficient to waive the privilege.[30] Similarly, another court held that releasing findings, but not a "significant part" of a report or a summary of evidence contained in the report, did not waive the attorney-client privilege.[31] Conversely, when clients reveal the basis of legal conclusions, courts have found a waiver.[32]

Practical Note: If someone within the company seeks legal advice from you, documents should reflect the request, confirming that the advice will be prepared and provided in your capacity as counsel.

Finally, when in a non-judicial proceeding, the corporate counsel's disclosure obligations are governed by the broader confidentiality rules of the relevant jurisdiction. Under Rule 1.6 of the ABA Model Rules of Professional Conduct, for example, "[t]he confidentiality rule … applies not only to matters communicated in confidence by the client but also to all information relating to the representation, *whatever its source*." *Id.* at cmt. 3 (emphasis added). Thus, without client consent, "virtually everything" in the attorney's files are immune from disclosure unless an exception to the confidentiality rule applies (*see infra*).[33]

Testimony about Confidential and/or Privileged Matters

It is generally believed that non-waiver or limited waiver agreements, which permit disclosure of otherwise privileged material without implicating a waiver as to all privileged materials, are "increasingly" becoming more common.[34] Such agreements, however, are only enforceable as between the parties.[35] For example, in *Ames v. Black Entertainment Television,* No. 98CIV0226, 1998 WL 812051 (S.D.N.Y. Nov. 18, 1998), the federal district court found no waiver where the parties agreed during the course of a deposition that in-house counsel could answer select questions without waiving the attorney-client privilege as to the communications on the same subject matter.[36] In the context of government investigations, applicants to the DOJ Antitrust Division Amnesty Program also receive the assurance that the Antitrust Division "will not consider disclosures made by counsel in furtherance of the amnesty application to constitute a waiver of the attorney-client privilege or the work-product privilege."[37] Thus, a company may be able to enter into similar such agreements permitting it to select the information and/or documents it wishes to disclose without causing a waiver as to other information and/or documents. It is imperative that the company realize, however, that these agreements are not binding as to third parties and a court will – in all likelihood – find a waiver of applicable privileges with respect to the disclosed information. *See infra*.

What would ordinarily be considered privileged information is also discoverable under the crime fraud exception. As stated by a leading treatise, "[w]hen a client consults a lawyer intending to violate elemental legal obligations, there is less social interest in protecting the communication." Restatement (Third) of The Law Governing Lawyers § 82, cmt. b (2000). Although the test varies by jurisdiction, there are two essential elements of the crime fraud exception – when the client:

> (a) consults a lawyer for the purpose, later accomplished, of obtaining assistance to engage in a crime or fraud or aiding a third person to do so, or
>
> (b) regardless of the client's purpose at the time of consultation, uses the lawyer's advice or other services to engage in or assist a crime or fraud.

Restatement (Third) of The Law Governing Lawyers § 82 (2000); *see also* 1 Paul R. Rice, *Attorney-Client Privilege in the United States* § 8:3 (2d ed. 1999) (citing cases). As to whether the criminal objective must be accomplished, as noted in the Restatement, the District of Columbia Circuit requires such proof. *See In re Sealed Case*, 107 F.3d 46, 49 (D.C.C. 1997). A leading treatise, however, suggests that this requirement is the minority approach and states that a client's criminal objective need not be reached in order to establish the crime fraud exception. *See* Rice at § 8.2 (citing cases).

As one treatise notes, the crime-fraud exception is particularly challenging in the context of in-house legal representation:

> It is a truism that while the attorney-client privilege stands firm for client's revelations of past conduct, it cannot be used to shield ongoing or intended future criminal conduct...[.] That principle is easily applied when a lawyer is retained to defend a client in a criminal prosecution or civil litigation related to an entirely completed course of action. But it is difficult to apply when the lawyer's role is more

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29 *See* Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* § 2017 (2d ed.) (citing *United States v. Aluminum Co. of Am.*, 193 F. Supp. 251, 253 (N.D.N.Y. 1960)). Some federal courts apply what is called the "primary" purpose test to determine whether the privilege applies, denying the privilege if the primary purpose was for commercial, rather than legal, purposes. *See*, *e.g.*, *United States v. Jones*, 696 F.2d 1069, 1072-73 (4th Cir. 1982) ("Upon reviewing the record, we doubt that the appellants have established that the alleged privileged communications fall within the scope of the attorney-client privilege. The appellants retained the attorneys primarily for the commercial purpose of obtaining written tax opinions to include in their coal lease promotion brochures rather than for the purpose of obtaining legal advice for their own guidance as clients.").

30 *United States v. White*, 887 F.2d 267, 270-71 (D.C. Cir. 1989).

31 *See In re Dayco Corp. Derivative Sec. Litig.*, 99 F.R.D. 616, 619 (S.D.Ohio 1983) (corporation released neither the underlying facts that led to the conclusions in the report nor the report itself).

32 *See*, *e.g.*, *In re Grand Jury Proceedings Oct. 12, 1995*, 78 F.3d 251, 254 (6th Cir. 1996) (noting that the clients "did not merely assert that their attorney had looked into the matter" but rather "[had] revealed their attorney's legal conclusions and the facts on which those conclusions were based.")

33 2 John K. Villa, *Corporate Counsel Guidelines* § 6.21 (2005).

34 Edna Selan Epstein, *The Attorney-Client Privilege and the Work Product Doctrine* 287 (4th ed. 2001).

35 *Akamai Techs., Inc. v. Digital Island, Inc.,* No. C-00-3508, 2002 WL 1285126 (N.D.Cal. May 30, 2002) (citing *Ames v. Black Entertainment Television,* No. 98CIV0226, 1998 WL 812051 (S.D.N.Y. Nov. 18, 1998); *Dowd v. Calabrese,* 101 F.R.D. 427, 439-40 (D.D.C. 1984); *Eutectic Corp. v. Metco, Inc.,* 61 F.R.D. 35, 42-43 (E.D.N.Y. 1973)).

36 *Ames*, 1998 WL 812051, at *3-*8 (characterizing agreement as a limited privilege waiver agreement).

37 *See The Corporate Leniency Policy: Answers to Recurring Questions* (Speech prepared by Gary R. Spratling, Deputy Assistant Attorney General Antitrust Division, U.S. Department of Justice for the ABA Antitrust Section 1998 Spring Meeting) (April 1, 1998) at Section IV (Model Amnesty Letter).

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> in the nature of business planning or counseling or bringing the client into compliance for past wrongs, as opposed to simply defending the client against a charge relating to past wrongs. The act of bringing a client into compliance with the law ordinarily and properly engages the lawyer in an effort to assure the client is sanctioned no more harshly than the law requires.[38]

Privileged information is also discoverable when the client asserts an "advice of counsel defense."[39] The defense, most often used in the criminal context, may be used in civil cases where intent is an element of the offense.[40] By asserting this defense, a party claims that they did not have the required intent because, due to advice received from counsel, they believed their actions were legal. A privilege holder impliedly waives the attorney client privilege when she asserts a claim that in fairness requires the examination of protected communications.[41] Fairness requires such an examination where the privilege holder attempts to use the privilege as both a sword and a shield – *i.e.* an offensive and defensive weapon.[42] In the words of the Second Circuit, "a party cannot partially disclose privileged communications or affirmatively rely on privileged communications to support its claim or defense and then shield the underlying communications from scrutiny by the opposing party."[43] "Were the law otherwise, the client could selectively disclose fragments helpful to its cause, entomb other unhelpful fragments, an in that way kidnap the truth-seeking process."[44]

WHO DECIDES IF COUNSEL CAN TESTIFY

A lawyer's duty of loyalty prohibits the lawyer from doing anything that would harm the client. Restatement (Third) of Law Governing Lawyers § 16, cmt. e (2000). In support of this duty, "[a] lawyer may not use or disclose sensitive information about the client, except in appropriate circumstances." *Id.* The difficult situations are those that fall under the "appropriate circumstances" exception to the duty to maintain confidences.

The Principal Rule – Obtain Client Consent to Disclose Information

A lawyer is generally prohibited from testifying about privileged or confidential matters, absent consent from his or her client or authorization by law. Under the broader duty to maintain a client's confidences, Rule 1.6(a) of the American Bar Association Model Rules of Professional Conduct states that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b)."

As corporate counsel, the attorney's client is the company, as represented through its "duly authorized constituents." *See* Model Rules of Prof'l Conduct R. 1.13(a). As such, "[t]he lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 1.6." Model Rules of Prof'l Conduct, R. 1.13 cmt. 2. Determining in practice who can provide consent can be challenging for in-house counsel, particularly when those persons implicated in the subject matter of the disclosure are in a position of authority in the company. Ideally, company by-laws or policies should be drafted to avoid these situations by providing clear guidance on who is authorized to waive the applicable privileges and who can authorize testimony by the company's attorney. Moreover, when raising the issue of testimony by in-house counsel, counsel should advise appropriate company representatives of the need to obtain independent legal advice about the risks and benefits of testimony by in-house counsel, particularly because in-house counsel may have a self-interest in whether or not he or she testifies.

Overriding Client Consent – Obligations to Disclose Information

American jurisprudence recognizes that lawyers and society must be able to demand some exceptions to the rule requiring client consent for disclosure of certain types of confidential information. In these instances, in-house counsel may have an obligation to override a decision by the relevant decision makers that corporate counsel refrain from disclosing confidential or otherwise privileged information.

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[38] 1 John K. Villa, *Corporate Counsel Guidelines* § 1.26 (2005) (quoting *United States v. Chen*, 99 F.3d 1495, 1500 (9th Cir. 1996)).

[39] Federal circuits have their own particular formulation of the advice of counsel defense. Each formulation, however, basically requires the defendant to demonstrate that there was (1) full disclosure of all pertinent facts to counsel and (2) that the defendant relied in good faith on the counsel's advice. *See United States v. Secor*, No. 02-4066, 2003 WL 21906021, at *7 n.2 (4th Cir. Aug. 11, 2003) ("In order to properly, invoke this defense, the defendant must demonstrate: 1) full disclosure of all pertinent facts to counsel; and 2) good faith reliance on counsel's advice"); *United States v. Butler*, 211 F.3d 826, 833 (4th Cir. 2000); *United States v. Schmidt*, 935 F.2d 1440, 1449 (4th Cir. 1991); *Covey v. United States*, 377 F.3d 903, 909 (8th Cir. 2004) (advice of counsel requires independent evidence showing "1) the defendant made full disclosure of all material facts to his or her attorney before receiving the advice at issue; and 2) he or she relied in good faith on the counsel's advice that his or her course of conduct was legal"); *United States v. Ibarra-Alcarez*, 830 F.2d 968, 973 (9th Cir. 1987) ("In order to assert an advice of counsel defense, a defendant must have made a full disclosure to his attorney, received advice as to the specific course of conduct that he followed, and relied on this advice in good faith"); *see also United States v. DeFries*, 129 F.3d 1293, 1308 (D.C. Cir. 1997) ("A defendant is entitled to an advice of counsel instruction if he introduces evidence showing: (1) he made full disclosure of all material facts to his attorney before receiving the advice at issue; and (2) he relied in good faith on the counsel's advice that is course of conduct was legal").

[40] *See Sedco Int'l v. Cory*, 683 F.2d 1201 (8th Cir. 1982) (suit by oil drilling company against an investor to recover amounts owing for services of its offshore drilling rig whose payment the investor had personally guaranteed); *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156 (9th Cir. 1992) (corporation brought action against stock purchaser, alleging violation of disclosure requirements); *Akeva L.L.C. v. Mizuno Corp.*, 243 F. Supp. 2d 418, 422-23 (M.D.N.C. 2003) (advice of counsel defense used to attempt to defeat plaintiff's claim of willful patent infringement); *see also* 1 Wayne R. LaFave and Austin W. Scott, *Substantive Criminal Law* § 5.1(e)(4) (1986).

[41] *See In re Grand Jury Proceedings*, 219 F.3d 175, 182 (2d Cir. 2000).

[42] *See In re Keeper of the Records v. United States*, 348 F.3d 16, 24 (1st Cir. 2003); *United States v. Bilzerian*, 926 F.2d 1285, 1292 (2d Cir. 1991); *United States v. Workman*, 138 F.3d 1261, 1263 (8th Cir. 1998).

[43] *Bilzerian*, 926 F.2d at 1292.

[44] *Keeper of the Records*, 348 F.3d at 24.

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Although varied by jurisdiction, under the American Bar Association Model Rules of Professional Conduct, situations in which in-house counsel does not need consent, generally include, but are not limited to the following:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(6) to comply with other law or a court order.[45]

It is Rule 1.6(b)(6) – "to comply with other law or a court order" – that typically requires in-house counsel to testify or disclose adverse information against his or her company despite the organization's desire that corporate counsel refrain from testifying.

In addition to the above ethics rules, Section 307 of the Sarbanes–Oxley Act of 2002 required the SEC to issue rules setting forth minimum standards of professional conduct for attorneys that practice before the SEC, including "up-the-ladder" reporting of material violations of securities laws or breaches of fiduciary duty. In response, the SEC issued Part 205, which provides that if a lawyer practicing before the SEC in the representation of a public company becomes aware of evidence of a "material violation" by the company or by an officer, director, employee or agent of the company, the lawyer must report such evidence to the company's chief legal officer or to both the company's chief legal officer and its chief executive officer. Unless the reporting lawyer reasonably believes that the chief legal officer or the chief executive officer has provided an appropriate response within a reasonable time, the lawyer must then report such evidence to the audit committee of the company's board of directors or, if there is no audit committee, to another committee of the board consisting solely of directors who are not employed by the company or, if there is no such committee, to the company's board of directors.[46] "Material violation" means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law or a similar material violation of any United States federal or state law.

Part 205 is, in some respects, a codification and extension of existing ethical obligations of a lawyer to an organizational client, as well as a formalization of practices that many diligent lawyers have followed when presented with evidence of client misconduct. Rule 1.13 of the ABA's Model Rules of Professional Conduct similarly provides that if a lawyer for an organization knows that an officer, employee or other associated person is "engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law."[47]

It should be noted that the SEC is still considering the "noisy withdrawal" provisions of its original attorney conduct rules proposal, which would require an attorney to withdraw from representing a company when the company's directors respond inappropriately to evidence of a material violation that is ongoing or has yet to occur and the attorney would be required to notify the SEC that he or she has withdrawn.[48] In contrast, ABA Model Rule 1.13(c) states that where the highest authority of the organization fails to appropriately address an action that is clearly a violation of law, and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, the lawyer *may* reveal information relating to the representation, but only if and to the extent the lawyer reasonably believes such disclosure is necessary to prevent substantial injury to the organization.[49]

Failure to adhere to the SEC's rules could expose the affected lawyer to SEC enforcement or disciplinary action. In a preview of how it is likely to enforce its attorney conduct rules, in September 2004 the SEC imposed a cease-and-desist order on the former general counsel of Electro Scientific Industries, Inc. ("ESI"), John E. Isselmann, Jr., for failing to report to the company's audit committee and outside auditors in a timely manner evidence of material fraud in the company's reported financial results. The SEC based this action on its conclusion that Mr. Isselmann's failure to convey material information regarding the legality of a significant accounting transaction to ESI's board of directors, audit committee and external auditors caused ESI to file a materially false and

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45 Model Rules of Prof'l Conduct R. 1.6(b). State laws vary greatly in the scope of reporting obligations. Corporate counsel must be certain to closely examine their state laws and bar rules governing disclosure without the consent of a client.

46 If the company's board has previously established a "Qualified Legal Compliance Committee" ("QLCC"), the reporting lawyer may comply with Part 205 by reporting the evidence of a material violation directly to that committee. A lawyer who reports to his or her supervisory attorney or to a QLCC will not be required to assess whether there has been an appropriate response to the report – although few companies have chosen to establish such a board committee. Part 205 also provides that "subordinate attorneys" who do not report directly to the chief legal officer will satisfy their obligations by reporting the matter to their "supervisory attorneys," who will then be subject to the reporting obligations under Part 205. *See* Securities and Exchange Commission Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8185 (effective August 5, 2003).

47 Model Rules of Prof'l Conduct R. 1.13(b).

48 *See* Securities and Exchange Commission Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8150.

49 *See* Model Rules of Prof'l Conduct R. 1.13(c).

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misleading quarterly report on Form 10-Q in violation of the Securities Exchange Act of 1934.[50] While Mr. Isselmann's failure to report occurred prior to the effective date of the SEC's attorney conduct rules, it is evident from the order that the SEC will vigorously enforce its up-the-ladder reporting requirements.

CONSEQUENCES OF TESTIFYING

Testimony by in-house counsel can carry significant legal and practical consequences. These include waiver of the attorney-client privilege and work product protection and disqualification of corporate counsel as attorney for the company in the matter – and, potentially, even more broadly. In addition, other collateral consequences, particularly if testimony is in the form of cooperation interviews with government investigators, include:

- First and foremost – there is no guarantee against prosecution even if the company consents to testimony by in-house counsel and/or waives the applicable privileges;
- The company may lose a claim of privilege in related civil litigation;
- If the government is also targeting officers, directors or employees, the company may have to cooperate "against" culpable employees and working with relationships with individual defense counsel may need to be severed;
- Prosecutors will learn the strengths and weaknesses of the defense and, correspondingly, the strengths and weaknesses of their case;
- The company may stand an increased chance of related investigations and/or litigation from other investigating agencies (*i.e.*, state attorney general) or third parties, including shareholders, who could gain access to no longer privileged materials and decide to sue the company based on information contained in those materials;
- The company will have to continue to cooperate with the government, most likely in a more intense and formal fashion;
- The company may use up "favorable" treatment in the eyes of the Department of Justice with respect to other investigations (*i.e.*, only "one bite at the apple");
- If multiple investigations are pending (*i.e.*, SEC and DOJ), the company may experience increased pressure to cooperate with government regulators on a uniform basis despite legal and factual distinctions in the investigations; and
- The company may experience a decrease in employees' willingness to come forward to report wrongdoing in the future because of the track-record of disclosures to the government, thereby having an adverse effect on the company's compliance program.

[50] *See In the Matter of John E. Isselmann, Jr.*, Order Instituting Cease and Desist Proceedings, Making Findings and Imposing a Cease-And Desist Order Pursuant to the Section 21C of the Securities Exchange Act of 1934, Accounting and Auditing Enforcement Release No. 2108 (September 23, 2004).

Practical Note: Absent an advance waiver, be prepared to limit testimony to factual information to avoid an implied waiver.

Implied Waiver

When in-house counsel testifies, the opposing party has every incentive to elicit counsel's reliance on privileged information during the course of the testimony, because once disclosed to a third party, the communications lose their privileged status. Ordinarily, a client must affirmatively and directly put its counsel's advice at issue in a manner that implicates the confidential communications in order to waive the attorney-client privilege.[51] For example, in *United States v. Pollard (In re Martin Marietta Corp.)*, 856 F.2d 619 (4th Cir. 1988) ("*In re Martin Marietta*"), the Fourth Circuit held that, because a company had provided a proffer to the government in which the company quoted and referred to witness statements and documents collected during the company's internal investigation, the disclosure acted as an implied waiver:

> [i]mplied waiver nullifies a privilege when disclosure of a privileged communication has vitiated confidentiality. Unlike express waiver which allocates control of the privilege between parties to the communication, implied waiver allocates control of the privilege between the judicial system and the party holding the privilege.[52]

Similarly, in *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1370 (D.C.C. 1984), the DC Circuit held that disclosure of privileged information to a governmental agency to ward off an investigation waived the attorney-client privilege as to subsequent litigants. Specifically, the court stated:

> Tesoro [the client] willingly sacrificed its attorney-client confidentiality by voluntarily disclosing material in an effort to convince another entity, the SEC, that a formal investigation or enforcement action was not warranted. Having done so, appellants cannot now selectively assert protection of those same documents under the attorney-client privilege. A client cannot waive that privilege in circumstances where disclosure might be beneficial while maintaining it in other circumstances where nondisclosure would be beneficial. "We believe that the attorney-client privilege should be available only at the traditional price: a litigant who wishes to assert confidentiality must maintain genuine confidentiality." Having failed to maintain genuine confidentiality, appellants are precluded from properly relying on the attorney-client privilege.[53]

The Risks of Knowing Waivers – No Selective Disclosure

Increasingly, federal prosecutors are requesting companies to waive the attorney-client privilege and work product protection. In fact, it is a significant factor considered in deciding whether a company is truly cooperating. *See* Thompson Memo. In particular, the Department of Justice has instructed federal prosecutors that the waiver "should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue. Except in unusual circumstances, prosecutors should not seek a waiver with respect to communications and work product related to advice concerning the government's criminal investigation." *Id.* at n.3; *see also* U.S. Sentencing Guidelines Manual § 8C2.5 n.12 (stating that

[51] *Cincinnati Ins. Co. v. Zurich Ins. Co.*, 198 F.R.D. 81, 87-88 (W.D.N.C. 2000) (finding a waiver of an attorney's opinion work product but no waiver of the attorney-client privilege where the attorney put his knowledge and opinions at issue but did so without implicating confidential communications); *In re Martin Marietta Corp.*, 856 F.2d 619 (4th Cir. 1988).

[52] *In re Martin Marietta,* 856 F.2d at 622-23 (noting that "[t]here could be no dispute" that otherwise privileged materials were disclosed to the government by Martin Marietta).

[53] *In re Subpoenas Duces Tecum*, 738 F.2d at 1370 (citations omitted).

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waiver of the attorney-client privilege and work product protection is not a prerequisite to a reduction in culpability score). Waiving privileges to ward off potential criminal prosecutions, however, has potential adverse consequences, primarily that it cannot be done selectively.

Courts have almost uniformly held that a party may not "selectively" refuse to disclose privileged information and documents in a proceeding when the party has provided the same information and documents to a governmental agency in an effort to gain favorable treatment in another proceeding. Although the company may be able to contractually limit the scope of its disclosure to government investigators,[54] any disclosure of privileged information would be inconsistent with the attorney-client privilege and the work product doctrine and would be viewed as a waiver as to other third parties.[55] Although one federal circuit has recognized an exception to the waiver rules for privileged materials voluntarily and selectively provided in the course of a governmental investigation,[56] many circuit courts addressing the issue have found that selective disclosures in the context of governmental investigations constitute a subject matter waiver of the attorney-client and work-product privileges. Thus, once privileged material is disclosed to government investigators, the privileges are waived as to other third parties, including other governmental agencies and private civil litigants.[57]

54 Primarily, the agreements are viewed as a contractual agreement between the disclosing party and the government. Indeed, the government may be more than willing to enter into such agreements as the agreements facilitate the government's goal in investigating all of the facts. The agreements, however, have no application to third parties. *See Tenn. Laborers Health & Welfare Fund v. Columbia/HCA Healthcare Corp. (In re Columbia/HCA Corp. Billing Practices Litig.,* 293 F.3d 289, 306 n.28 (6th Cir. 2002) (reviewing case law on the subject). Once waived, the privilege is waived – party may not selectively waive the privileges. For example, during the course of settlement negotiations with the federal government, Columbia/HCA attempted to preserve privileges applicable to its internal investigation when it disclosed certain documents to the Department of Justice. That agreement provided in part: "[t]he disclosure of any report, document, or information by one party to the other does not constitute a waiver of any applicable privilege or claim under the work product doctrine. Both parties to the agreement reserve the right to contest the assertion of any privilege by the other party to the agreement, but will not argue that the disclosing party, by virtue of the disclosures it makes pursuant to this agreement, has waived any applicable privilege or work product doctrine claim." The Sixth Circuit Court of Appeals ultimately held that the agreement would not protect against waiver as to third parties to the agreement (*i.e.*, private, civil litigants). *Id.*

55 *See, e.g., In re Columbia/HCA*, 293 F.3d at 306 n.28; *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1426-27 (3d Cir. 1991).

56 *See Diversified Indus., Inc. v. Meredith,* 572 F.2d 596, 606 (8th Cir. 1977) (en banc) (no waiver of attorney-client privilege where documents disclosed to the SEC). Recently, the federal district court for the Northern District of California held that a company did not waive work product protections where the company had entered into confidentiality agreements with the SEC and the US Attorney's Office pursuant to which it provided results of an investigation by the company's audit committee. *See In re McKesson HBOC, Inc. Securities Litigation*, No. C-99-20743 (March 31, 2005).

57 *See In re Columbia/HCA*, 293 F.3d at 302-307 (waiver of attorney-client privilege where party disclosed internal investigation documents to the Department of Justice); *Genentech, Inc. v. United States Int'l Trade Comm'n*, 122 F.3d 1409, 1416 (Fed. Cir. 1997) (waiver in private lawsuit waived the attorney-client privilege in subsequent administrative proceeding before the International Trade Commission); *Westinghouse Elec. Corp.,* 951 F.2d at 1426-27 (waiver of attorney-client privilege upon voluntary disclosure of information to SEC and Department of Justice); *In re Martin Marietta*, 856 F.2d at 622-23 (because proffer referred to documents collected during the internal investigation and quoted portions of interviews, the disclosure acted as a broad subject matter waiver of the attorney-client privilege and fact work product protection); *In re Subpoenas Duces Tecum,* 738 F.2d 1367 (D.C. Cir. 1984) (waiver of attorney-client privilege upon voluntary disclosure of information to SEC).

Numerous courts have held that disclosure to a government agency in connection with warding off an investigation, enforcement action or other adverse litigation constitutes disclosure to an "adversary" sufficient to waive the privilege.[58]

Subject Matter Waiver

Conflict exists in the federal courts with respect to defining the scope (or subject matter) of the waiver of the attorney-client privilege. Some courts apply a "limited waiver" rule, while others apply a "subject matter" rule. Some courts institute a broad waiver and hold that the privileged party "waives the attorney client privilege with respect to all communications, whether written or oral, to or from counsel concerning the transactions for which counsel's advice was sought."[59] Other courts confine the waiver to "communications about the matter actually disclosed," disallowing access to every document or communication that touches the more general question at issue.[60] Regardless of a particular court's interpretation of the term, in the majority of cases, notions of fairness and prejudice are at the heart of the court's concern.[61]

In *In re Martin Marietta*, the Fourth Circuit was called upon to decide which rule applied within the circuit.[62] In its decision, the court explained the two approaches:

> Most courts continue to state the rule of implied waiver in absolute form--any disclosure of a confidential communication outside a privileged relationship will waive the privilege as to all information related to the same subject matter. That is commonly referred to as subject matter waiver as opposed to limited waiver for which Martin Marietta argues. However, competing policy concerns, such as facilitating the settlement of litigation,[63] permitting full cooperation among joint defendants, expediting discovery and encouraging voluntary disclosure to regulatory agencies have led courts to carve out exceptions to the purportedly absolute rule of waiver. Martin Marietta argues that an exception should be found in the present case so as to limit the waiver to the information that it actually disclosed to the government (copies of which Pollard

58 *See, e.g., In re Columbia/HCA*, 293 F.3d at 306 n.28 (Department of Justice conducting investigation of company was an adversary); *In re Subpoenas Duces Tecum*, 738 F.2d at 1372 ("There is no question that the SEC was an adversary to Tesoro. This was not a partnership between allies. Tesoro was not simply assisting the SEC in doing its job. Rather, Tesoro independently and voluntarily chose to participate in a thorough disclosure program, in return for which it received the *quid pro quo* of lenient punishment for any wrongdoings exposed in the process.").

59 *Ward v. Succession of Freeman*, 854 F.2d 780, 787-8 (5th Cir. 1988); *see also In re Keeper of the Records*, 348 F.3d at 24 (holding that once a litigant chooses to put privileged communications at issue, "only the revelation of all related exchanges will allow the truth-seeking process to function unimpeded").

60 *Chevron Corp.,* 974 F.2d at 1162.

61 *See In re Keeper of the Records*, 348 F.3d at 24; *In re Grand Jury Proceedings*, 219 F.3d at 182.

62 856 F.2d 619, 623-26 (4th Cir. 1988).

63 Some courts are less likely to find a broader subject matter waiver if the party made the disclosure at issue during settlement negotiations. *See In re Commercial Fin. Servs., Inc.*, 247 B.R. 828, 847 n.28 (Bankr. N.D. Okla. 2000) ("[D]isclosure made in the furtherance of settlement negotiations generally does not constitute waiver of all privileged information relating to the same subject matter."). Such waiver may be limited to information actually disclosed during the settlement discussions. *See, e.g., Burlington Indus. v. Exxon Corp.*, 65 F.R.D. 26, 46 (D.Md. 1974). *But see Khandji v. Keystone Resorts Mgmt., Inc.*, 140 F.R.D. 697, 700 (D.Colo. 1992.) ("waiver occurs even when disclosure is made during the course of settlement negotiations. The mere fact that opposing parties may have a common interest in settling claims does not neutralize the fact of disclosure, because that common interest always exists between opposing parties in any attempt at settlement.").

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has been provided) rather than implying a waiver as to all materials on the same subject as those provided the government.[64]

Although some courts have held partial disclosures of privileged information constitute a "subject matter waiver" for purposes of the attorney client and non-opinion work product, the majority of courts also suggest that such a voluntary disclosure *does not* constitute a waiver of the work-product privilege as to *opinion* work product.[65]

Lawyer-Witness Rule

Rule 3.7 of the ABA Model Rules of Professional Conduct provides that disqualification of lawyers is required when the lawyer may become a necessary witness. Specifically, Rule 3.7 states:

> (a) A lawyer shall not act as advocate at a trial in which the lawyer is likely to be a necessary witness unless:
>
> (1) the testimony relates to an uncontested issue;
>
> (2) the testimony relates to the nature and value of legal services rendered in the case; or
>
> (3) disqualification of the lawyer would work substantial hardship on the client.

Thus, if in-house counsel becomes a "necessary witness," he or she can no longer represent the company in any trial on that subject.[66] Practically speaking, this rule may become relevant only if in-house counsel must enter an appearance for trial.

Practical Note: Avoid executing affidavits that controvert the opposing party. By executing an affidavit, you are placing yourself into the category of a fact witness.

BENEFITS OF TESTIFYING

Testifying can have significant benefits for a corporation, particularly when the testimony is in the form of "cooperation" interviews with the government. These benefits include:

- Prosecutors and regulators may consider the company for more favorable treatment than if company had not waived the privilege and refused counsel to be interviewed;
- Providing testimony from corporate attorneys demonstrates the integrity of the company by voluntarily waiving applicable privileges and cooperating with the government;
- Testimony helps prosecutors learn the issues, thereby providing a swifter resolution, and lower litigation costs, to the company; and
- Testimony, which aids in settlement resolutions, can help end uncertainty and risk for the company and its shareholders.

Voluntary Disclosures and Cooperation Benefits in General

Numerous federal and state agencies, including the Department of Justice and the Securities and Exchange Commission, have formal programs in place that encourage voluntary self-disclosure and cooperation. Thus, like mandated disclosures, the statutory and administrative agency regulations relating to voluntary self-disclosure are too numerous and complex to provide a detailed description here. These programs, however, share the underlying emphasis on the fact that a disclosure is voluntary and thorough.

The precise benefits for a company that elects voluntarily self-disclosure are, in some respects, unique to its regulated field. For example, the Department of Health and Human Services Office of Inspector General maintains a self-disclosure program for health care providers to report voluntarily fraudulent conduct affecting Medicare, Medicaid and other federal health care programs.

Many industries, however, share common benefits when it comes to self-disclosure. These include minimizing the potential cost and disruption of a full-scale agency audit and investigation, an opportunity to negotiate a financial settlement and resolution, and possibly an opportunity to reduce financial sanctions. Where conduct implicates possible criminal offenses, the company may also qualify for non-prosecution arrangements, such as immunity or amnesty or pretrial diversion, by voluntarily bringing the misconduct to the government's attention and cooperating in any resulting government investigation. In addition, senior officers at a company may be able to avoid a "bar order" or a regulatory "time-out" by cooperating.

Real World Benefits – Avoidance of Prosecution

In the event of self-disclosure to government agents, or if government investigations are already underway, a company must decide whether it will cooperate with the government. For many public companies, the natural decision, and the one the government will say is in the best interest of the shareholders, is to cooperate. In today's environment, understanding what cooperation really means is critically important.

In 2003, the Department of Justice revised its internal principles that aid federal prosecutors in exercising their prosecutorial discretion in determining whether a business entity should be charged with criminal conduct.[67] The "main focus" of the 2003 revision was an "increased emphasis

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64 *In re Martin Marietta*, 856 F.2d at 623 (stating that the Fourth Circuit applies subject matter waiver to assertions of the attorney-client privilege and non-opinion work product protection).

65 *See, e.g.*, *In re Martin-Marietta*, 856 F.2d at 623; *Neal v. Honeywell, Inc.*, No. 93C1143, 1995 WL 591461 (N.D.Ill. Oct. 4, 1995).

66 Rule 3.7, unlike its predecessor in the Model Code, limits a lawyer's disqualification to representation at trial. Thus, in most jurisdictions, a lawyer may still represent a client in the pretrial stage. Model Rules of Prof'l Responsibility R. 3.7. *See also Main Events Prods., LLC v. Lacy*, 220 F. Supp. 2d 353, 356-57 (D.N.J. 2002) ("a number of other courts interpreting [Rule] 3.7 have concluded that an attorney who will testify at trial need not be disqualified from participating in pre-trial matters."); *but see Stewart v. Bank of Am., N.A.*, 203 F.R.D. 585, 587 (M.D.Ga. 2001) ("this case has not yet moved to the point where it would be detrimental to the Plaintiff's interests to find substitute counsel. Rather, it is in Plaintiff's best interest for the attorneys to withdraw at this point before the case proceeds any further. Indeed, if the attorneys were not disqualified at this point, it is very likely that Plaintiff's case would be jeopardized. From the record before the Court, it is obvious that the Plaintiff has precious few witnesses, if any, to relate his side of the story to a jury.")

67 *See* Thompson Memo.

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on and scrutiny of the authenticity of a corporation's cooperation."[68] The revised principles state that, when determining whether to bring charges, a prosecutor should consider, among eight other factors:

> the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection[.][69]

Although cooperation was a factor in the original guidelines, the revised guidelines, and statements since their issuance, make clear that the Department of Justice will look beyond simple assurances of cooperation. Consider a June 2003 speech from then Deputy Attorney General Larry D. Thompson:

> One major focus of these revised guidelines is an increased emphasis on ensuring the authenticity of a corporation's cooperation. We have stated that in deciding whether to charge a corporation, prosecutors can look to whether the corporation has provided timely and voluntary disclosure. If possible, prosecutors may also consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and in appropriate circumstances to waive attorney-client and work product protection.
>
> We have stressed that corporate counsel must deliver what they promise when they tell us that their corporate client is cooperating. We have found that some corporations purport to cooperate with the Department's investigations but in fact take various steps to block the quick and effective exposure of the complete scope of wrongdoing.
>
> *We will not tolerate conduct that ultimately obstructs our investigations, whether veiled or overt. We are particularly watchful for:* (1) overly broad assertions of corporate representation of employees; (2) inappropriate directions to employees to not volunteer information or decline interviews; and *(3) presentations or assertions that contain misleading information or omissions.*
>
> The other side of this coin is that where corporations are cooperating, we will exercise appropriate prosecutorial discretion in perhaps deciding not to charge or to bring lesser charges. We are always mindful of the real world consequences of a decision to indict a corporation – especially disproportionate harm to innocent employees, communities and shareholders.[70]

68 *See* Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components, United States Attorneys (Jan. 20, 2003) (cover memorandum to Thompson Memo).

69 *Id.*

70 Larry D. Thompson, Deputy Attorney General, U.S. Dep't of Justice, Remarks at the Ninth Circuit Judicial Conference, Kaua'i, Hawaii (June 25, 2003) (emphasis added).

Prosecutors will inevitably measure cooperation in different ways depending on the facts and circumstances of the case. For federal prosecutors, however, the Department of Justice has identified certain key factors that demonstrate a company's cooperation. These include:

> the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; *to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection*[; or]
>
> whether the corporation appears to be protecting its culpable employees and agents[; or]
>
> whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction).[71]

Practical Note: Try to negotiate preservation of attorney-client privilege and work product protection and if the regulator still insists on waiver, try to limit waiver to certain categories of information.

While cooperation does not guarantee a non-prosecution decision, the company should be mindful of these principles not only when a company elects to reach out to prosecutors but also when it prepares the scope of the disclosure by counsel.

C. Consequences of Failing to Cooperate

Government regulators have not hesitated to penalize companies for failing to cooperate fully during the course of an investigation. In 2004, the SEC fined Banc of America Securities LLC ("BAS") $10 million for failing to cooperate. In the enforcement action, the SEC alleged that BAS failed to produce certain documents in a timely matter in the context of an SEC investigation. The SEC also alleged that BAS provided "misinformation" to the SEC concerning the availability and production status of those documents, and "engaged in dilatory tactics that delayed the investigation."[72] In another recent enforcement action against Lucent Technologies, Inc., the SEC found that Lucent had failed to cooperate in an accounting fraud action because it, among other things, allegedly provided incomplete document production and failed to provide timely and full disclosure to the SEC staff on a key issue. The SEC found that Lucent's conduct impeded "the staff's ability to conduct an efficient and comprehensive investigation," and "undermine[d] the integrity of SEC investigations." In settlement the SEC fined Lucent $25 million; required three former employees to pay civil penalties; barred one officer from acting as an officer or director of a public company for five years and barred another officer permanently.[73]

71 *See* Thompson Memo, § VI (emphasis added).

72 *See In the Matter of Banc of America Securities LLC*, Order Instituting Proceedings Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease and Desist Order, Exchange Act Release No. 49386, 2004 SEC LEXIS 548, at*3 (Mar. 10, 2004).

73 *See* Securities and Exchange Commission Press Release, Lucent Settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud: Lucent Agrees to Pay $25 Million Penalty: SEC Charges 10 Individuals with Securities Fraud, No. 2004-67 (May 17, 2004).

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PRACTICAL ADVICE – MITIGATING THE CONSEQUENCES OF TESTIMONY

Although there is no guarantee to keep in-house counsel out of the witness chair, there are steps counsel can take to reduce the likelihood of testifying or at least mitigating the consequences of the testimony. These include:

- If you can, avoid the likelihood that you will have to testify. Do not put yourself in the position of being the only attorney who conducts an internal investigation. Involve a non-lawyer to provide as a witness should the method or results of the investigation be called into question in the future. Better yet, bring in outside, experienced counsel.
- Along similar lines, if the matter involves active litigation, consider entering an appearance in the matter so that you will be viewed as counsel for the matter, rather than "just another" company employee. Other suggestions include signing the pleadings and appearing for hearings. Although there is no pro se prohibition against deposing attorneys, your jurisdiction may have favorable case law that discourages the practice of deposing attorneys for the opponent.
- Do not blur legal and business functions for in-house counsel. If possible, structure the department to keep compliance, government affairs and other quasi-legal duties in the hands of persons other than the general counsel.
- Avoid executing affidavits that controvert the opposing party. By executing an affidavit, you are placing yourself into the category of a fact witness.
- Absent an advanced waiver, be prepared to limit testimony to factual information to avoid an implied waiver.
- If someone within the company seeks legal advice from you, documents should reflect the request, confirming that the advice will be prepared and provided in your capacity as counsel.
- In instances where information gathering by others is required, you should send a memo to the person(s) responsible for the investigation, as well as the Board of Directors or other governing authority, stating that the investigation is being conducted under your investigation and outlining the scope of the investigation and the proper procedures for handling the results. These instructions should include:
    - All reports should be sent to you in draft form.
    - All documents generated should be labeled as work-product protected.
    - None of the documents or information generated as a result of the investigation should be divulged to anyone other than you without your authorization.
- If an outside consultant is to be used to assist you in rendering a legal opinion or in conducting an investigation, the consultant should be retained by you in your capacity as counsel for the company. Instructions to the consultant should specify that the work will be performed to assist you in advising the company, that the consultant is acting at your direction and under your supervision, and that the consultant will submit its report in draft form solely to you. The instructions should also specify that you will have the opportunity to personally review and revise any report before it is finalized.
- To the extent practicable, you should convene and participate in all significant meetings involving the evaluation of information that will be the basis of your legal opinion.
- Documents prepared by you in your capacity as counsel that contain privileged information should be distributed only to those employees whose corporate duties require them to participate in the decision-making or with persons who have a "need to know." Recipients should also be reminded that legal opinions and advice should not be communicated to persons outside the company without your specific authorization.
- All documents involving your responsibilities in a corporate compliance capacity should be maintained separately from legal department documents. Access to such files should be controlled.
- Consideration should be given as to whether there should be separate administrative support in maintaining corporate compliance versus legal department documents.
- In instances where your role requires you to act in a corporate compliance position and you require legal advice, you should request assistance from someone else in the legal department or outside counsel. Do not blur your role on the matter as legal and compliance advisor.
- If your company becomes involved in a government investigation:
    - Try to negotiate preservation of attorney-client privilege and work product protection and if the regulator still insists on waiver, try to limit waiver to certain categories of information.
    - Try to obtain a confidentiality agreement with the regulator to prevent the regulator from sharing company information with third parties, including other governmental agencies (but note such agreements may not be enforceable in some jurisdictions).
    - Try to get a commitment from the regulator to file an amicus curiae brief against waiver of privilege if a third party challenges the company's assertion of privilege.

****

For Further Reading

Association of Corporate Counsel (ACC): virtual library, http://www.acca.com/vl/ keyword "Attorney-Client Privilege"; Advocacy Page on Attorney-Client Privilege, http://www.acca.com/advocacy/attyclient.php, select "Privilege Resources."

H. Lowell Brown, *The Crime-Fraud Exception to the Attorney-Client Privilege in the Context of Corporate Counselling*, 87 KY L.J. 1191 (1999).

Daniel Fisher & Peter Lattman, *Ratted Out*, Forbes, Jul. 4, 2005, at 49.

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Grace M. Giesel, *The Legal Advice Requirement of the Attorney-Client Privilege: A Special Problem for In-House Counsel and Outside Attorneys Representing Corporations*, 48 Mercer L. Rev. 1169 (Spring 1997).

Ross G. Greenberg et al., *Attorney-Client Privilege*, 30 Am. Crim. L. Rev. 1011 (1993).

Brian M. Holt, *To Disclose or Not to Disclose: the Risk of Corporate Cooperation with Government Investigations*, Professional Lawyer, Spring 2003, at 26.

Molly McDonough, *Turning the Tables*, 89 A.B.A. J. 26 (Sept. 2003).

Leonard Post, *The Big Squeeze*, Corporate Counsel, Jul. 1, 2005, at 95.

Geanne Rosenberg, *Lawyers Fret over Counsel Who Testify*, Corp. Counselor, Dec. 1998, at 17.

Joseph J. Siprut, *An In-House Counsel's Guide to Preserving Attorney-Client Privilege*, 92 Ill. B.J. 586 (2004).

John K. Villa, *Deposing In-house Counsel in Actions Involving the Corporate Client: Isn't Life Complicated Enough?*, ACCA Docket, Nov./Dec. 2002, at 110.

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Paradise Tarnished:
Today's Sources of Liability Exposure For Corporate Counsel

March 1, 2005

(ACC thanks Lucian T. Pera and Brian S. Faughnan for their work in preparing this article)[1]

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I. Introduction

According to lore and tradition, the life of corporate counsel is the envy of all the profession.

The view from the outside looks rosy: no time sheets; just one client; no demands for higher billable hours or collections; a regular salary; stock options; corporate perks; dinner with the family more than once a week. In reality, while the demands of in-house practice are different, they are just as great, and carry with them their own weights and unique responsibilities, often related to larger business concerns. Even so, most in-house counsel would not consider swapping their positions to move back to private practice: they enjoy the challenges and opportunities presented by the corporate practice environment. But an increasing number of in-house lawyers are experiencing a strong upswing in professional uncertainty: corporate in-house practice and its challenges have changed significantly in the last few years.

Though very few companies were directly implicated, a thunderous series of corporate scandals rolled across the front pages over the last few years. The allegations and, in many cases, the truth of the scandalous behaviors behind them, deeply shocked and rocked the business world. More than a few formerly respected company names became synonymous for corporate wrongdoing.

One of the first questions asked by shareholders, regulators, the media, and even outraged colleagues at soon-to-be bankrupt companies was, "Where were the lawyers?" Quick on the heels of these scandals, Congress leapt into action with the adoption of Sarbanes-Oxley, and the SEC and other regulators began to re-examine and tighten regulations and oversight of all sorts for the clients of corporate counsel. And the SEC was specifically authorized to adopt regulations to ensure that appropriate attorney conduct was squarely in the center of the scrutiny imposed.[2] All these, and other factors, affect and will continue to drive the practice of corporate counsel for the foreseeable future, in ways small and large.

One area of focused, rising concern: The personal liability exposure of corporate counsel employed in companies accused of wrongdoing, either for acts or omissions, that may have contributed to the failure du jour. It is easy to discount high profile prosecutions of general counsel who appear to have been caught doing something outrageously illegal. But the impropriety in a number of these cases might not appear so obvious, if we try to take off our 20/20 hindsight glasses.

Indeed, the sheer number of in-house counsel prosecutions in the last few years is unheard of in a segment of the profession that historically has never been at the front of the prosecutors' radar. So what happened? Are the ranks of in-house counsel suddenly more likely to include criminals? Has the evolution of the in-house counsel's role placed them in positions where they are more likely to become corrupt? Or is the message to the in-house community one that might be read as, "We're watching you ever more closely and examining your actions or inactions with far greater scrutiny. Don't think that just because you're a lawyer that you're not responsible or that you're immune to prosecution."?[3]

While no startling new types of exposure or theories of liability have exploded on the legal landscape in recent prosecutions, and even though the existing data points may yet be too few to constitute a trend, there are, in fact, a series of new, high-profile instances of corporate counsel being held accountable in previously uncommon ways – ways that have caused or will cause many corporate counsel to sit up, take notice, and consider the implications for their own situations. And that is the purpose of this article: to consider the implications of recent developments in corporate counsel exposure for both corporate counsel and their clients.

One obvious starting point for any discussion of the emerging sources of liability exposure faced by corporate counsel is how, if at all, such sources have traditionally differed

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[2] Sarbanes-Oxley Section 307 authorized the SEC to develop a set of attorney conduct regulations, now codified at 17 CFR Part 205. Go to http://www.acca.com/legres/corpresponsibility/attorney.php for links to the rules, backgrounders, law department resources/benchmarks, and other information.

[3] See, for example, the Comments of Stephen M. Cutler, head of the SEC's enforcement division, to an audience at UCLA's law school on September 20, 2004 ("The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program," found at: http://www.sec.gov/news/speech/spch092004smc.htm):

> How about lawyers? Consistent with Sarbanes-Oxley's focus on the important role of lawyers as gatekeepers, we have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate. We have named lawyers as respondents or defendants in more than 30 of our enforcement actions in the past two years.
>
> * * *
>
> We have seen too many examples of lawyers who twisted themselves into pretzels to accommodate the wishes of company management, and failed in their responsibility to insist that the company comply with the law.
>
> * * *
>
> We have more to do in this area. Based on our current investigative docket, I think you can expect to see one or more actions against lawyers who, we believe, assisted their clients in engaging in illegal late trading or market timing arrangements that harmed mutual fund investors. We are also considering actions against lawyers, both in-house and outside counsel, who assisted their companies or clients in covering up evidence of fraud, or prepared, or signed off on, misleading disclosures regarding the company's condition. One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies. We are concerned that, in some instances, lawyers may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations.

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from those faced by attorneys in private practice. At the most basic level, the sources of liability exposure for attorneys in private and corporate practice are identical: (1) criminal liability and (2) civil liability. Further, the scope of civil liability exposure could be simply divided into two subcategories without distinguishing between corporate counsel and private practitioners: (1) potential civil liability to their clients[4] and (2) potential civil liability to third parties.

Because of the often specialized nature of the services often performed by corporate counsel, however, it is also helpful to divide corporate counsel's sources of liability exposure in a slightly different manner so as not to overlook important nuances. For purposes of this article, the spectrum of potential sources of liability exposure for corporate counsel will thus be divided into four categories: (1) governmental liability, including both criminal and civil liability in proceedings initiated by governmental agencies, such as the U.S. Securities and Exchange Commission; (2) liability to shareholders, both current and former; (3) liability to the client-employer; and (4) liability to others.

But there is also an additional overlay of exposure for many corporate counsel. Frequently, corporate counsel serve as officers (*e.g.*, vice president or secretary) or directors of their client-employer or of an affiliated company. Thus, to fully consider their potential exposure, these corporate counsel must consider two separate, but potentially overlapping, sources of liability: (a) liability flowing from actions they take as an attorney; and (b) liability flowing from actions they take as an officer or director of the company.[5] Further, recognizing these distinct roles played by corporate counsel is important not only for understanding the scope of such liability exposure, but also for a complete understanding of whether particular insurance coverages may be applicable to particular liability risks.

To consider the current environment of liability exposure for corporate counsel, this article will explore several noteworthy high-profile incidents over the last few years (1999-2004) in which corporate counsel have been individually named as defendants in multiple sets of legal proceedings,[6] often including criminal proceedings, as a means to examine: (1) how the traditional types of liability exposure for corporate counsel may be evolving; and (2) whether there exist legitimate grounds for corporate counsel to be concerned that their liability exposure is expanding.

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[4] For corporate counsel, of course, the client more often that not is also their employer. See Association of Corporate Counsel, "In-House Legal Department Ethical and Professional Conduct Manual Chapter Two: Who's The Client?" available at http://www.acca.com/protected/legres/conductmanual/.

[5] Obviously, in any particular situation, the precise role in which corporate counsel acted may not be altogether clear.

[6] One of the corporate counsel included as a case study, Philip Smith, was only named as an individual defendant in one legal proceeding; however, the issues raised in that proceeding are so novel as to merit inclusion. *See infra* at 12-14. Another, Jonathan Orlick, also was only named as an individual defendant in one proceeding, but he has also sued his former employer, Gemstar, for defamation with regard to the characterization of his termination as "for cause." *See infra* at 37-40.

In addition, this article will also discuss an increasingly important issue for today's corporate counsel -- methods of managing their potential liability exposure. Topics that will be addressed will include: (1) the effect that the changed corporate environment may have on the effectiveness of reliance solely upon indemnity provisions; and (2) the need for, and the availability of, different kinds of insurance coverage applicable to the types of claims that ethical, competent corporate counsel may be most concerned about, such as directors and officers' (D&O) insurance policies and malpractice insurance policies.

II. Overview of the Case Studies

We focus in this article on seven high-profile corporate scandals occurring from 1999 through 2003 which, as a result of the fall-out of the scandal, involved litigation, either civil or criminal, in which corporate counsel for the entity was named, usually in multiple proceedings, as an individual defendant.

When this article was originally conceived, our focus was upon a group of in-house counsel who were formally indicted or sued as of the original date of publication of this article, October 1, 2004. While often discussed, a great number of highly public scandal allegations did not give rise to indictments or suits against an in-house lawyer. During the process of updating this article through March 1, 2005, a number of additional in-house counsel have been added to the discussion in Section V.

The time-line of the seven corporate scandals involved is as follows:

1999 – HBOC/McKesson Corp.
1999 – Trace International
2000 – Rite Aid, Inc.
2001 – Enron
2002 – Qwest
2002 – Tyco, Inc.
2003 – Gemstar

As a result of the fall-out from those corporate scandals, the following corporate counsel found themselves in the cross-hairs, either of government lawyers or plaintiffs' counsel, and sometimes both:

Jay Lapine (HBOC/McKesson Corp.) was indicted and charged with criminal securities fraud. In addition, he was named as an individual defendant in a civil securities fraud lawsuit brought by the SEC and in securities litigation[7] pursued by private plaintiffs.

Philip Smith (Trace International) was named as an individual defendant in a civil lawsuit brought by Trace's bankruptcy trustee alleging, among other theories,

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[7] Throughout this article, the term "securities litigation," when used to refer to actions brought by private plaintiffs, will include shareholder derivative lawsuits where applicable.

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breach of fiduciary duty. Smith was ultimately determined by the trial court to be liable in the amount of approximately $21 million.

Franklin Brown (Rite-Aid) was indicted and ultimately convicted of making false statements to the SEC, obstruction of justice, and witness tampering. In October 2004, Brown was sentenced to ten years in prison.[8] Brown was originally ordered to begin serving his sentence on December 13, 2004, but, as a result of a ruling of the trial court, was permitted to remain free on bail pending a ruling by the United States Supreme Court regarding whether the mandatory nature of the Sentencing Guidelines was unconstitutional.[9] Ultimately, on February 10, 2005, Brown was ordered to surrender himself and begin serving his ten-year sentence on March 1, 2005.[10] Brown was also named as an individual defendant in a civil securities fraud lawsuit brought by the SEC and in securities litigation pursued by private plaintiffs.

James Derrick, Rex Rogers, Kristina Mordaunt, Scott Sefton, and Jordan Mintz (Enron) were each singled out in the final report by the examiner appointed by the bankruptcy court, commonly called the "Batson Report," as potentially having committed legal malpractice and breaches of fiduciary duty for which they could ultimately be found to have liability to Enron's bankruptcy estate. In addition, Derrick and Rogers were named as individual defendants in securities class action litigation and, as a result of the findings in the final Batson Report, were also added as individual defendants in a shareholder derivative action pending in Texas state court.

Drake Tempest (Qwest) was named as an individual defendant in securities litigation pursued by private plaintiffs. In addition, media reports continue to speculate that he may be the subject of ongoing investigations by the SEC and/or criminal prosecutors.[11]

Mark Belnick (Tyco) was indicted, but ultimately acquitted, on New York state criminal charges of falsifying business records and grand larceny. In addition, Belnick was named as an individual defendant in a civil securities fraud lawsuit filed by the SEC. Further, Belnick was also sued individually by Tyco, his former employer, for, among other things, breach of fiduciary duty and fraud.

[8] "Trials and errors," The Economist Global Agenda (January 14, 2005), available at http://www.economist.com/agenda/PrinterFriendly.cfm?Story_ID=3572974.

[9] Dochat, Tom, "Court ruling may affect sentencing," The Patriot-News (January 13, 2005), available at http://www.pennlive.com/business/patriotnews/index.ssf?/base/business/1105611782183840.xml.

[10] "Date Set for Rite Aid Exec's Prison Term," *ABCNews.com* (February 11, 2005), available at http://abcnews.go.com/Business/wireStory?id=491494.

[11] *See, e.g.,* Smith, Jeff, "Qwest inquiry moves up ladder, focuses on former top lawyer," Rocky Mountain News (August 21, 2004), available at: http://www.rockymountainnews.com/drmn/business/article/0,1299,DRMN_4_3127249,00.html.

Jonathan Orlick (Gemstar) was named as an individual defendant in a securities fraud lawsuit filed by the SEC. In addition, Orlick has sued Gemstar for defamation in connection with Gemstar's contention that Orlick's termination was "for cause."

An analysis of the case studies discussed here in which high-profile corporate counsel have been named as individual defendants in criminal or civil proceedings from 1999-2003 reveals that, other than the clear appearance that criminal prosecutions, SEC proceedings, shareholder derivative claims, and securities fraud class action claims against corporate counsel are being pursued with increasing frequency, there does not appear to be anything significantly new about the sources of liability exposure for corporate counsel that are classified above as "governmental liability" and "liability to current and former shareholders," although certainly post-Sarbanes-Oxley, the duties of corporate counsel are now more explicitly regulated than ever before.

Nevertheless, a review of those same high-profile events (many of which involve ongoing litigation or investigations) shows that there may ultimately be an expansion in the scope of exposure faced by corporate counsel with regard to potential liability to their client-employer and to third parties resulting from the final fallout of these particular corporate scandals.

III. Case Studies: Corporate Counsel in the Cross-Hairs

We turn now to our case studies of corporate counsel targeted for liability in connection with recent corporate scandals.

First, a word of caution about our sources and purposes: The information contained in this section detailing the events leading up to criminal or civil proceedings against corporate counsel, and describing the allegations made and causes of action pursued in those proceedings, is based on media reports and publicly-available documents, most of which has not been further verified by the authors. Wherever possible, we have tried to indicate the sources of our information.

Quite obviously, many of these accounts generated from ongoing proceedings are one-sided and do not present a complete picture of facts or defenses that may have been, or may yet be, offered by these corporate counsel in their own defense. Remember, the purpose of this article is merely to explore the first indications of any new or changed *potential* sources of liability exposure for corporate counsel, taking recent high-profile, publicly reported circumstances as a data set. This article is not intended to pass any judgments, or draw any conclusions, regarding the merits of any of the allegations in pending or contemplated proceedings against corporate counsel. Given the ongoing nature of most of the proceedings involved, it may well be years before any considered, final judgments are possible based on their outcome.

A. Jay Lapine (HBOC/McKesson)

On January 12, 1999, HBO & Company ("HBOC") and McKesson Corporation ("McKesson") merged, with the new merged entity becoming known as McKesson HBOC. Prior to the merger, HBOC and McKesson were engaged in distinct aspects of the health care

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industry. HBOC was in the business of developing (and subsequently marketing and selling) computer software for use in the health care industry. McKesson's primary business focus was manufacturing and distributing pharmaceuticals, health care supplies, and drinking water.[12]

In late April 1999, just three months after the merger, McKesson HBOC announced its discovery during its year-end audit that certain software sales transactions at HBOC had been recorded improperly and were being reversed.[13] The company's stock plunged as a result, and its market value dropped by more than $9 billion dollars in one day.[14] Subsequently, McKesson HBOC launched an extensive internal investigation and, ultimately, restated its financial statements for the prior three years.[15]

The primary component of the accounting problems identified post-merger by McKesson HBOC involved the use of "side letters" and "side agreements" in connection with software licensing contracts.[16] McKesson HBOC determined that, despite the fact that customers had the right to cancel contracts or return product if certain contingencies were not met, HBOC had been recognizing revenue from those contingent contracts prior to the satisfaction of such contingencies, which was in contravention of Generally Accepted Accounting Practices (GAAP).[17]

Moreover, McKesson HBOC's internal investigation revealed that, to accomplish this accounting manipulation, HBOC had been separating out the side letters from the corresponding contracts and not providing their outside auditors with those side letters. McKesson HBOC also identified another accounting manipulation — backdating certain contracts to record revenue in an earlier quarter and treating exchanges of cash and inventory as end-of-quarter "sales."

Upon completion of its investigation, McKesson HBOC turned over what has been termed a "virtual road map to the fraud"[18] to prosecutors and to the Securities and Exchange Commission (SEC).[19] Criminal proceedings against Albert Bergonzi, the former co-president of HBOC and the former President of the HBO division of McKesson HBOC and Jay Gilbertson, the former co-president and CFO of HBOC followed quickly.[20] Gilbertson pled guilty and implicated Jay Lapine, the former Vice President and General Counsel of the HBOC division of McKesson HBOC.[21] Lapine had been with HBOC since 1994, serving as Associate General Counsel from 1994 to 1997 and then serving as HBOC's General Counsel from 1997 until the merger became effective.[22] Lapine was terminated by McKesson HBOC in June 1999, about five months after the merger and about two months after the announcement of the discovery of accounting problems.[23]

The criminal proceedings.[24] A federal criminal indictment filed against Lapine in the Northern District of California was unsealed on June 4, 2003.[25] According to the U.S. Justice Department, Lapine was the first ever corporate general counsel to be indicted for securities fraud.[26] It was in connection with the indictment of Lapine that Deputy U.S. Attorney General Larry Thompson was first quoted as saying: "Major corporate fraud cannot happen over an extended period of time without the complicity of accountants, lawyers and other professionals."[27]

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[12] Complaint ¶¶ 8-9, filed September 27, 2001, in *SEC v. Lapine*, Civil Action No. C-01-3650 (VRW) (N.D. Cal.).

[13] April 28, 1999, Press Release, McKesson HBOC, available at http://www.mckesson.com/releases/1999/042899_191180013.htm.

[14] "SEC charges former HBO & Co. CEO McCall," *Atlanta Business Chronicle* (June 5, 2003), available at http://www.bizjourals.com/atlanta/stories/2003/06/02/daily42.html. McKesson HBOC went from a closing share price on April 27, 1999, of $65.75 to a closing price on April 28, 1999, of $34.50 per share. See http://bigcharts.marketwatch.com for historical stock quote information for McKesson HBOC (symbol:MCK).

[15] June 4, 2003, Press Release, Office of the United States Attorney for the Northern District of California, available at http://www.justice.gov/usao/can/press/html/2003_06_04_mckesson.html.

[16] *Id.*

[17] *Id.*

[18] Hoppin, Jason, "In a First for Feds, General Counsel Is Indicted for Fraud," *The Recorder* (June 6, 2003), available at http://www.law.com/jsp/article.jsp?id=1052440840504.

[19] Former McKesson HBOC Vice President and General Counsel Jay Lapine has sought access to McKesson HBOC's investigative report and findings, arguing that the disclosure of those materials to the SEC waived any work-product protection. The trial court has ruled that Lapine should have access to such and the matter is presently on appeal to the Ninth Circuit. *See generally* Brief of the Securites and Exchange Commission, *Amicus Curiae*, in Support of McKesson Corporation and Supporting Reversal, *U.S. v. McCall*, No. 03-10511 (9th Cir.), available at http://www.sec.gov/litigation/briefs/mckesson.htm.

[20] *See* Superseding Indictment, *United States v. Bergonzi*, No. CR-00-0505 MJJ (N.D. Cal.).

[21] June 4, 2003, Press Release, Office of the United States Attorney for the Northern District of California, available at http://www.justice.gov/usao/can/press/html/2003_06_04_mckesson.html; "Former McKesson HBOC chief indicted," *Silicon Valley/San Jose Business Journal* (June 5, 2003), available at http://www.bizjournals.com/sanjose/stories/2003/06/02/daily41.html?jst=s_rs_hl.

[22] Complaint ¶ 7, filed September 27, 2001, in *SEC v. Lapine*, Civil Action No. C-01-3650 (VRW) (N.D. Cal.).

[23] *Id.*

[24] *United States v. Bergonzi*, CR 00-0505 MJJ (N.D. Cal.).

[25] October 14, 2003, Stipulation and Order Staying Civil Proceedings While Criminal Case Is Pending, *SEC v. Lapine*, Civil Action No. C-01-3650 MJJ (N.D. Cal.).

[26] Hoppin, Jason, "In a First for Feds, General Counsel Is Indicted for Fraud," *The Recorder* (June 6, 2003), available at http://www.law.com/jsp/article.jsp?id=1052440840504.

[27] *Id.*

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The criminal indictment against Lapine charged him with: (1) conspiracy in violation of 18 U.S.C. § 371; (2) securities fraud in violation of 15 U.S.C. § 78j(b); (3) filing false documents with the SEC in violation of 15 U.S.C. § 78ff; and (4) circumventing accounting controls and falsifying books and records in violation of 15 U.S.C. § 78m(b).

The SEC lawsuit.[28] Lapine also had been named as a defendant in a securities fraud proceeding filed by the SEC on September 27, 2001.[29] The SEC action asserts claims against Lapine for (1) violating Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b5 and 13b2-1 (the antifraud, internal controls, and books and records provisions of the federal securities laws); (2) aiding and abetting violations by HBOC of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20 and 13a-13 (the requirement for filing accurate periodic reports with the Commission).[30] The forms of relief sought by the SEC against Lapine include an injunction barring Lapine from ever serving in the future as an officer or director of a public company and disgorgement of bonus compensation and sale proceeds from stock sales.[31]

Lapine has stated in pleadings filed in connection with the SEC action against him that he "intends to agree to the proposed settlement of the SEC's claims against him, but requires additional time to resolve certain personal matters prior to formally entering into an agreement."[32]

Shareholders derivative suits and securities fraud class actions. Not surprisingly, as a result of McKesson HBOC's announcement of the problems with the integrity of its financials, a number of securities fraud class action suits and shareholder derivative lawsuits were filed against McKesson HBOC. In January 2005, McKesson announced that it had agreed to pay $960 million to settle federal lawsuits that had been filed against it by institutional investors, (*In re McKesson HBOC Securities Litig.*, No. 99-20743 (N.D. Cal.)).[33] Simultaneously, McKesson revealed that it had set aside $240 million for the purpose of resolving other suits filed in state courts in California and beyond.[34]

Lapine is a named defendant in at least one shareholder derivative suit filed in Delaware state court,[35] as well as at least one securities fraud class action suit filed in California.[36] Lapine has been named as an individual defendant in these suits because of his trading activity.

The allegations of wrongdoing that have been leveled at Lapine include the following:

•that he was personally involved in backdating contractual documents related to a multi-million dollar software transaction with Data General Corporation so as to record the associated revenue in the previous financial period and meet analysts' expectations;

•that he was personally involved in the negotiations of two transactions in which "side letters" were negotiated in order to be able to prematurely record revenue associated with the transactions; and

•that he profited from such actions because he received significant bonuses that were tied to meeting earnings expectations and sold company stock at prices that were inflated as a result of acts of fraud.

B. Philip Smith (Trace International)

On July 21, 1999, Trace International, a privately-held holding company with substantial investments in two publicly-traded companies, Foamex and UAG,[37] and another privately-held company, filed for bankruptcy protection under Chapter 11.[38] As is discussed more fully later in this article, the fact that these companies were not publicly-held is of great significance to corporate counsel evaluating their present potential liability exposure.[39]

After its Chapter 11 case was converted to a Chapter 7, the Chapter 7 bankruptcy trustee, John Pereira, filed a civil lawsuit seeking to recoup tens of millions of dollars back into Trace's

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[28] *S.E.C. v. Lapine*, Civil Action No. C-01-3650 (VRW) (N.D. Cal.).

[29] S.E.C. Litigation Release No. 17189 (October 15, 2001), available at http://www.sec.gov/litigation/litreleases/lr17189.htm. During a deposition that occurred in connection with the SEC proceedings, Lapine exercised his Fifth Amendment right against self-incrimination. *See* Memorandum of Points and Authorities in Support of Defendant Jay Lapine's Motion For Stay of Discovery at 4, filed Aug. 21, 2002, in *SEC v. Lapine*, No. C-01-3650-MJJ (N.D. Cal.). Lapine also exercised his Fifth Amendment right against self incrimination in his Answer to the SEC's complaint filed on October 7, 2002. *See* Answer to the Complaint (filed October 7, 2002), *SEC v. Lapine*, No. C-01-3650-MJJ (N.D. Cal.)

[30] Complaint ¶¶ 31-46 (filed September 27, 2001), *SEC v. Lapine*, Civil Action No. C-01-3650 (VRW) (N.D. Cal.).

[31] *Id.* at 10-11.

[32] Memorandum of Points and Authorities in Support of Defendant Jay Lapine's Motion For Stay of Discovery at 4 (filed August 21, 2002), *SEC v. Lapine*, No. C-01-3650-MJJ (N.D. Cal.).

[33] Chorney, Jeff, "McKesson Agrees to $960M Settlement in Class Lawsuits," The Recorder (January 13, 2005), available at http://www.law.com/jsp/article.jsp?id=1105364100416.

[34] *Id.*

[35] *Kelly v. McKesson HBOC, Inc.*, C.A. No. 17282-NC (Del. Chancery Ct., New Castle County).

[36] *Merrill Lynch Fundamental Growth Fund, Inc. v. McKesson HBOC, Inc. et al*, No. CGC 02 405792 (Cal. Superior Ct., San Francisco County).

[37] Together, Trace's holdings in those three companies constituted 90-95% of its assets. *Pereira v. Cogan*, 294 B.R. 449, 470 (S.D.N.Y. 2003).

[38] *Pereira*, 294 B.R. at 463.

[39] *See infra* Section IV.D.

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bankruptcy estate. The lawsuit named as defendants the controlling shareholder of Trace, Marshall Cogan, and seven other former officers or directors of Trace, including Philip Smith, Trace's General Counsel, Vice President,[40] and Secretary.[41] The claims brought by the bankruptcy trustee against Smith were for (1) breach of fiduciary duty; and (2) unlawful payment of dividends and redemption of preferred stock.[42] The overarching theory behind the lawsuit was that Trace had been operated to pursue the best interests of Cogan, and not Trace, and that creditors of Trace had been damaged by the actions of Trace's officers and directors occurring while Trace was in the "zone of insolvency."

In his role as Trace's General Counsel, Smith hired and supervised outside counsel. Further, in his role as Trace's Secretary, "Smith maintained the corporate minute books and, when requested by the chairman, sent out notices of board meetings. He took the minutes of Board meetings and drafted unanimous consents."[43] In addition to being General Counsel, Vice President, and Secretary of Trace, Smith was also General Counsel and Secretary of Foamex and UAG, two public companies in which Trace had substantial investments.[44]

Despite the fact that there were no allegations that Smith received any personal benefit from any of the transactions that were challenged by the bankruptcy trustee, the trial court, addressing what it considered to be "novel issues of corporate governance,"[45] on May 12, 2003, found Smith to be liable for damages to the bankruptcy estate in excess of $21 million.[46]

[40] Along with Smith, a number of other professionals at Trace held the title of Vice President, and the trial court noted that such title did not automatically confer or denote any decision-making authority. *Id.* at 522.

[41] Smith joined Trace as its General Counsel, Vice President, and Secretary in 1988, after spending 8 years in private practice at Akin, Gump, Strauss Hauer & Feld LLP. *Id.* at 468. Prior to his time at Akin Gump, Smith worked at the SEC.

[42] Second Amended Complaint ¶¶ 31-64, *Pereira v. Cogan*, No. 00-CIV-619 (RWS) (S.D.N.Y.).

[43] *Pereira*, 294 B.R. at 469.

[44] Interestingly, Smith received his salary from Foamex and UAG, and not Trace. The only compensation Smith received from Trace involved a company car and occasional bonuses. As an example, for the year 1999, Smith's total compensation from Trace only amounted to $60,000. *Id.*

[45] *Pereira v. Cogan*, 294 B.R. at 462. Among the novel issues involved was the imposition of legal liability upon officers and directors for acts and omissions occurring at a time when the company, although not actually insolvent, is within the "zone of insolvency." *See* Epstein, Michael, J., "Furthering Insolvency: How did we get here from there?" TRGUSA.com, available at http://www.trgusa.com/Furthering_insolvency_MJE.htm.

[46] The award against Smith was for $21,392,974.45, comprised of an award of $13,984,712.52 ($13,411,712.52 for loans to Cogan; $573,000 for loans to two other insiders; and $3,000,000 for the Dow redemption transaction) plus pre-judgment interest. Final Judgment (June 24, 2003), *Pereira v. Cogan*, No. 00-CIV-619 (RWS) (S.D.N.Y.).

Specifically, Smith was found to have liability in connection with improper loans made to Cogan and two other Trace insiders and the structuring of a transaction that was undertaken in order to satisfy Trace's obligation to redeem a specific amount of Trace preferred stock that had been issued to Dow Chemical Company.[47] The trial court did not find Smith liable with regard to any unlawful payments of dividends concluding that Smith appropriately discharged his obligations as General Counsel by providing legal advice regarding when dividends can be issued.[48] Smith appealed the trial court's decision to the Second Circuit on July 21, 2003. Oral argument occurred on November 12, 2004, and that appeal remains pending.

The allegations of wrongdoing that have been leveled at Smith include the following:

•devising a scheme to avoid certain legal impediments that existed that prevented Trace from redeeming Trace shares from Dow Chemical Corp. that it was obligated to redeem by disguising the redemption as a purchase of the shares from Dow by Cogan in which Trace loaned the purchase price amount to Cogan and Cogan, in turn, pledged the Dow shares to Trace;

•failing to take actions to prevent Trace from improperly paying out dividends; and

•failing to understand and to properly advise the Board of Directors of its responsibility to approve of loans made to Cogan and other insiders;

C. Franklin Brown (Rite-Aid)

At the end of 1999, Rite-Aid's board of directors announced that its preliminary results for the second quarter of 2000 indicated a $67.9 million dollar loss. At the same time, Rite-Aid also announced its intention to restate its financials for prior years.[49]

Prior to its ultimate restatement, the board of directors undertook an eight-month internal investigation that commenced in October or November 1999.[50] Rite-Aid's ultimate July 2000 restatement of earnings was, at the time, the largest restatement of corporate income in U.S. history and served to eliminate all of its originally reported profits from 1996 through the first quarter of 2000.[51]

The problems associated with the integrity of Rite-Aid's financials included a variety of accounting manipulations designed to positively affect Rite-Aid's stock price, including premature recording of revenue, improper extensions of asset depreciation time periods, and improperly recording revenue from payments made by insurance carriers for medicine that had

[47] *Pereira*, 294 B.R. at 534-35, 537-38.

[48] *Id.* at 523.

[49] Indictment ¶ 43, *U.S. v. Grass*, No. 1:02-CR-146 (M.D. Pa.).

[50] *U.S. v. Grass*, 239 F. Supp. 2d 535, 536 (M.D. Pa. 2003).

[51] Indictment ¶ 47-48, *U.S. v. Grass*, No. 1:02-CR-146 (M.D. Pa.).

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been ordered by customers of Rite-Aid but never actually picked up by those customers.[52] Another major source of Rite-Aid's financial problems was that Rite-Aid had been inflating its revenues by manipulating its right to credits from its suppliers for damaged and outdated goods.[53]

At the time this massive restatement was announced by Rite-Aid, Franklin Brown was Rite-Aid's Chief Legal Counsel, Executive Vice President, and Vice Chairman of Rite-Aid's Board of Directors. Brown was one of the four top corporate officers of Rite-Aid, and his compensation was tied to the performance of Rite-Aid's stock. Brown resigned his employment with Rite-Aid on February 25, 2000, and resigned from its Board of Directors three months later.[54]

The criminal proceedings.[55] Brown was indicted by a federal grand jury in June 2002 and charged with: (1) conspiracy to defraud; (2) fraud in connection with the purchase or sale of securities; (3) thirteen counts of making false statements to the SEC; (4) ten counts of mail fraud; (5) six counts of wire fraud; (6) criminal forfeiture; (7) conspiracy to obstruct justice; (8) obstruction of grand jury proceedings; (9) obstruction of government agency proceedings; and (10) tampering with a witness.[56]

Brown was convicted after a jury trial in October 2003 of making false statements to the SEC, obstruction of justice, and tampering with a witness; Brown was, however, acquitted of wire fraud.[57] Brown was the first executive post-Enron to be convicted by a jury.

After ruling that she would not apply the Federal Sentencing Guidelines believing them to be likely unconstitutional after United States v. Blakely, Judge Sylvia Rambo, using the recommended 10-12 ½ year sentencing range appearing in the Federal Sentencing Guidelines only as a "framework," sentenced Brown to ten years in prison. Brown, however, was allowed to remain free on bail until such time as the United States Supreme Court issued its ruling as to whether the logic of Blakely was going to apply to the Federal Sentencing Guidelines.[58] Judge Rambo's prediction regarding the impact of Blakely was borne out when the United States Supreme Court determined on January 12, 2005, that the "mandatory" nature of the Federal Sentencing Guidelines was unconstitutional. United States v. Booker, Nos. 04-104 and 04-105, 2005 U.S. LEXIS 628 (January 12, 2005) (holding "two provisions of the Sentencing Reform Act of 1984 . . . that have the effect of making the Guidelines mandatory must be invalidated"). Ultimately, on February 10, 2005, Judge Rambo issued an order that will require Brown to begin serving his ten-year sentence on March 1, 2005.[59]

Prior to Brown's conviction, the former CEO of Rite-Aid, Martin Grass, pled guilty in June 2002 to two counts of conspiracy and received an eight-year prison sentence.[60]

The SEC action. Brown was also named as a defendant in civil proceedings brought by the SEC alleging accounting fraud.[61] In its civil lawsuit, the SEC asserts claims against Brown for: (1) violating Section 17(a) of the Securities Act; (2) violating Section 10(b) of the Exchange Act and Rule 10b-5; (3) violating Section 13(b)(5) and Rules 13b2-1 and 13b2-2; (4) violating Section 14(a) of the Exchange Act and Rules 13a-11 and 14a-9(a) (controlling person liability); and (5) violating Section 20(a) of the Exchange Act and Rules 12b-20 and 13a-1 (controlling person liability).[62] The forms of relief sought by the SEC against Brown included permanent injunctive relief, civil monetary penalties, a bar against Brown acting as an officer or director of a public company in the future, and disgorgement of ill-gotten gains, including performance-based bonuses.[63]

Securities fraud litigation. Brown was named as an individual defendant, along with other corporate directors of Rite-Aid, in a number of securities litigation class actions. The allegations leveled against Brown, however, involved duties allegedly owed by Brown as a result solely of his status as Vice-Chairman of the Board of Directors and not as a result of his status as Chief Legal Counsel or Executive Vice-President.[64]

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[52] S.E.C. Litigation Release No. 17577 (June 21, 2002), available at http://www.sec.gov/litigation/litreleases/lr17577.htm.

[53] *Id.*

[54] Indictment ¶ 9, *U.S. v. Grass*, No. 1:02-CR-146 (M.D. Pa.).

[55] *U.S. v. Grass*, No. 1:02-CR-146 (M.D. Pa.).

[56] Indictment, *U.S. v. Grass*, No. 1:02-CR-146 (M.D. Pa.); *see* "Ex-Rite Aid execs indicted," (June 21, 2002), available at http://money.cnn.com/2002/06/21/news/companies/riteaid/.

[57] Taub, Stephen, "Jury Conviction for Former Rite Aid Exec," CFO.com (October 21, 2003), available at http://www.cfo.com/printarticle/0,5317,10939|C,00.html?f=options.

[58] Voreacos, David, "Judge rules on Rite Aid case," *The Detroit News* (August 19, 2004), available at http://www.detnews.com/2004/business/0408/19/b03-247028.htm.

[59] "Date Set for Rite Aid Exec's Prison Term," *ABCNews.com* (February 11, 2005), available at http://abcnews.go.com/Business/wireStory?id=491494.

[60] "Former Rite Aid CEO Pleads Guilty To Conspiracy," WSOCTV.com (June 17, 2003), available at http://www.wsoctv.com/print/2274654/detail.html?use=print. It has been reported that Brown had been offered a chance to plead guilty to one count, but backed out of a plea agreement during the summer of 2003. *See* Taub, "Jury Conviction for Former Rite Aid Exec," *supra* note 40.

[61] *S.E.C. v. Bergonzi*, No. 1:CV-02-1084 (M.D. Pa.); *see* S.E.C. Litigation Release No. 17577 (June 21, 2002), available at http://www.sec.gov/litigation/litreleases/lr17577.htm.

[62] Complaint ¶¶ 69-94, 100-113, *SEC v. Bergonzi*, No. 1:CV-02-1084 (M.D. Pa.), available at http://www.sec.gov/litigation/complaints/complr17577.htm.

[63] Complaint, Prayer for Relief, *SEC v. Bergonzi*, No. 1:CV-02-1084 (M.D. Pa.), available at http://www.sec.gov/litigation/complaints/complr17577.htm.

[64] *See In re: Rite Aid Corporation Securities Litigation*, MDL-1360 (Master File No. 99-CV-1349 (SD) (E.D. Pa.); *Manzo v. Rite Aid Corporation*, No. 184511-NC (Del. Chancery Ct., New Castle County); *In re Rite Aid Corporation Derivative Litigation*, No. 174440-NC (Del.

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The allegations of wrongdoing that were leveled at Franklin Brown include the following:

•having knowledge of a wire transfer in which $2.6 million was wired from Rite-Aid to CCA Associates, Inc., whose only shareholders were Martin Grass and a member of his family and not taking steps to disclose the related-party nature of the transaction;

•engineering a payment of $11 million in order to settle a lawsuit that had been brought by a fired Senior Vice-President in response to a threat by that individual that he would go public with his knowledge of Rite-Aid's practice of upcharging its vendors for damaged and outdated goods credits;

•executing loan guarantees without the Board's knowledge or consent and creating Certificates of Excerpts from Minutes that falsely represented that the Board had authorized him to execute the loan guarantees;

•participating in the creation of severance letters for certain employees containing lucrative severance payments that were back-dated to periods in which Grass was still Rite-Aid's CEO;

•falsifying, or causing others to falsify documents;

•paying a former employee of Rite-Aid $5,000 cash in exchange for agreeing to sign an affidavit that would provide necessary support for Rite-Aid's accounting entries;

•attempting to learn how to alter the internal clock on company computers in order to make the file generation date match the dates on back-dated letters;

•conspiring to inflate Rite-Aid's reported income; and

•misleading federal investigators and Rite-Aid's internal investigators.

D. James Derrick, Rex Rogers, Kristina Mordaunt, Scott Sefton, and Jordan Mintz (Enron)

The accounting scandal at Enron is now the stuff of legend. The media saturation that followed the revelation of Enron's problems and the coverage of the details of the particular types of accounting manipulations involved may be unprecedented. This article assumes that readers have a passing familiarity with the basic details of Enron's demise. However, as short refresher, the following is a pared-down timeline of some of the most noteworthy events involved:

•August 2000 – Enron shares are trading at their highest price ever of $90.

Chancery Ct., New Castle County). The *Manzo* lawsuit was dismissed on December 19, 2002. The other lawsuits appear to have been resolved either directly or indirectly via a class settlement upon terms that did not require Brown to make any settlement payment.

•December 2000 – Enron announces that Jeffrey Skilling will assume the position of CEO in February 2001, while Kenneth Lay, who had been Chairman and CEO, will remain Chairman.

•August 14, 2001 – Skilling resigns after only six months as CEO. Lay reassumes the CEO role.

•August 22, 2001 – Sherron Watkins, an Enron finance executive, has a private meeting with Lay and discusses her concerns that accounting fraud might ruin Enron. Watkins had previously provided Lay with an anonymous memo that said "I am incredibly nervous that we will implode in a wave of accounting scandals."

•October 16, 2001 – Enron reports a $638 million third-quarter loss and also discloses a $1.2 billion reduction of shareholder equity.

•October 24, 2001 – Andrew Fastow is removed from his position as CFO.

•November 8, 2001 – Enron restates its financials for the preceding 5 years to show losses of $586 million.

•November 28, 2001 – Enron's stock share price drops below $1.

•December 2, 2001 – Enron files bankruptcy.

•January 23, 2002 – Lay resigns as Enron's Chairman and CEO.[65]

An incredible amount of public scrutiny has been directed toward executives such as Kenneth Lay,[66] Andrew Fastow,[67] and Jeffrey Skilling.[68] However, the role played by Enron's in-house counsel has also been the subject of some significant media attention.[69]

[65] Associated Press, "Chronology of Enron Corp" (July 15, 2004), available at http://www.newsday.com/business/nationworld/wire/sns-ap-enron-chronology,0,6766906.story?coll=sns-ap-business-headlines.

[66] Lay is the former Chairman and CEO of Enron. Lay resigned from Enron on January 23, 2002, and was indicted on federal criminal charges on July 7, 2004. *See* Crawford, Krysten, and Arena, Kelli, "Enron's Lay Indicted" (July 7, 2004), available at http://money.cnn.com/2004/07/07/news/newsmakers/lay/; "Lay resigns as Enron Chief" *CNN.com* (January 24, 2002), available at http://www.cnn.com/2002/US/01/23/enron.lay/.

[67] Fastow is the former CFO of Enron and was ousted from that position on October 24, 2001. Fastow was indicted on federal criminal charges on October 31, 2002, and pled guilty on January 14, 2004. *See* Rogers, Jen, "Fastow and his wife plead guilty" (Jan. 14, 2004), available at http://money.cnn.com/2004/01/14/news/companies/enron_fastows/; "Enron's ex-CFO seeks protection from lawsuits" *HoustonChronicle.com* (June 21, 2002), available at http://www.chron.com/cs/CDA/story.hts/front/1465229.

[68] Skilling resigned from his position as CEO of Enron in August 2001, after serving only 6 months in that role. He was indicted on federal criminal charges on February 19, 2004. "Skilling

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Enron filed for bankruptcy in the Southern District of New York on December 2, 2001.[70] In the bankruptcy proceedings, the court, pursuant to 11 U.S.C. § 1104(c), authorized and directed the appointment of an examiner. On May 22, 2002, the United States Trustee appointed R. Neal Batson, an attorney with Alston & Bird, LLP in Atlanta, as the Enron examiner and the Batson appointment was approved by the bankruptcy court on May 24, 2002.[71] Batson's first three interim reports were released on September 21, 2002, January 21, 2003, and June 30, 2003, respectively. On November 4, 2003, Batson's fourth and final report was publicly released.[72]

The Final Report of Neal Batson, Court-Appointed Examiner (the "Batson Report") is the most complete, publicly-available analysis of the questionable accounting and business practices that ultimately led to Enron's descent into bankruptcy. Anyone interested in gaining an understanding of the nature and details of those accounting and business practices should look to the Batson Report and not this article. In an attempt at the briefest of summaries regarding the nature of the wrongdoing at Enron, the primary accounting issues at Enron involved failure to properly disclose the existence and scope of related party transactions, its use of special purpose entities (SPEs) to manipulate its financial picture, and Enron's proclivity for entering into transactions that had no legitimate business purpose in order to bolster its balance sheet.

Appendix C to the Batson Report is entitled "Role of Enron's Attorneys."[73] Appendix C focuses upon Enron's outside counsel,[74] as well as certain of its in-house counsel, and the roles they played in certain SPE transactions, Enron's disclosures about those transactions, and the internal investigation launched by Enron in response to allegations of wrongdoing that were made in a letter sent to Kenneth Lay by Sherron Watkins, an Enron employee and former accountant.[75] That portion of the Batson Report advised that Batson had concluded that Enron had potentially viable claims for malpractice and breach of fiduciary duty against five of its in-house counsel: James Derrick, Rex Rogers, Kristina Mordaunt, Scott Sefton, and Jordan Mintz.

All this said, do be aware that the Batson Report is not intended as a complete evaluation of the liability of Enron's former lawyers, which would surely have to take into account factual and legal defenses that these lawyers might have. The report was commissioned to assist Enron's bankruptcy trustees in evaluating whether to pursue claims against these lawyers. In other words, it identifies claims that Enron may possess for which a conclusion could be reached that factual issues exist that would require a jury determination, *i.e.*, claims that would survive summary judgment. Specifically, the standard applied in the Batson Report for determining that a claim was potentially viable is expressed as follows:

> Where the Examiner reaches the conclusion that there is *sufficient evidence for a fact-finder to conclude* that a claim exists, the Examiner has determined that in a legal proceeding regarding such matter, the proposition would be submitted to the fact-finder for decision. In most cases, the fact-finder would be a jury, although in equitable subordination actions the bankruptcy court serves as the fact-finder. The decision of the fact-finder would be made after evaluating the documentary evidence, the testimony and credibility of witnesses and the reasonable inferences that may be drawn from this evidence.[76]

The Batson Report also made clear, with regard to malpractice claims against any professional, where normally a qualified expert opinion would be necessary that the standard of care was not satisfied, that "[w]here the Examiner reaches the conclusion *that there is sufficient evidence for a fact-finder to conclude* that these types of negligence claims exist, the Examiner has determined that the plaintiff would be able to produce a qualified expert to express such an opinion."[77]

The Batson Report outlined three types of causes of action that may be viable: (1) legal malpractice premised upon a failure to comply with Texas Rule 1.12[78] (Texas' corollary to ABA

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indicted for fraud" (Feb. 19, 2004), available at http://money.cnn.com/2004/02/19/news/companies/skilling/.

69 France, Mike, "What About Enron's Lawyers?" *BusinessWeek Online* (December 23, 2002), available at http://businessweek.com/magazine/content/02_51/b3813093.htm; France, Mike, "The Case of Enron's Top Lawyer," *BusinessWeek Online* (Dec. 19, 2002), available at http://businessweek.com/bwdaily/dnflash/dec2002/nf20021219_2395.htm.

70 *In re Enron Corp.*, No. 01-16034 (AJG) (S.D.N.Y.)

71 Final Report of Neal Batson, Court-Appointed Examiner, November 4, 2003, p.1 ("Batson Report") (available at http://www.enron.com/corp/por/examinerfinal.html. The full report is also available at http://www.acca.com/public/article/corpresp/batsonreport.pdf.

72 The fourth and final report, including Appendices A-G spans 1,115 pages. In total, the collection of all four reports from Batson spans 4,440 pages.

73 Appendix C to the Batson Report is available for download in two parts at http://www.enron.com/corp/por/examinerfinal.html and can also be found at http://www.acca.com/public/article/corpresp/batsonappendix.pdf.

74 Specifically, the law firms of Vinson & Elkins, L.L.P. and Andrews Kurth LLP. Batson Report, Appendix C at 21-26.

75 Batson Report, Appendix C at 26-176.

76 Batson Report at 13-14 (emphasis in original).

77 Batson Report at 14 n. 26 (emphasis in original).

78 "Texas Rule 1.12 addresses the attorney's role when the attorney represents an organization (such as a corporation) and learns that a representative of the organization has committed or intends to commit a violation of law which might reasonably be imputed to the organization (such as the dissemination misleading financial information)." Batson Report, Appendix C at 3. "Thus, an attorney for Enron who knew that (i) an officer was engaging in wrongful conduct, (ii) substantial injury to Enron was likely to occur as a result of that conduct, and (iii) the violation was within the attorney's scope of representation, but failed to take appropriate affirmative steps to cause reconsideration of the matter -- including referral of the matter to a higher authority in the company, including, if appropriate, the Enron Board -- would not have acted as an attorney

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Model Rule 1.13)[79]; (2) legal malpractice based on negligence; and (3) aiding and abetting the Enron officers' breaches of fiduciary duty. The Rule 1.12 and aiding and abetting claims would require *actual knowledge* of the wrongdoing on the part of counsel. The Batson Report concludes that only circumstantial evidence of this exists.

As for aiding and abetting, the attorney needs to have actual knowledge, needs to have given substantial assistance (routine services will not constitute substantial assistance), and the resulting injury needs to be direct or reasonably foreseeable result of the conduct. The Batson Report notes that, although this standard would apply to in-house counsel as well, because of the fiduciary duties owed by an in-house counsel who is also an officer of the company,[80] their conduct is better viewed through the breach of fiduciary duty prism than aiding and abetting concepts.[81]

The Batson Report identified the following in-house counsel at Enron as individuals against whom claims believed to be viable enough to withstand summary judgment could be made:[82]

James Derrick

Derrick, a former partner at Vinson & Elkins LLP and former judicial clerk on the United States Court of Appeals for the Fifth Circuit, is the former General Counsel of Enron.[83] According to the Batson Report, Derrick "viewed his principal role as administrator of the law department, relying upon the general counsel of each business unit to manage the attorneys and transactions within that business unit."[84] Derrick became Enron's General Counsel in 1991.

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of reasonable prudence would have acted in a similar situation." Batson Report, Appendix C at 4.

79 The text of Texas Rule 1.12 and comments is available at: http://www.txethics.org/reference_rules.asp?view=conduct&num=1.12.

80 Rex Rogers, Scott Sefton, and Jordan Mintz, in addition to being in-house counsel, also each were corporate officers holding the title of Vice President.

81 Batson Report, Appendix C at 5.

82 Subsequent to the completion of the Batson Report, the bankruptcy court in New York gave permission to plaintiffs' counsel representing Enron's creditors in a civil fraud and negligence suit pending in Texas to name in-house counsel at Enron as defendants in that suit. "Judge says Enron creditors may sue law firms, auditor," *Houston Business Journal* (December 2, 2003), available at http://www.bizjournals.com/houston/stories/2003/12/01/daily13.html?jst=s_rs_hl.

83 Prepared Witness Testimony of James V. Derrick, Jr., Esq. before the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigation (March 14, 2002), available at http://energycommerce.house.gov/107/hearings/03142002Hearing511/Derrick,Jr.855.htm.

84 Batson Report, Appendix C at 11.

Enron's in-house legal department was comprised of approximately 250 attorneys and was highly decentralized. Each of Enron's business units had its own legal department that was supervised by a general counsel for that business unit.[85] Within each business unit's legal department, the attorneys were given various titles such as "Senior Counsel," "Assistant General Counsel," and "Vice President."[86] Each general counsel for the business units had dual reporting obligations with an obligation to report to the head of the particular business unit and to Derrick.[87]

Derrick's oversight of the activities of other Enron in-house counsel included weekly meetings in his office involving the general counsel of Enron's major business units and monthly meetings in his office that also involved the general counsel of Enron's entities located overseas.[88] Derrick played a significant role in litigation involving Enron, but apparently did not get involved in business transactions generally unless something specific was brought to his attention.[89] Derrick often attended meetings of Enron's Board of Directors, but primarily attended such meetings for the purpose of making presentations to the Board about litigation matters and rarely gave legal advice to the Board.[90]

Derrick also was responsible for retaining Vinson & Elkins to head up Enron's investigation launched in response to Enron employee Sherron Watkins' letter to Enron Chief Executive Officer Kenneth Lay expressing serious concerns with Enron's business and accounting practices.[91]

The potential allegations of wrongdoing against Derrick identified in the Batson Report include the following:

- failing to educate himself as to the underlying facts and governing law with regard to the LJM1/Rhythms Hedging Transaction prior to advising the Enron Board of Directors regarding the basis on which it could approve that related party transaction;

- failing to have any substantive involvement in any Enron business transactions unless a particular issue was brought to his attention;

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85 Batson Report, Appendix C at 15.

86 Batson Report, Appendix C at 17 n. 25.

87 Batson Report, Appendix C at 17.

88 Batson Report, Appendix C at 18.

89 Batson Report, Appendix C at 11.

90 Batson Report, Appendix C at 11. In fact, Derrick personally made a presentation to Enron's Board about whether Enron's Code of Conduct would prohibit Fastow from having an ownership interest in one of Enron's SPEs -- known as LJM1. *Id.*

91 Batson Report, Appendix C at 159-166.

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•rarely advising the Board of Directors and failing to advise them even when significant issues came to his attention;

•failing to confirm that other lawyers to whom he had delegated responsibility were adequately performing their duties;

•failing to inform himself adequately about the content of Enron employee Sherron Watkins' letter to Lay that expresses concerns about Enron's business and accounting transactions; and

•failing to inform himself adequately about Enron outside counsel Vinson & Elkins' involvement in the transactions criticized by Sherron Watkins' letter prior to tasking Vinson & Elkins with investigating the allegations.[92]

Potential causes of action. The Batson Report identifies and concludes that Enron might have viable causes of action against Derrick for legal malpractice based on negligence, but concluded that claims for aiding and abetting a breach of fiduciary duty by Enron officers, or legal malpractice premised upon a failure to comply with Texas Rule 1.12 (the Texas equivalent of ABA Model Rule 1.13), would not be viable claims against Derrick.[93]

Securities litigation. Derrick is an individually-named defendant in a securities fraud class action suit filed in federal court in Texas by former Enron shareholders.[94] Derrick has also been added as a named individual defendant to a shareholders derivative lawsuit pending in state court in Montgomery County, Texas.[95]

Rex Rogers

At the time that the Enron scandal broke, Rogers held the title of Vice President and Associate General Counsel.[96] He was the Enron in-house attorney with primary responsibility for Enron's securities disclosures. All SEC filings and SEC-related matters went through him.[97] Rogers supervised approximately eight attorneys and was near the top of Enron's organizational chart.[98]

[92] Batson Report, Appendix C at 190-191.

[93] Batson Report, Appendix C at 11-12, 190-191

[94] *In re Enron Corp. Securities Litigation*, No. H-01-3624 (*Wilt v. Fastow*, No. H-02-0576) (S.D Tex.).

[95] *Official Committee of Unsecured Creditors of Enron Corp. v. Fastow et al.*, Case No. 02-10-06531 (Dist. Ct. for 9th Judicial Dist., Montgomery County, Texas).

[96] Batson Report, Appendix C at 15 n.17.

[97] Batson Report, Appendix C at 17.

[98] Batson Report, Appendix C at 17 n. 27.

Rogers provided legal advice as the lead attorney with respect to Enron's SEC filings, including such items as proxy statements and annual and quarterly reports.[99]

Rogers also was somewhat involved in the Watkins investigation, meeting with Enron employee Sherron Watkins after she circulated her letter to Lay.[100]

The potential allegations of wrongdoing against Rogers identified in the Batson Report include the following:

•failing to fulfill his responsibility to Enron with regard to advising it as to how it must disclose SPE transactions;

•failing to inform the Enron Board of the Raptors restructuring in early 2001 which involved the issuance of stock;

•failing to make certain that the 2001 proxy statement disclosed Fastow's compensation from the LJM2 transactions; and

•substantially assisting Enron's officers in intentionally withholding information from the Board.[101]

Potential causes of action. The Batson Report identifies and concludes that Enron might have viable causes of action against Rogers for legal malpractice based on negligence, legal malpractice based on failure to take remedial action in violation of Texas Rule of Professional Conduct 1.12, and breach of fiduciary duty.[102]

Securities litigation. Rogers is an individually-named defendant in a securities fraud class action suit filed in federal court in Texas by former Enron shareholders.[103] Rogers has also been added as a named individual defendant to a shareholders derivative lawsuit pending in state court in Montgomery County, Texas.[104]

Kristina Mordaunt

[99] Batson Report, Appendix C at 82 n.310

[100] Batson Report, Appendix C at 159.

[101] Batson Report, Appendix C at 191-193.

[102] Batson Report, Appendix C at 191-193.

[103] *In re Enron Corp. Securities Litigation*, No. H-01-3624 (*Wilt v. Fastow*, No. H-02-0576) (S.D Tex.).

[104] *Official Committee of Unsecured Creditors of Enron Corp. v. Fastow et al.*, Case No. 02-10-06531 (Dist. Ct. for 9th Judicial Dist., Montgomery County, Texas).

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Mordaunt was the in-house attorney with Enron who was responsible for certain SPE transactions occurring in 1997, known as the Chewco transactions. At that time, Mordaunt was the Assistant General Counsel of Enron Capital and Trade.[105]

Mordaunt served as a senior in-house counsel on a number of SPE transactions within Enron Global Finance, after Enron Global Finance and its corresponding legal department had been created in the third quarter of 1999.[106]

With regard to another scrutinized SPE transaction, the LJM1 Formation and the LJM1/Rhythms Hedging Transaction, it appears that Mordaunt may have been directing the legal work on Enron's behalf, but the full scope of her role is murky in light of the fact that "Mordaunt has exercised her Fifth Amendment Privilege" with respect to the topic.[107] Neither Mordaunt, nor any other Enron attorneys who were actually involved with the LJM1/Rhythms Hedging Transaction, were present at the time this transaction was presented to the Board of Directors for approval in June 1999.[108] Instead, as noted above, Derrick, who had not actually worked on the transaction, made the Board presentation.

Mordaunt also came under fire in connection with an investment she made into one of Enron's SPE's – Southampton. Mordaunt invested less than $6,000 in Southampton, one of Enron's SPEs, without receiving the necessary approval, and received a return on her investment in excess of $1 million.[109]

The potential allegations of wrongdoing against Mordaunt identified in the Batson Report include the following:

•failing to adequately analyze the conflict of interest created by an Enron officer also serving as general partner of Chewco;

•failing to inform Enron's Board of the related party nature of the Chewco transaction despite knowing that the Board believed that Chewco was not affiliated with Enron;

•actively participating in the LJM1/Rhythms Hedging Transaction which was intended solely to manipulate Enron's financial statements; and

•placing her personal interests ahead of her client's and entering into a prohibited transaction with her client in connection with her $1 million profit on her unapproved investment in Southampton when she knew that LJM1 was a related party.[110]

Potential causes of action. The Batson Report identifies and concludes that Enron might have viable causes of action against Mordaunt for legal malpractice based on negligence or a breach of her own fiduciary duty, legal malpractice based on failure to take remedial action in violation of Texas Rule of Professional Conduct 1.12 and for aiding and abetting a breach of fiduciary duty.[111] In addition, the Batson Report also concluded that Enron might have viable causes of action against Mordaunt for legal malpractice involving violation of Texas Rule of Professional Conduct 1.06(b),[112] and legal malpractice involving violation of Texas Rule of Professional Conduct 1.08.[113]

Scott Sefton

Sefton joined the legal department of Enron Gas Services in 1994. From January 1995 to September 1999, he was the acting chief legal counsel at Enron Global Finance in London. He was named Vice President and General Counsel of Enron Global Finance and returned to Houston in September 1999. In that final position at Enron, he reported directly to Fastow and to Enron's Deputy General Counsel.[114]

As Enron Global Finance's General Counsel, Sefton had what the Batson Report describes as an "overview" of the Enron Global Finance transactions.[115] Sefton became aware of conflict of interest issues posed by certain of Enron's SPEs, including Project Nahanni, and certain related party transactions, but did not advise Enron's Board of those issues.[116] Sefton

[105] Batson Report, Appendix C at 110.

[106] Batson Report, Appendix C at 18.

[107] Batson Report, Appendix C at 116.

[108] Batson Report, Appendix C at 119.

[109] Batson Report, Appendix C at 13.

[110] Batson Report, Appendix C at 193-194.

[111] Batson Report, Appendix C at 12-13, 193-194.

[112] "Texas Rule 1.06(b) provides that an attorney shall not represent a party if the representation of that party becomes adversely limited by the attorney's own interest." Batson Report, Appendix C at 194.

[113] Batson Report, Appendix C at 194. "Texas Rule 1.08 forbids an attorney from entering into a business transaction with a client unless, in general, the terms of the arrangement are fair to the client, the terms are understood by the client, the client has an opportunity to seek advice of counsel and the client gives written consent as to the attorney's participation." *Id.*

[114] Batson Report, Appendix C at 19.

[115] Batson Report, Appendix C at 19. "Sefton had to be informed of all transactions underway at Enron Global Finance to manage the workload of the attorneys in his department. 'Deal flow sheets' (a report listing all pending transactions and the attorneys assigned to each project that was prepared and circulated to attorneys in EGF Legal) and a 'mission critical' list provided Sefton with a summary of such transactions." *Id.*

[116] Batson Report, Appendix C at 72.

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was also one of the two in-house attorneys at EGF principally involved in another of the controversial Enron SPEs known as "The Raptors."[117]

Sefton resigned from Enron in October 2000 after he was informed that he was being replaced as EGF's General Counsel.[118]

The potential allegations of wrongdoing against Sefton identified in the Batson Report include the following:

•knowingly facilitated, as lead counsel, the Project Nahanni transaction which had no business purpose other than to impact Enron's financial statements;

•failing to advise the Enron Board, or even Derrick, of the conflict of interest issues related to the LJM1 and LJM2 transactions; and

•participating in two of the four LJM2/Raptors Hedging Transactions which had no business purpose other than to impact Enron's financial statements.[119]

Potential causes of action. The Batson Report identifies and concludes that Enron might have viable causes of action against Sefton for legal malpractice based on negligence, legal malpractice based on failure to take remedial action in violation of Texas Rule of Professional Conduct 1.12, and breach of fiduciary duty.[120]

Jordan Mintz

Mintz succeeded Sefton as General Counsel to Enron Global Finance, but also held the title of Vice-President.[121] Mintz remained in the position of General Counsel for EGF until December 2002.[122] As had Sefton, Mintz "received sufficient information to have an overview of the transactions undertaken by Enron Global Finance, including the 'mission critical' list of pending deals."[123]

[117] Batson Report, Appendix C at 14.

[118] Batson Report, Appendix C at 20.

[119] Batson Report, Appendix C at 194-197.

[120] *Id.*

[121] Batson Report, Appendix C at 20 & n.42. Mintz had originally joined Enron in 1996 as Vice President of Tax for Enron Capital and Trade. *Id.* at 20, n.42

[122] Batson Report, Appendix C at 20, n.42.

[123] Batson Report, Appendix C at 20.

Mintz also served as lead in-house counsel for Enron with regard to the $2.6 million dollars payment to the Chewco SPE.[124] Despite having a strong belief that Enron was not required to make such a payment, Mintz complied with instructions regarding the making of that $2.6 million payment to Chewco without ever advising Derrick or any other officer of his opinion.[125]

In addition, Mintz personally was involved in a Board presentation in which certain information regarding the investment activity of one of Enron's SPEs was purposefully held back from Enron's Board.[126] Mintz also was aware that Fastow desired to keep information from the Board regarding the level of compensation he was receiving from one of Enron's SPEs. Mintz also was the recipient of an internal legal memorandum written by Stuart Zisman that expressed a concern about "financial statement manipulation" at Enron, and was himself the author of a memorandum that identified a number of concerns with the way certain related-party transactions were being approved by Enron.[127]

The potential allegations of wrongdoing against Mintz identified in the Batson Report include the following:

•knowingly assisting an Enron officer, Fastow, in violating his fiduciary duty of loyalty to Enron by not disclosing to the Board or to Derrick that Fastow did not want the Board to know the extent of his LJM compensation;

•participating in a presentation to Enron's Board that failed to include pertinent information regarding LJM2's investment activity with Enron during 2000, specifically that Enron had repurchased certain assets from LJM2;

•failed to adequately perform his role as counsel with regard to determining whether Fastow's interest in the LJM transactions needed to be disclosed;

•failing to disclose to Derrick, senior Enron officers, or the Board his misgivings regarding the LJM2 transactions; and

•failed to take any actions to prevent Enron from paying $2.6 million to Chewco despite believing that Enron was not legally obligated to make said payment.[128]

Potential causes of action. The Batson Report identifies and concludes that Enron might have viable causes of action against Mintz for legal malpractice based on negligence, legal

[124] Batson Report, Appendix C at 131.

[125] Batson Report, Appendix C at 134.

[126] Batson Report, Appendix C at 129.

[127] Batson Report, Appendix C at 132.

[128] Batson Report, Appendix C at 197-201.

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malpractice based on failure to take remedial action in violation of Texas Rule of Professional Conduct 1.12, and breach of fiduciary duty.[129]

E. Drake Tempest (Qwest Communications)

Pervasive problems with Qwest Communications' accounting treatment of a variety of types of transactions came to light after Qwest was involved in a reverse acquisition with U.S. West. After completing its own internal investigation and undergoing a re-audit, Qwest expunged $2.5 billion of revenue based on what it deemed improper accounting from its 2000-2002 books.[130]

During the time periods in question, Drake Tempest, who started with Qwest in October 1998, was the General Counsel, Executive Vice President, and Chief Administrative Officer.[131] In September 2002, during congressional hearings regarding Qwest and Global Crossing, Tempest's role in setting financial goals at Qwest and accomplishing deals was a subject of much focus.[132] Committee Chairman Rep. Billy Tauzin (R-La.) read an anonymous e-mail during the hearing that alleged that Qwest's CEO, Joseph Nacchio, and Tempest set "impossible" financial goals for Qwest and that, as a result, Qwest managers bent the rules in order to achieve the financial goals that had been set.[133]

Tempest has publicly denied that Qwest intentionally published "misleading financial statements by electing an accounting treatment for optical-capacity sales that other companies do not use."[134]

In 2002, the SEC launched a formal probe of Qwest. Initially, the focus of that probe was Qwest's accounting treatment of asset swaps engaged in with other telecommunications companies. The SEC's investigation subsequently expanded, however, to include a comprehensive review of a number of accounting issues at Qwest from 2000 to 2002.[135] In April 2004, it was reported that settlement talks between the SEC and Qwest had broken down over the amount of the fine that the SEC was seeking from Qwest.[136] On September 10, 2004, however, reports began to surface in the media that Qwest had agreed to pay a quarter of billion dollars to settle with the SEC.[137]

In December 2003, the SEC reportedly notified at least eight current and former Qwest executives that they were being investigated in relation to Qwest's swap transactions.[138] It has been reported that "several small companies that supply telecom gear to Qwest disclosed in recent months that federal investigators have contacted them about their dealings with Qwest. Of interest is whether Qwest executives forced suppliers to grant them stock." Former General Counsel Tempest is among the executives at Qwest who accepted stock from Qwest's suppliers.[139] On February 18, 2005, an indictment was filed by the United States Attorney's Office in Denver against Marc Weisberg, a former Qwest Vice-President, which accuses Weisberg with forcing Qwest vendors to grant him stock.[140]

In mid-April 2004, the criminal prosecutions of four mid-level Qwest executives on trial in federal court in Denver did not result in a single guilty verdict.[141] Two of the four executives were completely acquitted of all charges. One of the executives was acquitted on some of the charges while the jury deadlocked on the remaining charges. The jury deadlocked as to all of the charges against the fourth executive.[142] With regard to the deadlocked charges, Grant Graham subsequently pled guilty to a single felony count – accessory after the fact to wire fraud – and

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[129] *Id.*

[130] Backover, Andrew, "Qwest resists SEC request for report," *USA Today* (May 28, 2003), available at http://www.usatoday.com/money/industries/telecom/2003-05-27-qwest-probe_x.htm.

[131] Qwest Press Release, "Qwest Announces Top Executive Team for Merger with US West," (March 3, 2000), available at http://www.qwest.com/about/media/pressroom/1,1281,250_archive,00.html. Previously, Tempest had, at one point, held the title of Corporate Secretary of Qwest. *See* http://www.qwest.com/about/investor/financial/reports/1998/board.html.

[132] Hudson, Kris, "Previous regime's players scrutinized," *Denver Post* (Sept. 25, 2002), available at http://www.denverpost.com.

[133] *Id.*

[134] Letter to the Editor of Drake Tempest, *Denver Post* (Sept. 10, 2001).

[135] Backover, Andrew, "Federal investigation of Qwest's books widens," *USA Today* (May 30, 2003), available at http://www.usatoday.com/money/industries/telecom/2003-05-29-quest-usat_x.htm.

[136] Hudson, Kris, "Qwest Reaches Impasse with SEC over Accounting Probe Fines," (April 15, 2004), available at http://www.miami.com/mld/miamiherald/business/national/8442006.htm.

[137] *See* "Qwest settling SEC charges," *Denver Business Journal* (September 10, 2004), available at http://denver.bizjournals.com/denver/stories/2004/09/06/daily34.html.

[138] Hudson, Kris, "Qwest case outcome may ripple," *Denver Post* (April 5, 2004), available at http://www.denverpost.com.

[139] *Id.*

[140] McGhee, Tom, "Ex-Qwest exec accused of illegal investing," *The Denver Post* (February 19, 2005), available at http://www.denverpost.com/Stories/0,1413,36~33~2720579,00.html.

[141] Cook, Dave, "Qwest Prosecutors End Up Empty-Handed," (April 19, 2004), available at http://www.cfo.com/article.cfm/3013277/c_3042553?f=TodayInFinanceInside.

[142] Vuong, Andy and McGhee, Tom, "Qwest trial ends in no convictions," *Denver Post* (April 18, 2004), available at http://www.denverpost.com.

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was sentenced to one year of probation; Thomas Hall subsequently pled guilty to a single misdemeanor count – falsifying a document – and was also sentenced to one year of probation.[143]

On July 28, 2004, the SEC filed a subpoena enforcement action against Tempest after Tempest objected and opted not to comply with a subpoena requiring him to testify before the SEC.[144] Tempest's lawyer, in explaining that Tempest objected to the subpoena because he should not be deposed until a United States Department of Justice criminal investigation of Qwest's accounting was completed, identified Tempest "as a subject in the related 'grand jury investigation.'"[145] In October 2004, Judge Lewis Babcock ruled in the SEC's favor, ordering Tempest to testify before the SEC, but stayed the ruling until November 10, 2004 to allow Tempest's lawyers time to appeal the ruling.[146] In December 2004, the SEC informed Tempest that it was withdrawing its subpoena.[147] Recent media reports in connection with the aforementioned indictment of Weisberg state that Tempest is still the subject of investigation by the SEC and the Department of Justice and have speculated that Weisberg could not have legally made certain investments in Qwest suppliers without Tempest's approval.[148]

From November 1999 to April 2001, Tempest allegedly sold 466,600 shares of Qwest stock resulting in proceeds in the amount of $20,876,780.[149] Tempest has been named as a defendant both in securities fraud class action litigation against Qwest and in a shareholders' derivative class action on Qwest's behalf against a number of Qwest's former officers and directors.[150] With regard to the securities fraud class action litigation, the plaintiffs' claims against Tempest, which involve primarily allegations of insider trading and responsibility for certain statements and omissions in Qwest's public filings under the "group published" doctrine, have withstood a motion to dismiss.[151]

Securities fraud class action.[152] The claims asserted against Tempest in the securities fraud class proceedings are for: (1) violating Section 10(b) of the Exchange Act and Rule 10b-5; (2) violating Section 20A of the Exchange Act; and (3) Section 11 of the Securities Act.

Shareholder derivative suit.[153] The claims asserted against Tempest in the shareholders derivative suit involve: (1) intentional breach of fiduciary duty; (2) negligent breach of fiduciary duty; (3) gross negligence; (4) corporate usurpation; (5) waste of corporate assets; (6) abuse of control; (7) unjust enrichment; (8) gross mismanagement; (9) violation of Section 14A of the Exchange Act; (10) breach of contract; and (11) contribution and indemnification.

The allegations of wrongdoing that were leveled at Tempest in the securities fraud class action and shareholders' derivative suits include the following:

•signing multiple Registration Statements which incorporate inaccurate and misleading financial information;

•failed to make a reasonable investigation into whether the statements contained in certain Registration Statements and prospectuses were true and did not omit material facts;

•failing to ensure that Quest did not engage in fraudulent and illegal activity;

•misusing his position to profit through the receipt of friends and family shares of stock from vendors seeking to do business with Qwest in violation of federal and state law;

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143 Smith, Jeff, "Ex-Qwest exec given probation," *Rocky Mountain News* (February 9, 2005), available at http://www.msnbc.com/id/6939009/.

144 S.E.C. Litigation Release No. 18804 (July 28, 2004), available at http://www.sec.gov/litigation/litreleases/lr18804.htm.

145 McGhee, Tom, "SEC seeking testimony from former Qwest lawyer," *The Denver Post* (July 29, 2004), available at http://www.denverpost.com/Stories/0,1413,36%257E26430%257E2300986,00.html.

146 "Former Qwest Executive Ordered to Testify," *NYSSCPA.org* (October 26, 2004), available at http://www.nysscpa.org/printversions/nysscpa/2004/1004/4week/printversion22.htm.

147 "SEC Withdraws Subpoena for Ex-Qwest Lawyer," *NYSSCPA.org* (January 13, 2005), available at http://www.nysscpa.org/home/2005/105/2week/article56.htm.

148 McGhee, Tom, "Ex-Qwest exec accused of illegal investing," *The Denver Post* (February 19, 2005), available at http://www.denverpost.com/Stories/0,1413,36~33~2720579,00.html.

149 Fourth Consolidated Securities Complaint ¶ 255, *In re Qwest Communications Int'l, Inc., Securities Litig.*, Civil Action No. 01-RB-1451 (PAC) (consolidated with Civil Action Nos. 01-RB-1472, 01-RB-1527, 01-RB-1616, 01-RB-1799, 01-RB-1930, 01-RB-2083, 02-RB-0333, 02-RB-0374, 02-RB-0507, and 02-RB-0658) (D. Colo.).

150 *See In re Qwest Communications Int'l, Inc., Securities Litig.*, Civil Action No. 01-RB-1451 (securities fraud class action) and *Troch v. Anschutz et al.*, Civil Action No. 01-RB-2083 (PAC) which have been consolidated with each other and with Civil Action Nos. 01-RB-1472, 01-RB-1527, 01-RB-1616, 01-RB-1799, 01-RB-1930, 02-RB-0333, 02-RB-0374, 02-RB-0507, and 02-RB-0658) (D. Colo.).

151 "The false statements alleged in the Complaint all were made in registration statements, prospectuses, SEC forms, or in statements to the press concerning Qwest's financial performance. All of these statements are subject to a presumption of collective action by corporate directors and officers under the group publication doctrine." *In re Qwest Comms. Int'l, Inc. Securities Litig.*, Civil Case No. 01-RB-1451 (CBS) (Consolidated with Civil Action Nos. 01-RB-1472, 01-RB-1527, 01-RB-1616, 01-RB-1799, 01-RB-1930, 01-RB-2083, 02-RB-333, 02-RB-374, 02-D-507, 02-RB-658, 02-RB-755, 02-RB-798), 2004 U.S. Dist. LEXIS 584, at *36 (D. Colo., January 13, 2004).

152 *In re Qwest Communications Int'l, Inc., Securities Litig.*, Civil Action No. 01-RB-1451 (Consolidated with Civil Action Nos. 01-RB-1472, 01-RB-1527, 01-RB-1616, 01-RB-1799, 01-RB-1930, 01-RB-2083, 02-RB-0333, 02-RB-0374, 02-RB-0507, and 02-RB-0658) (D. Colo.).

153 *Troch v. Anschutz et al.*, Civil Action No. 01-RB-2083 (PAC) (Consolidated with Civil Action Nos. 01-RB-1451, 01-RB-1472, 01-RB-1527, 01-RB-1616, 01-RB-1799, 01-RB-1930, 02-RB-0333, 02-RB-0374, 02-RB-0507, and 02-RB-0658) (D. Colo.).

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•engaging in insider trading; and

•failing to act independently to fulfill the fiduciary duties owed to Qwest and its shareholders by approving improper stock grants to other members of Qwest's Board.

F. Mark Belnick (Tyco)

At the beginning of 2002, questions arose about the integrity of Tyco's financial statements and their accounting treatment, and the SEC began an investigation into the activities of certain Tyco executives, including its CEO, Dennis Kozlowski, and its CFO, Mark Swartz. In response, Tyco's stock declined from its opening price of $58.80 per share on January 2, 2002, to a closing price on January 31, 2002, of $35.15 per share.[154] On May 3, 2002, Tyco received a subpoena in connection with a criminal tax investigation of Kozlowski. Tyco's Chief Corporate Counsel Mark Belnick, in response to that subpoena, retained separate criminal counsel for Kozlowski and for Tyco, but apparently did not advise Tyco's Board of Directors regarding the subpoena being received.[155]

Prior to joining Tyco, Belnick was an attorney with Paul, Weiss, Rifkind, Wharton & Garrison in New York City from 1971 into 1998 (with the exception of a one-week stint in 1994 as Cornell's general counsel).[156] Belnick is often described as a close friend and protégé of the late Arthur Liman.[157] While in private practice, Belnick had served as a co-counsel, along with Liman, to the United States Senate Committee investigating the Iran-Contra affair.[158] Belnick joined Tyco as its Chief Corporate Counsel in 1998.

On June 3, 2002, Kozlowski resigned as CEO of Tyco. The next day he was indicted on criminal tax evasion charges. On June 10, 2002, Tyco terminated Belnick's employment.[159] On June 17, 2002, Tyco filed a civil lawsuit in the United States District Court for the Southern District of New York against Belnick seeking to recoup $30 million in allegedly undisclosed compensation, bonuses, and interest-free loans paid to Belnick.[160]

Tyco lawsuit.[161] Tyco's lawsuit against Belnick asserts the following causes of action: (1) breach of fiduciary duty; (2) inducing breach of fiduciary duty by Kozlowski; (3) conspiracy to breach fiduciary duty; (4) accounting; (5) constructive trust; and (6) fraud.[162] Tyco seeks the following forms of relief as against Belnick: (1) an award of damages; (2) forfeiture; (3) restitution; (4) an accounting; and (5) a declaratory judgment that Belnick's Retention Agreement is void.[163]

On October 21, 2002, Belnick filed a demand for arbitration with the American Arbitration Association, and a motion to compel arbitration, based upon an arbitration provision contained in what Belnick contends is his employment agreement with Tyco.[164] Tyco's lawsuit against Belnick was subsequently transferred to multi-district litigation in the United States District Court for the District of New Hampshire.

Criminal proceedings.[165] On September 12, 2002, Belnick was indicted by New York state authorities on six counts of falsifying business records; the indictment was later amended on February 3, 2003, to add three more counts, including one count of grand larceny.[166] The larceny charge related to Belnick's acceptance of a $12 million bonus that prosecutors allege he knew at the time he received it had not been authorized by the Board. Belnick's criminal trial in New York state court began in May 2004. On July 15, 2004, during the fifth day of the jury's deliberations, Belnick was acquitted of all criminal charges.[167]

SEC lawsuit.[168] In addition to the unsuccessful criminal proceedings against him and the lawsuit filed by Tyco, the SEC filed civil proceedings against Belnick on September 12, 2002, related to insider trading and the failure to publicly disclose aspects of his compensation.[169] The SEC has asserted the following claims against Belnick: (1) violation of Section 17(a) of the

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[154] *See* http://bigcharts.marketwatch.com for historical stock quote information for Tyco Int'l (symbol: TYC).

[155] Rozen, Miriam, "Losing It All," *Corporate Counsel* (Jan. 21, 2003), available at http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1045686304997.

[156] *Id.*

[157] Lin, Anthony, "Ex-Tyco GC Belnick Acquitted of All Charges," *New York Law Journal* (July 16, 2004).

[158] *Id.*

[159] Miriam Rozen, "Losing It All," *Corporate Counsel* (January 21, 2003), available at http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1045686304997.

[160] Complaint (filed June 17, 2002), *Tyco Int'l Ltd. v. Belnick*, No. 02-CV-4644 (S.D.N.Y.).

[161] Amended Complaint filed September 25, 2002, *Tyco Int'l Ltd. v. Belnick*, No. 02-CV-4644 (SWK) (S.D.N.Y.).

[162] *Id.* ¶¶ 96-138.

[163] *Id.* at 41-42

[164] *See* October 28, 2002, letter from David W. Shapiro to Judge Shirley Wohl Kram.

[165] *People v. Belnick*, No. 5258/02 (N.Y. Supreme Court).

[166] *People v. Belnick*, No. 5258/02 (N.Y. Supreme Court); *see* "Tyco Counsel Charged with three further counts" (Feb. 4, 2003), available at http://www.srimedia.com/artman/publish/article_376.shtml.

[167] Associated Press, "Belnick acquitted of grand larceny, securities fraud, falsifying records," *MSNBC.com* (July 15, 2004), available at http://www.msnbc.com/id/5444957.

[168] *S.E.C. v. Kozlowski*, No. 02-CV-7312 (S.D.N.Y.).

[169] S.E.C. Litigation Release No. 17722 (Sept. 12, 2002), available at http://www.sec.gov/litigation/litreleases/lr17722.htm.

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Securities Act; (2) violation of Section 10(b) of the Exchange Act and Rule 10b-5; (3) violation of Section 13(a) of the Exchange Act, Rule 12b-20, and Rule 13a-1; (4) violation of Section 14(a) of the Exchange Act and Rule 14a-9; (5) violation of Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1; and (6) violation of Section 13(b)(5) of the Exchange Act and Rule 13b2-2.[170]

The SEC seeks the following forms of relief against Belnick: (1) disgorgement of all loan amounts he received from, and did not properly repay to, Tyco; (2) disgorgement of imputed interest on all low-interest or interest-free loans from Tyco that he should have publicly disclosed; (3) disgorgement of a dollar amount equal to the financial losses Belnick avoided through his allegedly manipulative stock sales; (4) disgorgement of all rent payments he received from Tyco for his home office located in his Utah residence; (5) an award of prejudgment interest as to all disgorged sums; (6) imposition of civil monetary penalties; (7) a bar preventing Belnick from serving in the future as an officer or director of a public company; and (8) a permanent injunction against Belnick committing future violations of federal law.[171]

The allegations of wrongdoing that have been leveled against Belnick include the following:

•failing to prevent the making of, and once made failing to disclose, low-interest and interest-free loans to Kozlowski and Swartz by Tyco;

•accepting low-interest and interest-free loans himself which had not been properly authorized by Tyco's Board and which had allegedly not even been disclosed to Tyco's Board;

•failing to disclose certain of his personal sales of Tyco stock;

•failing to cooperate with and/or attempting to interfere with Tyco's internal investigation into wrongdoing at Tyco;

•failing to repay to Tyco amounts that Belnick allegedly has admitted he owes to Tyco;

•instructing, through counsel, that Tyco delete information from Belnick's work computer, and personally deleting electronic information, in violation of Tyco policies that Belnick himself, as general counsel, created;

•failing to make certain that Tyco's Board was properly informed of all information that it reasonably needed to know, including instances of self-dealing, conflict-of-interest transactions, and serious legal or ethical issues;

•failing to disclose to Tyco's auditors the existence of a second version of each of his compensation agreements with Kozlowski;

[170] Complaint ¶¶ 62-74 (filed Sept. 12, 2002), *SEC v. Kozlowski*, No. 02-CV-7312 (S.D.N.Y.).

[171] Complaint at 20-22, *SEC v. Kozlowski*, No. 02-CV-7312 (S.D.N.Y.).

•accepting unauthorized loans from Tyco pursuant to a loan program for which he knew he did not qualify;

•engaging in self-dealing with regard to his 2002 employment agreement;

•misleading Tyco's Board with regard to the status and details of Belnick's 2002 Retention Agreement;

•approving SEC filings by Tyco that were not truthful, complete, or accurate;

•failing to disclose to Tyco's Board that an unauthorized $20 million "finder's fee" payment had been made by Kozlowski to Frank Walsh in connection with Tyco's acquisition of CIT and failing to advise the Board that it had the legal right to recover that unauthorized payment; and

•failing to timely advise Tyco's Board of the criminal investigation against Kozlowski.

G. Jonathan Orlick (Gemstar)

On March 18, 2002, Gemstar, a seemingly successful entity that was known for its interactive television program guide, announced the resignation of its co-president Peter Boylan, effective April 1, 2002. Simultaneous with the announcement of Boylan's resignation, Gemstar announced that Jonathan Orlick was being promoted from Senior Vice President and Deputy General Counsel to Executive Vice-President and General Counsel.[172] Approximately at the same time, Gemstar warned Wall Street that its licensing and technology revenues would drop by 50% during 2002, despite the company having previously reported solid earnings for the first quarter.[173]

In January 2003, Orlick, who is also a former member of Gemstar's Board of Directors, was replaced as Executive Vice President and General Counsel and appointed to a newly-created position at Gemstar, President of Intellectual Property.[174] In March, 2003, Gemstar announced that it would be restating its financials in an ultimate amount of approximately $200 million dollars.[175]

[172] "Gemstar-TV Guide Announces Management Changes, Licensing Deal with JVC," *Digital Media Wire* (March 18, 2002), available at http://www.digitalmediawire.com/archives_031802.html.

[173] Donohue, Steve, "Boylan Resigns From Roiling Gemstar," *Multichannel News* (March 25, 2002), available at http://print.google.com/print/doc?articleid=hmmnQOOSuIK.

[174] "Publishing Industry Soundbytes," *The Write News* (January 10, 2003), available at http://www.writenews.com/2003/011003_soundbytes.htm.

[175] Gemstar-TV Guide Press Release, "Gemstar-TV Guide International Announces Further Anticipated Restatements Related to Previously Disclosed Review," (March 10, 2003), available at http://www.gemstartvguide.com/pressroom/display_pr.asp?prId=149.

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In June 2003, the SEC filed a securities fraud lawsuit against former Gemstar CEO Henry Yuen and former Gemstar CFO Elsie Yeung.[176] The securities fraud alleged to have occurred at Gemstar involves the manipulation of financial results by improperly reporting licensing and advertising revenue for its interactive television program guide from agreements that had either expired, were disputed, or did not exist; improperly reporting advertising revenue for its interactive television program guide for related transactions, including "round-trip" transactions as if they were unrelated transactions; improperly classifying revenues derived from its other business sectors as if those revenues were related to advertising for its interactive program guide; improperly reporting advertising revenue received from *TV Guide* for its interactive television program guide when Gemstar had not actually run the advertising; and improperly recognizing revenue during a twelve-month period from an eight-year licensing contract with AOL.[177]

On June 5, 2003, Orlick was fired by Gemstar "for cause."[178] On July 9, 2003, Orlick filed a defamation lawsuit against Gemstar claiming that the "for cause" designation was defamatory in that Orlick had not been convicted of any felony and had not been sued for fraud or embezzlement.[179] In addition to naming Gemstar as a defendant, Orlick's suit named Gemstar's CEO and Rupert Murdoch, CEO of NewsCorp, which owns 42% of Gemstar.[180] Orlick's defamation lawsuit sought both damages and a retraction of the company's statements that the termination was for cause. Apparently, Orlick also contended that he was terminated only after he tried to retrieve documents from his office that Gemstar had failed to provide to the SEC.[181] On October 29, 2004, Gemstar announced that it had reached a settlement with Orlick regarding his defamation lawsuit.[182] In February 2004, Gemstar submitted for approval a proposed settlement of securities fraud class claims against it in which it would pay to settlement class members $67.5 million in cash and stock.[183] In connection with the announcement of the proposed settlement of that class action, Gemstar advised that it would pursue its own claims against former management.[184] It is unclear whether Gemstar is contemplating a lawsuit against Orlick.

On January 5, 2004, Orlick was added as a named defendant by the SEC in its securities fraud lawsuit previously filed against Yuen and Yeung.[185] The SEC has asserted claims against Orlick for the following: (1) violations of Section 10(b) of the Exchange Act and Rule 10b-5; (2) violations of Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1; (3) violations of Section 13(b)(5) of the Exchange Act and Rule 13b2-2; (4) aiding and abetting violations of Section 13(a) of the Exchange Act, Rule 13a-1, and Rule 13a-13; and (5) aiding and abetting violations of Rule 12b-20.[186]

The SEC sought the following forms of relief against Orlick: (1) civil monetary penalties; (2) disgorgement of ill-gotten gains, including his salaries, bonuses, and the proceeds he received from sales of Gemstar stock; (3) a bar against Orlick serving in the future as an officer or director of a public company; and (4) a permanent injunction against Orlick engaging in any other violations of federal law. Although the SEC did not pursue similar relief against Orlick, it is worth noting that the SEC previously employed Section 1103 of the Sarbanes-Oxley Act of 2002 to obtain a court order placing into escrow and under court supervision "approximately $37.64 million in cash payments that Gemstar had previously agreed to pay Yuen and Leung."[187]

The allegations of wrongdoing that were leveled at Orlick by the SEC included:

•participating in Gemstar's fraudulent disclosure and recording of interactive television program guide licensing and advertising revenue;

•knowingly failing to disclose that Gemstar was improperly recognizing and reporting material amounts of revenue;

•making false representations to Gemstar's auditors regarding the status of negotiations between Gemstar and Scientific Atlanta;

•falsifying Gemstar's books and records; and

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[176] Patrick, Aaron, "Ex-Gemstar head charged with fraud," *The Age* (June 29, 2003), available at http://www.theage.com.au/articles/2003/06/28/1056683948989.html.

[177] S.E.C. Litigation Release No. 18199 (June 20, 2003) available at http://www.sec.gov/litigation/litreleases/lr18199.htm.

[178] "Former Gemstar counsel sues for defamation" (July 9, 2003), available at http://losangeles.bizjournals.com/losangeles/stories/2003/07/07/daily30.html.

[179] *Id.*

[180] *Id.*

[181] Patrick, "Ex-Gemstar head charged with fraud," at http://www.theage.com/au/articles/2003/06/28/1056683948989.html.

[182] "Gemstar settles suit with ex-general counsel" (October 29, 2004), available at http://www.bizjournals.com/losangeles/stories/2004/10/25/daily58.html.

[183] Veiga, Alex, "Gemstar-TV Guide settles shareholder suits for $67.5 million in cash, stock," *CANOE Money* (Feb. 12, 2004), available at http://money.canoe.ca/News/Sectors/Media/2004/02/12/345577-ap.html. Orlick was not a named defendant in that securities fraud class action lawsuit.

[184] *Id.*

[185] S.E.C., "SEC Sues Three Additional Former Senior Executives of Gemstar-TV Guide for Their Part in Financial Fraud" (Jan. 5, 2004), available at http://www.sec.gov/news/press/2004-1.htm; "SEC sues 3 more ex-Gemstar executives," *MSNBC.com* (Jan. 6, 2004), available at http://msnbc.msn.com/id/3887659/.

[186] S.E.C. Litigation Release No. 18530 (Jan. 6, 2004), available at http://www.sec.gov/litigation/litreleases/lr18530.htm.

[187] *Id.*

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•aiding and abetting reporting and record-keeping violations committed by others at Gemstar.

In January 2005, Orlick, without admitting or denying any wrongdoing, agreed to settle the SEC charges brought against him by paying in excess of $305,000 to the SEC and agreeing to be barred for a ten-year period from serving as an officer or director of a public company.[188]

IV. Possible Effects of Recent High-Profile Cases on Sources of Exposure for Corporate Counsel

It seems clear from the above discussion of certain criminal and civil litigation brought against corporate counsel, as well as from several other high-profile cases,[189] that corporate counsel are being named as individual defendants in securities fraud class actions, shareholder derivative lawsuits, criminal proceedings, and SEC investigations and proceedings with increasing frequency**.** However, setting aside this undeniable increase in frequency of instances in which corporate counsel are caught in the cross-hairs of government or plaintiff's lawyers, it is not altogether clear whether there are any other emerging trends affecting sources of liability exposure for corporate counsel that can be identified as a result of an analysis of these high-profile cases.

A. Impact on Scope of Governmental Liability Exposure?

Perhaps the most important lesson to be learned from these cases is that prosecutors and the SEC now appear to be more willing than ever before to pursue criminal and securities fraud charges against corporate counsel.

Competent, ethical corporate counsel have always known that theft, back-dating documents or otherwise falsifying records, lying to auditors, and tampering with witnesses are all illegal and that corporate counsel who commit such acts risk criminal prosecution. Further, although prior to Lapine's indictment it appears never to have actually happened,[190] corporate counsel also have known that acts of securities fraud could not only result in potential liability to the SEC, but also potential criminal prosecution. But there's certainly a difference between knowing that the possibility exists and knowing that prosecutors have brought such prosecutions and will likely do so again.

1. Criminal proceedings: New developments?

The criminal prosecution of Belnick by New York state prosecutors presented the potential for a drastic expansion of the scope of corporate counsel's liability exposure. As described above, prosecutors charged Belnick with falsifying business records and larceny. It was the larceny charge, however, that had a potentially devastating impact on liability exposure for corporate counsel.

The theory behind the larceny charge lodged against Belnick was that his receipt of an allegedly multi-million dollar bonus from Tyco amounted to a criminal act. As part of his defense, Belnick argued that he believed that the bonus paid to him had been authorized and that he had no reason to take any independent action to determine whether the Board of Directors had authorized such payments. Depending upon the basis for determination, a conviction of Belnick on the larceny charge could have resulted in a staggering increase in corporate counsel's liability exposure: corporate counsel would be faced with the dilemma of independently confirming an executive officer's authority to award compensation, on pain of criminal liability exposure. The idea that it is an affirmative duty of the general counsel to independently confirm executives' authority to take other kinds of actions might follow. The resulting risk of criminal liability for not making the right judgment call and questioning virtually every major decision of your boss is something that should cause general counsel a great deal of discomfort. Since it was a surprise to many in the legal community that Belnick was acquitted by the jury, and since prosecutors were enraged by the verdict, it is entirely possible that similar allegations will be vigorously sought and prosecuted in the future, perhaps with greater prosecutorial success.

According to media reports, the jury instruction that was given by the judge in the Belnick case made clear that the jurors, when determining the merits of the larceny charge, "could consider whether Belnick had a good-faith reasonable belief that he had a right to accept the bonus offered by Kozlowski."[191] A jury instruction of that nature certainly helps to ameliorate concerns over the potential breadth of the prosecution's larceny theory. A different instruction could have lead to a much different result.

Fortunately for Belnick, he was acquitted on all counts in the New York criminal proceedings. (As noted, he still faces additional civil suits disputing the appropriateness of his actions, which have yet to come to trial.) Belnick's criminal case acquittal, however, does not necessarily mean that the legal theory offered by the prosecutors for the larceny charge was not, or would not be on other facts, a viable prosecution theory. And, of course, prosecutors read the newspaper accounts of novel theories offered by their colleagues, as much or more than corporate counsel do.

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[188] Veiga, Alex, "Ex-Gemstar-TV Guide Exec Settles Charges" (January 24, 2005), available at http://biz.yahoo.com/ap/050121/gemstar_settlement_2.html.

[189] David Rosenblatt, the former General Counsel and Senior Vice President of Homestore, and Nancy Temple, a former in-house attorney for Arthur Andersen, also found themselves named as individual defendants in class action securities fraud lawsuits, but unlike Drake Tempest of Qwest, they were able to secure trial court rulings dismissing those claims against them under the PSLRA (Private Securities Litigation Reform Act of 1995). *See In re Homestore.com, Inc. Securities Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003); *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 2003 WL 230688 (S.D. Tex. 2003).
Also, David Klarman, the former general counsel of US Wireless, was indicted in connection with allegations involving embezzlement and ultimately pled guilty in December 2003 to mail fraud and money laundering. "High-tech exec pleads guilty to mail fraud, money laundering," *Silicon Valley/San Jose Business Journal* (Jan. 27, 2004), available at http://www.bizjournals.com/sanjose/stories/2004/01/26/daily32.html?t=printable.

[190] Hoppin, Jason, "In a First for Feds, General Counsel Is Indicted for Fraud," *The Recorder* (June 6, 2003).

[191] Maull, Samuel, "Ex-Tyco Counsel Acquitted Amid Plea Talks," AP Wire (July 16, 2004).

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2. SEC proceedings: New developments?

With regard to SEC civil proceedings, it appears from the cases described above that, other than the increased frequency of same, the types of claims being pursued by the SEC and the forms of relief sought remain fairly steady. The provisions that corporate counsel are most likely to find themselves facing, if they are in the unfortunate position of having SEC proceedings initiated against them, include Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(5), 14(a), and 20(a) of the Exchange Act, Sections 11 and 17(a) of the Securities Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, 13b2-1, 13b2-2, and 14a-9.

3. Sarbanes-Oxley: What impact?

Most corporate counsel are already familiar, to at least some extent, with the corporate governance changes imposed by Congress upon public companies in the Sarbanes-Oxley Act of 2002 and the attorney conduct standards now in place as a result of the SEC's enactment of the final regulations called for under Section 307 of Sarbanes-Oxley ("the Part 205 regulations").[192] In a nutshell, the Part 205 regulations impose a new layer of federal regulation upon corporate counsel that is more specific and more demanding than any professional conduct rules currently in existence at the state level.[193] These regulations focus on the public company attorney's duty to report allegations of wrongdoing up-the-ladder of command within the company, all the way to the board, if necessary. (Please note that Part 205's regulation of attorney conduct was not effective when the cases examined in this article arose, and thus, we are unable to draw any inferences about how such prosecutions will proceed in the future.)

Obviously, in light of the fact that Sarbanes-Oxley was enacted in response to the wave of high-profile incidents that included some of the very corporate scandals described above, corporate counsel can and should expect that future SEC proceedings brought against corporate counsel will seek to rely upon some new regulatory and legal weapons granted to government regulators.

Sarbanes-Oxley, however, does not just impose obligations upon corporate counsel. It also provides new remedies to the SEC to be used in pursuing alleged wrongdoing. One example, Section 1103 of Sarbanes-Oxley, grants the SEC the ability to obtain a court order placing into escrow and under court supervision monetary amounts that a company has agreed to pay in the future to the defendant in such proceedings and would appear to be a very powerful new provision in certain circumstances.

4. Erosion of privilege and its consequences

For several years, government regulators and prosecutors alike have been demanding that companies voluntarily turn over reports of investigations of internal misconduct and other related materials that would otherwise be protected by the attorney-client privilege or the work product doctrine.[194] Although the government has often been willing to formally agree with the company involved to maintain the confidentiality of the materials being produced and to include a "non-waiver" provision in the formal agreement, courts have not been uniformly willing to honor government agencies' commitments of confidentiality by accepting this "selective waiver" of privilege or work-product protection as a legal argument for avoid disclosure of those materials to other third parties.[195]

This trend toward the forcing of companies to choose between potentially waiving any right to attorney-client privilege or work-product protection with regard to the rest of the world or incurring the full wrath of the federal government will likely increase, particularly in light of recently approved amendments to sentencing guidelines.[196] Those proposed amendments

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[192] The SEC's Part 205 regulations became effective after a long process of public comment and debate in August of 2003. *See* SEC Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205 (2003). *See generally,* ACC's SEC Attorney Conduct Rules homepage at http://www.acca.com/legres/corpresponsibility/attorney.php; *see also,* "Emerging and Leading Practices in Sarbox 307 Up-the-Ladder Reporting …," available at http://www.acca.com/protected/article/corpresp/lead_sarbox.pdf; *see also* Broc Romanek & Kenneth B. Winer, *The New Sarbanes-Oxley Attorney Responsibility Standards*, ACCA Docket (May 2003), available to ACCA members at http://www.acca.com/protected/pubs/docket/mj03/standard2.php.

[193] However, the lay of the land at the state level is by no means static, The obligations imposed on lawyers by state ethics rules with regard to "reporting up" and "reporting out" for all clients are undergoing significant reform throughout the nation. For the status of these effects, see the ABA's website at http://www.abanet.org/cpr/jclr/jclr_home.html.

[194] Federal prosecutors, for example, have been instructed by U.S. Department of Justice leadership to consider during its investigation when determining whether to bring charges and in negotiating any plea agreement whether a company has been willing to waive privilege and work-product protections. Memorandum from Deputy U.S. Att'y Gen. Larry D. Thompson, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. This policy was originally articulated by Deputy Attorney General Eric Holder in 1999, in a predecessor memorandum entitled, *Bringing Criminal Charges Against Corporations,* or, as it's come to be known, "The Holder memorandum," available at http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html

[195] Compare *Tenn. Laborers Health & Welfare Fund v. Columbia/HCA Healthcare Corp. (In re Columbia/HCA Healthcare Corp. Billing Practices Litig.)*, 293 F.3d 289 (6th Cir. 2002) (rejecting the concept of selective waiver) with *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1978) (allowing selective waiver) and *Teachers Insurance & Annuity Association of America v. Shamrock Broadcasting Co*., 521 F. Supp. 638 (S.D.N.Y. 1981) (allowing selective waiver in certain situations). *See also U.S. v. Bergonzi,* No. 03-10511 (September 2004, 9th Cir.), in which McKesson Corporation is trying to convince the court to recognize the company's right to exclude information it shared with the SEC in resolving an allegation against it from being released to subsequent third parties.

[196] "Sentencing Commission Approves Changes to Guidelines Pertaining to Organizations," Current Reports, ABA/BNA Lawyers' Manual on Professional Conduct, 20 Law. Man. Prof. Cond. 207 (April 21, 2004); Sentencing Guidelines for United States Court, 69 Fed. Reg. 28,993 (May 19, 2004) (a copy of the amendments to the Sentencing Guidelines as approved and effective November 1, 2004, is available on the Sentencing Commission's website at http://www.ussc.gov/GUIDELIN.HTM); Statement of the Association of Corporate Counsel to

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suggested that "cooperation" for the purposes of qualifying for mitigation in sentencing should include waiver of attorney-client privilege and work product protection for relevant information. Ultimately, the wording of the amendment to the Commentary to Section 8C2.5 of the Federal Sentencing Guidelines that was approved reads as follows: "Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization." These amendments went into effect on November 1, 2004.

B. Impact on Scope of Liability to Current and Former Shareholders

Corporate counsel have always been potential targets in the inevitable wave of securities fraud class action suits that follows many earnings restatements and other marked fluctuations of stock prices of publicly-traded companies if they have engaged in extensive stock trading during the time frame of the putative class period. This particular type of liability exposure appears to stem more, however, from their position as an officer or director of the company than from their role as corporate counsel.

For corporate counsel, until recently, the case law with regard to potential liability in securities fraud class actions appeared very favorable, as there could be no "aiding and abetting liability" and corporate counsel could only be liable as a primary violator.[197] The fact that the claims against Tempest survived a motion to dismiss is a cause for some concern. That concern is mitigated, however, by that fact that, even though the claims against Tempest, which relied heavily upon the concept of "group-published information,"[198] were allowed to survive a motion to dismiss under the Private Securities Litigation Reform Act ("PSLRA"), other jurisdictions have reached the conclusion that the "group-published information" doctrine was abrogated by the PSLRA.[199]

Other than the Qwest securities litigation and the survival of the claims against Tempest based solely on the "group-published" information concept, none of the securities fraud class action lawsuits discussed above in which corporate counsel have been named as individual defendants truly alters the landscape with regard to liability exposure for corporate counsel.

Nevertheless, it stands to reason that, in light of the enactment of Sarbanes-Oxley, plaintiffs in securities class actions and plaintiffs in shareholder derivative lawsuits will continue to look to corporate counsel as potential individual defendants and to seek to impose liability upon corporate counsel separate and apart from whether they engaged in extensive trading activity. Given the duties and responsibilities imposed upon corporate counsel with regard to taking remedial actions, under Sarbanes-Oxley, for example, in an effort to try and prevent corporate wrongdoing, it does not take much imagination to identify the types of causes of action that securities fraud class action plaintiffs and shareholder derivative lawsuit plaintiffs will pursue when they believe that corporate counsel had sufficient information regarding wrongdoing and failed to take the appropriate remedial actions to try and prevent or limit the impact of such wrongdoing upon the corporation and public investors. The most obvious provisions for growth include corporate counsel's "reporting up" obligations and allegations that if corporate counsel had properly "reported up" as required that the public would not have been damaged.

Furthermore, in an environment where a company's very survival may increasingly depend upon such complete "cooperation" with criminal investigators or SEC regulators that the company essentially retains no attorney-client privilege, after-the-fact scrutiny by plaintiffs' counsel and others will certainly only increase, thus increasing the sources, and potential, for exposure for those who serve as corporate counsel.

Another provision concerning "whistleblowing" may also actually serve as additional fodder for plaintiffs' attorneys seeking to hold corporate counsel responsible in a securities or shareholders suit. Under Section 806 of Sarbanes-Oxley, a federal cause of action has been created for any corporate employee (including corporate counsel) who provides information or assists in an investigation relating to a company's violation of federal securities or anti-fraud laws.[200] Further, Section 1107 of Sarbanes-Oxley makes the act of retaliation against a "whistleblower" a federal crime punishable by a sentence of up to ten years in prison.[201] Thus, the combination of Sections 806 and 1107 could likely be argued by plaintiffs' counsel in a securities or shareholders suit to have provided sufficient protection such that a corporate counsel who is alleged to have known of wrongdoing, but failed to act on such knowledge, might be argued to have no room to argue an inability to raise legitimate issues in later litigation where she is named as a defendant.

It is not clear how allegations of securities fraud that may rely upon corporate counsel's obligations under Sarbanes-Oxley will fare in light of the pleading requirements set forth by the PSLRA. Thus, even if ultimately the United States Supreme Court determines that the "group-published information" doctrine is no longer viable in light of the PSLRA, there is no reason to believe that corporate counsel will not continue to find themselves being named as individual defendants by plaintiffs in securities fraud class actions and fending off allegations regarding the levels of knowledge they possessed about alleged corporate wrongdoing and what, if any, actions they took to comply with their reporting obligations under Sarbanes-Oxley.

Further, it appears that, given the nature of shareholder derivative actions and how the focus of such lawsuits is different from securities fraud class actions, such actions provide an even more fertile field for the pursuit of claims against corporate counsel (and, significantly, without regard to whether they also happen to be officers or directors of the company) relying

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the Proposed Changes to Sentencing Guidelines for Corporate Defendants – Chapter 8 (March 17, 2004), available at http://www.acca.com/public/comments/governance/sentence.pdf.

[197] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

[198] *See supra* note 151.

[199] *See, e.g.*, *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 619 (D.N.J. 2001); *Alison v. Brooktree Corp.*, 999 F. Supp. 1342, 1350-51 (S.D. Cal. 1999); *Marra v. Tel Save Holdings, Inc.*, No. 98-3145, 1999 WL 317103, at *5 (E.D. Pa., May 19, 1999); *Coates v. Heartland Wireless Comms., Inc.*, 26 F. Supp. 2d 910, 916 (N.D. Tex. 1998).

[200] Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514A (2004).

[201] 18 U.S.C. § 1513(e).

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upon allegations regarding failure to comply with the obligations imposed on corporate counsel by Sarbanes-Oxley.

C. Impact on Scope of Liability to Client/Employer

Potentially, the most significant development in liability exposure arising from the high-profile cases discussed above is the lawsuit pursued by Tyco against its former general counsel, Mark Belnick. Setting aside the issues that such litigation raises with regard to the effect on the attorney-client privilege[202] and Belnick's ability to use confidential client information to defend himself against the claims made by Tyco, the causes of action pursued by Tyco and the rhetoric they have used in so doing are unusual and worthy of analysis.

From the outset of the story that Tyco tells in its lawsuit against Belnick, Tyco leaves no doubt with regard to the level of obligations it claims are owed to it by its Chief Corporate Counsel:

•"As one of Tyco's three executive officers, Belnick owed the Company fiduciary duties of honesty, good faith, care, and loyalty."[203]

•"More than any other person, Belnick was obligated to ensure that the Company and its personnel fulfilled their legal and ethical duties, and to ensure that any conflict of interest, self-dealing, or other potentially serious legal or ethical problem was promptly brought to the attention of the Company's Board of Directors."[204]

•"As a knowledgeable professional, Belnick was aware of the very large liability and damage to which the Company would be potentially exposed if it failed to fulfill its disclosure obligations."[205]

•"The Chief Corporate Counsel must be the principal protector of the Board and the Company against the kind of misconduct engaged in by the Company's former Chief Executive Officer."[206]

Despite the direction in which such positions would appear to head, Tyco's Amended Complaint does not ultimately assert any cause of action against Belnick for legal malpractice. Instead, Tyco alleges that Belnick breached his fiduciary duty, induced Kozlowski to breach his fiduciary duty, entered into a conspiracy to breach fiduciary duty, and committed fraud against Tyco.[207] The breach of fiduciary duty cause of action appears to rely both on the fiduciary duty that Belnick, as an attorney, owed to Tyco as his client *and* the fiduciary duty that Belnick, as an officer of the corporation, owed to Tyco. It also appears to raise allegations that should serve as a further basis for corporations and corporate counsel alike to question whether or not it always makes sense for corporate counsel to also be asked to serve in another role as an officer or director of the corporation.

Specifically, Tyco makes certain allegations that almost appear to be "breaches of fiduciary duty squared." Tyco's allegations appear to insist that Belnick in his role as corporate counsel breaches his fiduciary duty to the corporation arising from the attorney-client relationship by not blowing the whistle on his own alleged wrongdoing performed in his role as an officer of the corporation.[208] Possibly, Tyco could make a similar argument against any officer or director of the corporation who fails to be totally candid with the corporation, without regard to whether that officer or director also serves as a lawyer for the corporation. These allegations by Tyco may, however, be more likely directed at supporting its claim against Belnick for inducing the breach of fiduciary duty by others and its claim against Belnick for conspiring with Kozlowski to commit a breach of fiduciary duty.[209]

Interestingly, according to media reports, prior to the acquittal of Belnick by a criminal jury in New York, Belnick had been offered a plea deal that would not only have resolved the criminal charges pending against him, but also Tyco's civil lawsuit.[210] In fact, those reports attribute Belnick's rejection of the offered plea deal because of "terms demanded by Tyco's lawyers."[211]

At one level, the Tyco lawsuit against Belnick may be a little more than an anomaly that arises simply from a set of peculiar circumstances. The fact that other corporations, such as, for example, McKesson HBOC and Rite-Aid have not pursued civil lawsuits against their former corporate counsel despite the fact that both Lapine and Brown were also subjected to criminal

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202 Perhaps not surprisingly, Belnick's replacement as General Counsel of Tyco, William Lytton, has recently been quoted as saying: "For all practical purposes, the attorney-client privilege no longer exists, whether for inside counsel or outside counsel. You have to anticipate that whatever advice you give, at some future point you may have to give that information up to someone who can make your life very difficult if you do not give it up." *ABA/BNA Lawyers' Manual on Professional Conduct*, "Impact on Corporate Attorney-Client Privilege May Not Be All Bad, Some IBA Panelists Say," 20 Law. Man. Prof. Conduct 125 (March 10, 2004).

203 Amended Complaint ¶ 1 (filed Sep. 25, 2002), *Tyco Int'l, Ltd. v. Belnick*, No. 02-CV-4644 (SWK) (S.D.N.Y.).

204 *Id.*

205 *Id.* ¶ 3.

206 *Id.* ¶ 5.

207 *Id.* at ¶¶ 96-114, 131-138.

208 *See, e.g.*, Amended Complaint ¶ 4. At one level, such an allegation seems closely akin to the notion that under the old ABA Model Code of Professional Responsibility (DR 1-103(A)) an attorney had an obligation of self-reporting to disciplinary authorities and that, as a result, any disciplinary infraction would actually amount to two infractions unless the attorney turned himself in to the disciplinary authorities.

209 Amended Complaint ¶¶ 102-114.

210 Lin, Anthony, "Ex-Tyco GC Belnick Acquitted of All Charges," *New York Law Journal* (July 16, 2004).

211 *Id.*

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charges, may suggest that the Tyco lawsuit is a one-of-a-kind event. The Tyco suit may also simply be a product of underlying animosity between Belnick and Joshua Berman of Tyco, which, according to media reports, simmered throughout Belnick's tenure at Tyco.[212] However, the Belnick lawsuit could nevertheless turn out to be a watershed event and, in light of the clearly expressed obligations that corporate counsel has, under Sarbanes-Oxley, to take action to try and prevent corporate wrongdoing, such lawsuits may become much more common in the event of future corporate scandals.

The findings in the Batson Report with regard to the potential claims that Enron may have against its in-house counsel provide another example of the possibility that, in the future, companies (or their bankruptcy trustees) will be forced to confront the question of whether they should pursue claims against corporate counsel if, or when, some form of corporate wrongdoing results in significant injury to the corporate entity. In addition to breach of fiduciary duty claims, the Batson Report confronts directly claims not asserted by Tyco in its lawsuit against Belnick — claims for legal malpractice. The Batson Report, however, not only identifies malpractice claims based on negligence, but also specifically based on failure to comply with an obligation under the Texas analog to ABA Model Rule 1.13 to take remedial actions in an effort to prevent corporate wrongdoing, which is similar in large degree to the types of obligations imposed by the federal legislature through Sarbanes-Oxley. It will be intriguing to see whether Enron (through its bankruptcy trustee) follows Tyco's lead and actually follows through with a lawsuit against some or all of the in-house counsel identified in the Batson Report.

Traditionally, the negative implications for the attorney-client privilege of suing one's own attorney have acted as a powerful force weighing against a company ultimately deciding to file a civil suit against its former corporate counsel. Because it has been universally recognized that the attorney-client privilege cannot be used as both a "sword" and a "shield," in making a decision to sue its former corporate counsel, a company must evaluate the ramifications flowing from the fact that the former corporate counsel will be permitted to disclose privileged communications or materials to the extent necessary to defend against the charges against her.

One development that would appear to increase the likelihood that companies will, over time, become more willing to bring suit directly against their own corporate counsel is the erosion to the value of the attorney-client privilege to companies being effected by the increasing insistence by government lawyers that companies waive any claim to attorney-client privilege lest they not be treated as cooperating fully with any governmental investigation.[213] Thus, because companies that find themselves in the midst of a governmental investigation are increasingly being placed into a position where they have to agree to waive the attorney-client privilege in order to be seen as cooperating with the investigation, such companies may have much less of a disincentive to pursuing a suit against their former corporate counsel with regard to any issues that are a part of the governmental investigation.

D. Impact on Scope of Liability to Third Parties

If the Tyco lawsuit against Belnick is the most significant development in the high-profile case studies described above, then the lawsuit by Trace's bankruptcy trustee against Trace's former General Counsel Philip Smith comes in a close second.

Unlike Tyco, Trace is a private company and, as such, the ramifications caused by the imposition of liability and award of damages in excess of $20 million against Smith could even be more far-reaching than Tyco's decision to sue its corporate counsel. In a post-Sarbanes-Oxley world, corporate counsel should not be complacent about their potential exposure based solely on the fact that they work for a private or a non-profit employer – the scrutiny that has come to public companies through Sarbanes-Oxley is already focusing in on the private company and not-for-profit sector.[214]

Further, the nature of the claim set forth by the bankruptcy trustee in the Trace proceedings was not only that Smith and others had acted in ways that were harmful to Trace, but that they had acted in ways that were harmful to Trace's creditors. Thus, the lawsuit against Smith in his role as corporate counsel not only creates a precedent to be used against corporate counsel for private or public companies, but also could be used as precedent to extend the scope of duties that a corporate counsel owes to third parties.

The acts and omissions for which Smith was found by the court to have liability all appear to have stemmed solely from his responsibilities as a lawyer for the company, General Counsel, and not because of his status as Secretary or Vice-President of Trace.

The court absolved Smith of any responsibility for the payment of unlawful dividends because it found Smith had adequately discharged his duties to advise regarding the law as to the issuance of dividends.[215] With regard to Smith's liability for unauthorized loans to Cogan and other insiders, the court seems clearly to have concluded (without calling it such) that Smith committed a form of malpractice. The court emphasized that Smith not only did not advise the Board of Directors of Trace of its obligation to approve loans made to Cogan and other insiders,

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[212] Miriam Rozen, "Losing It All," *Corporate Counsel* (January 21, 2003), available at http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1045686304997; Lin, Anthony, "Tyco Dispute Grows More Bitter," *New York Law Journal* (June 19, 2002), available at http://www.law.com.

[213] See footnote 194 *supra* on the Holder and Thompson Memoranda setting policy for federal prosecutors that suggests that they should not negotiate or offer settlement options to non-cooperative targets (defined as those who don't waive privilege). Add to this the Federal Sentencing Guidelines' proscription, in both the original and amended version, that assigns negative "points" to companies that are not cooperative, defined to mean those who, amongst other things, don't waive privilege rights. *See* http://www.ussc.gov/GUIDELIN.HTM.

[214] *See* ACC's library of resources on the application of Sarbanes-Oxley principles and standards on private companies and non-profits at http://www.acca.com/vl/search.php?anytext=private+companies&subject=&documenttype=&country. With a number of states considering or enacting what is essentially mini-Sarbox legislation (applicable to *all* companies in the state), and with insurance, financial, and investment institutions all demanding that their faith in their clients be verified by a showing of best-practice governance, and with prosecutors, the media and other stakeholders assuming that all companies should be held to the same standards of sound leadership and compliance, private companies and non-profits find themselves scrambling to enact reforms that will evidence their commitment to accountability and transparency, in order to compete in a world where public company competition is setting the standards.

[215] *Pereira*, 294 B.R. at 523.

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but that he did not believe that the Board of Directors actually had that obligation.[216] The court stated that Smith had admitted to not having read the relevant Delaware statute.[217] The clear tone of the court's ruling in that regard is that Smith failed to fulfill his duty to the company with regard to giving them sound legal advice.[218] However, the court fails to acknowledge or address whether such ignorance of the law had any relevance at all given that Smith had never been asked by the Board of Directors to ever provide any legal advice regarding any requirements for approval of such loans.

With regard to its ruling that Smith was liable for negligence in transactions in which Trace redeemed its preferred Trace shares from Dow Chemical Company through Cogan, the court's ruling is less clear with regard to how liability against Smith can be justified based on his status as General Counsel. The only apparent basis for liability against Smith is that the Dow redemption was a redemption occurring at a time when Trace was insolvent.[219] However, it is difficult to fathom how liability can flow to Smith when the court made no finding that Smith either knew, or even should have known, that Trace was insolvent at the time. The court merely concluded that Smith's "active involvement" in the Dow transaction "suggested that it was within his discretionary authority and that he had the ability to prevent the redemption."[220]

The court's ruling is also chilling from the perspective of corporate counsel because it is unclear how Trace, who unlike any creditors was actually Smith's client, was damaged as a result of the "creative solution" that was devised by Smith in that ultimately whether Trace would owe $3 million to Dow or owe $3 million to Cogan, Trace was still going to have to pay someone $3 million. In fact, as the court appears to acknowledge, the whole reason that Smith devised the approach that was used was that Trace would actually have had to pay out $5 million if it had not loaned the $3 million to Cogan to redeem the shares. Thus, ultimately, under the questionable liability standard imposed by the trial court, Smith created personal liability for himself to the tune of $3 million by constructing a transaction that may actually have saved his client $2 million in cash. Further, Smith was not enriched in any way as a result of the transaction, it is at least arguable that none of Trace's creditors were injured, and the transaction appeared to have served to benefit Trace's shareholders.

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[216] *Id.* at 523-24.

[217] *Id.* at 524.

[218] "Smith, as General Counsel, was supposed to advise the Board as to its obligations and responsibilities. Smith admits never giving the Board advice on the duties of corporate officers. He never discussed with the Board its duty to manage the corporation, the need to establish compliance and monitoring programs or an audit committee, the obligation to make decisions on redemption of the corporation's securities, the obligation to supervise and evaluate Cogan as CEO and to inform themselves as to transactions between Cogan and Trace. Smith did not believe that the directors had the legal duty to determine if loans should or should not be made to Cogan or other insiders, and he admittedly never read the Delaware statute that made such duty a Board responsibility." *Id.* at 500.

[219] *Pereira*, 294 B.R. at 534.

[220] *Id.* at 522.

If nothing else about the *Pereira* decision is clear, it is clear that it is incredibly difficult to reconcile with the traditional notion that an attorney is the agent of his client and not vice versa. The *Pereira* decision finds fault with Smith's conduct because the trial court believed that Smith was obligated to advise the Board of Directors regarding what it should and should not do and specifically failed to properly advise the Board of the "need to establish compliance and monitoring procedures or an audit committee;"[221] however, the court made no finding that Smith's client had asked him to provide any such service and certainly did not provide any guidance on how a General Counsel should go about providing such advice to the board of directors when he has not been asked for any advice on the subject matter. It is difficult to fathom under traditional agency principles one would expect to be applied to an attorney-client relationship how Smith could have been found liable for a failure to render such advice unless he had been charged by the board of directors with providing them advice regarding what sort of standards should be enacted.

The *Pereira* decision likely will significantly alter the landscape of liability exposure unless its impact is effectively limited. As has been noted by a prominent Columbia Law School professor, the ruling against Smith "should particularly chill the hearts of inside general counsel."[222] The best case scenario for corporate counsel would involve a reversal or significant alteration of the trial court's ruling on appeal. The worst case scenario is that *Pereira* could mark the beginning of a new legal trend of holding corporate counsel liable for failing to adequately exercise oversight responsibilities over company transactions, even with regard to transactions of which corporate counsel is completely unaware. Given the high-stakes involved in the outcome of *Pereira* on appeal, a number of general counsel and entities have filed an *amicus curiae* brief in appeal before the Second Circuit urging reversal of the *Pereira* ruling and arguing that the trial court's ruling "established an affirmative duty for corporate legal officers to control and supervise the board of directors, ensuring that directors ferret out, expose and prevent transactions that may damage the corporation and others."[223]

V. More Corporate Counsel In The Cross-Hairs: 2004 and Beyond . . .

Clearly, the ultimate outcome of the proceedings mentioned in the case studies above will have a significant impact on the liability landscape for corporate counsel and there will obviously be more such situations that will arise in the days to come. Odds are that the future cases will not be simply dismissed in the wake of Mark Belnick's acquittal, nor as bleak as may be feared as a result of the *Pereira* ruling. And the most recent examples of corporate counsel facing governmental liability appears to bear out the conclusion that the sky has not fallen.

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[221] *Pereira*, 294 B.R. at 523.

[222] Coffee, John C., Jr., "Post-Enron Jurisprudence," N.Y.L.J. (July 17, 2003), p.5 at 15 col. 2, available at http://www.law.columbia.edu/media_inquiries/news/july_2003/coffee_nyljjuly.

[223] Brief *Amicus Curiae* of Corporate Law Department Section of the Los Angeles County Bar Association et al. in Support of Appellant-Cross Appellee Philip Smith for Reversal at 3, *Pereira v. Cogan*, Nos. 03-5053, 03-5055, 03-5057, 03-5063, 03-5067 (2d Cir.).

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A. Bruce Hill (Inso Corp.)

In June 2002, the SEC filed a civil injunctive action against the former general counsel of Inso Corp., Bruce Hill.[224] In that civil suit, the SEC alleged that Hill participated in "a fraudulent revenue recognition scheme designed to falsely boost the amount of Inso's third quarter and annual revenues for 1998."[225] Specifically, the SEC's civil suit focused upon Hill's role in an alleged sham $3 million transaction with a Malaysian distributor that was documented at the end of Inso's third quarter when an anticipated sale to an existing major Inso customer failed to close.[226] The SEC accused Hill of failing to disclose the oral terms of the sale – namely an alleged oral promise to the Malaysian distributor that it would never have to pay Inso for the transaction.[227] The SEC also accused Hill of covering up the transaction by "orchestrat[ing] the providing of $4 million in letters of credit to the Malaysian distributor," causing "a false board resolution to be provided to Inso's bank purporting to authorize the letters of credit," and giving "false information to Inso's chief financial officer and outside auditors about the purpose of the letters of credit."[228]

The SEC's civil suit seeks monetary penalties, a permanent injunction, disgorgement, and an order barring Hill from serving as an officer or director of any public company and alleges that Hill's actions violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Sections 13(a), 13(b)(2)(A), and 13(b)(5) of the Exchange Act and Rules 12b-20, 13a-13, 13b2-1, and 13b2-2.[229]

On May 5, 2004, the United States Attorney for the District of Massachusetts, based on the same factual allegations related to the alleged sham $3 million transaction and alleged efforts to conceal indicted Hill on nine criminal counts, including securities fraud, wire fraud, and the making of false statements to accountants.[230] Also included in the indictment was a perjury charge based an allegedly false testimony provided to the SEC by Hill with regard to the transactions with the Malaysian distributor.[231]

B. Leonard Goldner (Symbol Technologies)

On June 3, 2004, the U.S. Attorney's office announced that Leonard Goldner,[232] former General Counsel and Executive Vice President of Symbol Technologies,[233] had been indicted by federal prosecutors.[234] At that same time, the SEC publicly announced that it had charged Goldner with securities fraud.[235] The SEC filed an 82-page complaint detailing the alleged dealings of Goldner and 10 other executives at Symbol. Interestingly, however, the allegations of wrongdoing leveled against Goldner did not relate to the primary fraudulent practices allegedly engaged in by the other Symbol executives, but rather appear to involve completely unrelated events. In fact, at no point does the SEC complaint allege that Goldner was aware of, or should bear any responsibility for, the financial and accounting manipulations allegedly engaged in by other high-ranking officers of Symbol.[236]

Instead, the SEC, and the U.S. Department of Justice alike, have gone after Goldner for an alleged scheme through which Goldner manipulated stock option exercise dates for certain executives including himself, in violation of the terms of Symbol's written stock option plans, including fraudulently backdating official documents regarding the exercise of such options. The SEC has alleged that Goldner violated Sections 10(b), 13(b)(2) and 13(b)(5) of the Exchange Act and Rules 10b-5 and 13b2-1; Section 13(a) of the Exchange Act and Rules 12b-

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[224] S.E.C. Litigation Release No. 17578 (June 21, 2002), available at http://www.sec.gov/litigation/litreleases/lr17578.htm.

[225] Complaint ¶ 1 (filed June 21, 2002), *SEC v. Bruce Hill et al.*, (D. Mass.), available at http://www.sec.gov/litigation/complaints/complr17578b.htm.

[226] *Id.* ¶¶ 2-3.

[227] *Id.* ¶ 3.

[228] *Id.* ¶ 4.

[229] *Id.* ¶¶ 70-105, and 110.

[230] S.E.C. Litigation Release No. 18699 (May 7, 2004), available at http://www.sec.gov/litigation/litreleases/lr18699.htm.

[231] *Id.*

[232] Goldner, after representing Symbol for nearly a decade as an outside counsel, joined Symbol as its general counsel in September 1990. According to a national survey, Goldner was the ninth-highest paid general counsel in the nation as of 2000. Bobelian, Michael, "Eight Charged in Fraud Case, Including Former GC," *New York Law Journal* (June 7, 2004), available http://www.law.com.

[233] Symbol, a publicly-traded company, primarily engages in the design, manufacture, marketing, and servicing of bar code scanners and similar devices.

[234] June 3, 2004, Press Release of Robert Nardoza, United States Attorney's Office for the Eastern District of New York, available at http://www.usdoj.gov/usao/nyc/pr/2004jun3.htm.

[235] S.E.C. Litigation Release No. 18734 (June 3, 2004), available at http://www.sec.gov/litigation/litreleases/lr18734.htm.

[236] These alleged practices which are the focus of the overwhelming majority of the substance of the SEC's complaint included: (1) "fraudulent 'topside' entries" intended "to conform the unadjusted quarterly results to management's projections"; (2) creating "cookie jar" reserves by artificially reducing operating expenses through fabricating and misusing restructuring charges and other non-recurring charges; (3) "channel stuffing" schemes and other schemes for improperly recognizing revenue; and (4) concealing the adverse side effects of their other fraudulent schemes by manipulating levels of inventory and data regarding accounts receivable. *Id.*

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20, 13a-1 and 13a-13; Section 17(a) of the Securities Act; Section 16(a) of the Exchange Act and Rule 16a-3; and Section 14(a) of the Exchange Act and Rules 14a-3 and 14a-9.[237]

The criminal indictment against Goldner, like the SEC complaint, is based upon Goldner's alleged manipulation of Symbol's stock option plan to benefit himself and other selected company executives.[238] The indictment accuses Goldner of falsifying dates on official documents regarding the date that certain options were exercised, using dates that would be more favorable with regard to the amount of tax owed on the transactions.[239] According to prosecutors, these actions amounted to tax evasion and also defrauded Symbol of tax deductions the company could have taken if the appropriate dates had been identified on the official documents.[240] Despite the fact that Goldner was General Counsel, the indictment does not contain any allegations of securities fraud, but does allege conspiracy to commit mail and wire fraud, tax evasion, and conspiracy to impair, impede, and obstruct the Internal Revenue Service.[241]

The federal investigation into alleged accounting manipulations and wrongdoing at Symbol began in April 2001 as a result of the sending of an anonymous letter to the SEC.[242] Symbol also commenced its own internal investigation at about the same time. In connection with its dealings with federal investigators, Symbol has waived the attorney-client privilege.[243]

Interestingly, Sarbanes-Oxley plays a role in the Goldner proceedings, but not perhaps as some observers might have expected. The SEC complaint against Goldner states as follows: "Goldner continued the 'look-back' practice until the Sarbanes-Oxley Act of 2002 was enacted into law on July 30, 2002. The legislation's two-day deadline for filing Forms 4 and the prohibition on company loans to officers and directors rendered the practice unfeasible. Under prior law, Forms 4 could be filed as late as the tenth day of the month following the month in which the transaction occurred."[244]

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[237] Complaint ¶¶ 156-183, 192-201 (filed June 3, 2004), *SEC v. Symbol Techs., Inc.*, (E.D.N.Y.), available at http://www.sec.gov/litigation/complaints/comp18734.pdf.

[238] June 3, 2004, Press Release *supra* note 209.

[239] *Id.*

[240] *Id.*

[241] *Id.*; *see* "Ex-Symbol Counsel Pleads not Guilty to Fraud Charge," (June 8, 2004), available at http://www.nysscpa.org/home/2004/604/2week/article34.htm.

[242] June 3, 2004, Press Release *supra* note 209.

[243] Lohr, Steve, "Ex-Executives of Symbol Technologies Charged With Fraud," *The New York Times* (June 4, 2004).

[244] Complaint ¶ 133, *SEC v. Symbol Techs., Inc.* (E.D.N.Y.) available at http://www.sec.gov/litigation/complaints/comp18734.pdf.

C. David Drummond (Google, Inc.)

Although the travails of Hill and Goldner may be seen as more of the same with respect to the kinds of actions that corporate counsel clearly know they need to avoid in order to steer clear of liability, the much shorter story of David Drummond's dealings with the SEC seem more significant.

In early 2005, the SEC announced that Google, Inc. and its general counsel, David C. Drummond, had agreed to the entry of an order against them requiring them to cease and desist from violating Section 5 of the Securities Act.[245] The SEC charged Google with violating Section 5 by, in connection with the issuance of over $80 million of stock options as compensation to employees between 2002-2004, failing to either provide the appropriate financial information to the employees or register those securities offerings with the SEC.[246] In the press release announcing the charges and the settlement, the SEC stated:

> The Commission's order further finds that Google's General Counsel David Drummond, 41, of San Jose, Calif., was aware that the registration and related financial disclosure obligations had been triggered, but believed that Google could avoid providing the information to its employees by relying on an exemption from the law. According to the Commission, Drummond advised Google's Board that it could continue to issue options, but failed to inform the Board that the registration and disclosure obligations had been triggered or that there were risks in relying on the exemption, which was in fact inapplicable.[247]

In that same press release, Helane Morrison, District Administrator of the Commission's San Francisco District Office was quoted as follows: "Attorneys who undertake action on behalf of their company are no less accountable than any other corporate officers. By deciding Google could escape its disclosure requirements, and failing to inform the Board of the legal risks of his determination, Drummond caused the company to run afoul of the federal securities laws."[248]

VI. What Corporate Counsel Can Do To Manage Their Liability Exposure

Historically, corporate counsel have not paid the same level of attention toward securing and evaluating the appropriate level of personal protection for their liability exposure in connection with their legal practice as have their counterparts in private practice.

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[245] S.E.C. Press Release 2005-6 (January 13, 2005), available at http://www.sec.gov/news/press/2005-6.htm.

[246] *Id.*

[247] *Id.*

[248] *Id.*

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Senior-level corporate counsel, who often serve as officers or directors of their corporate employer, have sometimes relied upon indemnification agreements with their corporate employer or directors' and officers' (D&O) liability insurance coverage, if available to them. For junior-level corporate counsel, however, indemnity coverage has historically been thought to be their only option for personal protection from out-of-pocket liability. In the current environment, corporate counsel (senior-level and junior-level alike) can no longer afford to simply assume that traditional indemnity arrangements or D&O coverage provide sufficiently adequate protection.

A. Whither Indemnification?

Indemnification is a straightforward concept.

A number of traditional sources for indemnification are commonplace, including indemnity agreements and statutory provisions concerning indemnification obligations. Under either framework, the company is required (either by agreement or by statute) to indemnify its corporate counsel for certain liabilities that corporate counsel may incur in connection with performing her duties for the company. Obviously, indemnification offers no protection for corporate counsel from claims made by the client-employer. What is not as obvious, however, is that the protection afforded by indemnification may also be insufficient for other reasons. Corporate indemnification, in situations where corporate counsel's liability stems from a corporate scandal that itself has the potential to be an entity-threatening event, may not provide a reliable source of relief.

Further, as a result of the increasing pressure placed by prosecutors on companies and the increasing need by companies under investigation to be perceived as cooperating fully with any outside investigation, corporate counsel must begin to seriously question whether reliance solely upon rights of indemnity will be sufficient. As more and more pressure is brought to bear on companies being investigated, and greater and greater requirements are imposed upon those companies in order to be treated as having "cooperated" with any investigations, it can be expected that companies will be pressured to withhold indemnification from those to whom indemnification might otherwise be made available. The SEC has already begun to question the appropriateness of indemnification provided to targeted executives in cases under their investigation, suggesting that it is an inappropriate use of company resources.

The ever-expanding list of requirements being imposed by prosecutors upon the companies they investigate in order to qualify for being considered to be fully cooperating now appears to include refusing to pay the legal costs of employees unless those employees who are willing to talk to prosecutors. A real world example of this concept can be found in the ongoing federal investigation of KPMG.[249] KPMG reportedly has told thirty-two of its employees and partners who have been informed by prosecutors that they are the subjects of a grand jury investigation that it will advance up to $400,000 for their legal costs, but only if those partners and employees agree to talk to prosecutors.[250] Attorneys for nineteen of those partners and employees have been reported as having stated that KPMG has imposed this restriction on the advancement of funds because it believes it has to do so in order to be seen by investigators as fully cooperating.[251]

In this environment, corporate counsel should be wary of assuming that the prospect of indemnification by their employer is sufficient protection alone against their liability risks.

B. Insurance Coverage Options

Other than reliance upon indemnification, out-of-pocket liability protection can be found from liability insurance. The most common types of insurance available are D&O insurance and employed lawyers professional liability insurance.

Directors & Officers Liability Insurance

D&O insurance is usually limited to providing coverage for undertakings by corporate counsel in her role as an officer or director and not when acting as a lawyer, *i.e.*, not when providing professional services or legal advice to the company. However, it can often be written so as to expand the scope of coverage to include other in-house lawyers generally or some limited subset of in-house lawyers, such as in-house lawyers involved in certain types of SEC claims. This type of coverage will also usually contain an exclusion with regard to the payment of fines and penalties.

Many in-house lawyers who believe that their company's D&O policies cover their business actions may find that their insurers will argue that *any* services provided by a lawyer are professional services for which the D&O policy excludes coverage. "'[P]rofessional liability' exposures have traditionally been viewed as outside the normal duties of a director or officer for purposes of D&O insurance."[252] Another layer of difficulty stems from the likelihood that the insurer providing D&O insurance may argue that when a lawyer also happens to be an officer or director, *any* services provided by the lawyer to the company are in the nature of professional services and are excluded from coverage under a D&O policy.[253]

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[249] Cohen, Laurie P., "Prosecutors' Tough New Tactics Turn Firms Against Employees," *Wall Street Journal*, A1 (June 4, 2004).

[250] *Id.*

[251] *Id.*

[252] Chubb Group of Insurance Companies letter of December 17, 2002, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, available at http://www.sec.gov/rules/proposed/s74502/smfitzpatrick1.htm.

[253] For those seeking more extensive information about the topic of D&O liability insurance, *see* Gische, David M., and Fishman, Vickie E., "Directors and Officers Liability Insurance Overview," available at http://profs.lp.findlaw.com/insurance/insurance5.html; and "Does Your D&O Policy Cover Your In-House Legal Staff" (Willis Executive Risks Alert, October 2003), available at http://www.willis.com/news/publications/ER_alert.pdf.

For those more specifically seeking how to confront the D&O insurance issue in a post-Enron environment, *see* White Paper: "Some Thoughts on D&O Insurance Strategies-Post-Enron," by Charles R. Lotter, Executive VP, General Counsel & Secretary of J.C. Penney Corporation, Inc., available at http://www.acca.com/protected/article/governance/dol_strategy.pdf.

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Employed Lawyers Professional Liability Insurance

Employed lawyers policies are primarily designed as a product to cover claims made against corporate counsel by third parties and are "designed to pick up where a traditional directors and officers liability insurance policy leaves off, providing more specialized coverage for the attorneys."[254] Such policies are usually limited to coverage for professional services rendered and might not extend to acts performed by corporate counsel in connection with business or other fiduciary responsibilities, *i.e.*, as an officer or director. Usually, coverage for the payment of fines, sanctions, or penalties is expressly excluded.[255]

Errors and Omissions Insurance

This type of insurance coverage likely would be the only type of coverage on which corporate counsel could expect to rely if faced with an adverse claim pursued by her employer, such as a claim for legal malpractice.[256]

C. General Counsel's Dilemma

In addition to the personal issues that every corporate counsel faces with regard to questions of indemnification and insurance coverage, corporate counsel who also happen to be General Counsel potentially face the obligation of advising the corporation regarding what types of coverage to provide its corporate counsel.

There is, of course, a natural conflict that is often created between the interests of senior-level corporate counsel and junior-level corporate counsel. As discussed above, junior-level corporate counsel are likely not going to qualify for coverage under normal D&O liability policies. Thus, a company's decision not to provide employed lawyers professional liability insurance coverage will likely leave many such junior-level corporate counsel unprotected (unless those corporate counsel obtain coverage on their own). The failure to offer such coverage to junior-level corporate counsel may serve to make those lawyers more skittish with regard to their obligations, such as "reporting out" or "reporting up," or could create a natural inclination on the part of such corporate counsel to *always* err on the side of reporting any allegations of which they become aware.

Senior-level corporate counsel will often qualify for D&O liability coverage. Thus, senior-level corporate counsel may not feel as great a need for employed lawyers coverage to be made available. However, the key question to be resolved in determining whether the perceived conflict is really a true conflict is whether the particular D&O policy being offered will cover claims against an attorney-officer or attorney-director that involve the provision of professional services or legal advice to the company. If not, then a decision to offer employed lawyers coverage can be seen as being simultaneously in the best interest of both senior-level and junior-level corporate counsel.

Some of the basic factors for consideration when determining whether a need exists to obtain employed lawyers professional liability insurance include: (1) the extent to which the company can afford to indemnify corporate counsel or to pay for or provide for defense costs for their corporate counsel; (2) internal expectations with regard to the responsibilities of corporate counsel, such as whether they are expected to sign off on opinion letters, certify corporate information, provide legal advice to persons other than their employer, or provide pro bono services; and (3) the potential for liability exposure (*i.e.*, shareholder suits, securities lawsuits, and other third-party claims) that exists in connection with the type of work performed by the particular corporate counsel, or particular segment of corporate counsel.

In the present environment in which corporate counsel are already becoming more likely and inviting targets for inclusion in lawsuits by plaintiffs' counsel, however, an additional issue must be borne in mind. It may be that a company that provides substantial insurance coverage to its corporate counsel, such as a combination of D&O insurance and employed lawyers insurance, could create a perverse incentive to plaintiffs' counsel that could serve to attract claims against corporate counsel by others.[257]

VII. Conclusion

Although the ultimate effect of the last few years of corporate scandal and reform upon the potential liability of corporate counsel remains somewhat unclear and fundamentally unsettled, it is clear that these events have raised the bar and the stakes personally for corporate counsel in many ways. What is clear is that corporate counsel will more often be the focus of government enforcement efforts, including criminal prosecutions and SEC proceedings, as well as shareholder derivative claims, securities fraud class actions, and maybe even malpractice suits by their own clients.

Thus, until the true scope of this changed landscape comes into clear focus, it is incumbent upon corporate counsel to remain vigilant and continually aware of the risks they face from the traditional sources of liability exposure, potential new risks and variations on those traditional sources of liability exposure that may come about if, for example, Tyco's lawsuit against Mr. Belnick meets with judicial success or if the *Pereira* ruling is not rebuked on appeal and the available options for obtaining indemnity and insurance coverage to help manage their own personal liability exposure.

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[254] Sablak, Laurie J., "Cover Me," *Corporate Counsel* (April 12, 2004), available at http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1071719738502.

[255] For greater detail regarding Employed Lawyers policies, *see* Gardner, Eriq, "Naked as a Jaybird," *Corporate Counsel* (Sept. 1, 2003), available at http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1061306535093.

[256] *See* Frostic, Dennis L., Brusstar, Thomas A., and Mitrovic, Suzanne, "Legal Malpractice Liability of Employed Attorneys," *ACCA Docket* (Fall 1993), available at http://www.acca.com/protected/pubs/docket/fall93/legalmal.html.

[257] For a very helpful look at what several companies are doing in this area, *see* "Indemnification and Insurance Coverage for In-House Lawyers: What Companies are Doing," available to ACC members at http://www.acca.com/vl/practiceprofiles.php.

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POTENTIAL COVERAGE FOR CLAIMS AGAINST IN-HOUSE COUNSEL

I. Potential Sources of Coverage for In-House Counsel

- Review the indemnification provisions in the company's by-laws or other agreements to determine the potential protection afforded to in-house counsel.
- Review the company's directors' and officers' liability ("D&O") policy and/or professional liability policy to determine if they encompass Claims against in-house counsel.
- Determine if a separate employed lawyers liability policy has been purchased, or should be explored.

II. Potential Protections for In-House Counsel under a Company's D&O Policy

- Review the terms and conditions of the Company's D&O policy, including (but not limited to) the following:
  - Definition of "Wrongful Act"
    - D&O policies generally cover "Loss" arising from "Claims" made against directors and officers for alleged "Wrongful Acts." Some policies define a "Wrongful Act" as alleged breaches of duty, neglect, errors, misstatements, misleading statements or omissions by the Insured in his or her capacity as a director or officer of a corporation or matters claimed against such director or officer *solely* by reason of his or her status as such.
      - Check the definitions in the D&O policy. The word "solely" in the definition of a "Wrongful Act" may lead a carrier to assert, depending on the allegations, that there is no coverage where a director or officer is sued in a dual capacity, i.e. as both a director or officer and outside or in-house counsel. For this reason, Insureds should negotiate to have the word "solely" deleted from the definition of "Wrongful Act," if possible.
      - Insureds may also negotiate an endorsement to the policy which provides specific coverage for "Wrongful Acts" made by general counsel in their capacity as such. For example, some carriers may be willing to offer an enhancement providing "errors and omissions" coverage for all in-house counsel.
  - Definition of "Insureds" and/or "Insured Persons"
    - Many D&O policies define "Insureds" and/or "Insured Persons" to be only the directors and officers elected or appointed to such positions in accordance with a company's by-laws and/or certificate of incorporation.
      - If in-house counsel are not otherwise covered by the definition, Insureds may seek to revise the definition of "Insureds" and/or "Insured Persons" to include specific persons who may not legally be officers or directors, such as general counsel and their in-house colleagues.
  - Professional Liability Exclusion
    - Many D&O policies contain a Professional Liability Exclusion, which may preclude coverage for Claims arising out of the performance or failure to perform professional services or any act, error or omission relating thereto.
      - If the Exclusion cannot be deleted, it should be narrowed. The language of the Exclusion should be clearly limited to "professional negligence," so that a claim involving the general counsel's business decisions in situations such as settlement are not excluded.
      - In addition, the Exclusion should be limited to liability arising out of work performed for a third party for a fee. The intent is to narrow the Claims that may be excluded.

III. Employed Lawyers Insurance

- If there is potential exposure to in-house counsel and if there is a question as to whether the company's bylaws and/or current policies provide adequate coverage, a company may wish to explore an employed lawyers policy.
- A company should carefully review and negotiate the terms and conditions of an employed lawyers policy just as it would a D&O policy. Consider all the terms and conditions of the proposed policy, including (but not limited to) the following:
  - Does the insurer defend the Claim and provide counsel or is the Insured obligated to defend and seek reimbursement? If the insurer defends, does the Insured or the carrier choose defense counsel? Is use of Panel Counsel required?
  - If the carrier has a duty to defend, does a retention apply to Defense Costs? Is there a retention for non-indemnifiable as well as indemnifiable Claims?
  - How does the policy interact with a D&O policy? Does the employed lawyers policy apply only as excess coverage to a D&O policy?

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- How is a "Claim" defined? Does it encompass actions emanating from Section 307 of the Sarbanes-Oxley Act? Are investigations included as "Claims"?
- How are "Legal Services" (or the equivalent term in the policy) defined? Does the definition include pro bono or other services to third parties performed at the request of the Company?
- What constitutes "Loss"? Are fines, penalties or punitive and exemplary damages covered? Are expenses incurred to comply with injunctive relief covered?
- What is the definition of a "Securities Claim"? What is the definition of an "Employment Claim"? Are there sublimits of liability for different types of Claims?
- What is the scope of the definition of "Wrongful Act"?
- What are the exclusions in the policy? Review the "misconduct exclusions," i.e. exclusions for fraud/criminal conduct and the gaining of an illegal profit, in the policy. Do the misconduct exclusions apply only after a final judgment or adjudication that the misconduct occurred or can they be applied based on a lower standard? Are Defense Costs covered even if there is ultimately a criminal conviction or judgment of dishonesty?
- Are the exclusions "severable," so that the misconduct of one Insured does not preclude coverage for "innocent" Insureds?
- What information is considered to be part of the application for the policy? Does the policy contain a severability provision with respect to the application, so that a misrepresentation or omission by one Insured is not imputed to others? How broad is the severability language? Can the policy be made non-rescindable?

** The information for this outline was obtained from the following source:
Carolyn H. Rosenberg et al., *"Protecting Directors, Officers, and General Counsel in the 'New World' of Insurance,"* American Bar Association General Counsel Forum (2004).

Legal Department Risk Management: The Time is Now

By Peter R. Jarvis[*]
and David J. Elkanich[**]

I. Introduction

The job of the corporate legal department is to help corporate management avoid unnecessary or unwise legal risks. But if Murphy's Law can and does apply outside of the corporate legal department, it also can and does apply to the legal department itself. Put another way, legal departments can at times be a cause of, as well as a cure for, unnecessary risk.

Outside law firms are beginning to learn this lesson. Over the past decade, an increasing number of large, medium-sized and even relatively small law firms have begun to rethink their management structure and to appoint risk management or professional responsibility counsel to help identify weaknesses that could lead to civil, disciplinary or even criminal liability. Although a corporate legal department's position is different insofar as it is unlikely ever to be sued for damages, the principles are the same: life is not risk-free, but only careful planning and vigilance will minimize risk. Anything less is whistling in the dark: if something can happen, it can happen here.[1]

In this article, we will briefly discuss both some of the sources of corporate legal department risk and some of the possible steps that can reduce such risks. The reader should be warned, however, that this is only an overview of a very complex topic. As some of us used to write in high school or in college, more research on this vitally important topic is necessary.

II. Risks in Corporate Legal Departments

Several years ago, a state attorney general's office had a rude awakening when it was discovered that a lower-level deputy attorney general had mistakenly kept the service copy of a judgment order adverse to the state in her office until after the appeals period had run. The result was that the state lost a chance to appeal a $17 million adverse judgment. In one brief moment, that state learned at its expense what many private practice firms had previously learned at their expense: centralized docketing of key dates is not only extraordinarily important but is in fact best done at the moment that the documents first arrive at a law firm or legal department office.

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[1] For a similar analysis of private law firm problems, *see* Peter R. Jarvis, "Learning from Rocket Science," *The Professional Lawyer* 26-28 (Vol. 14, Issue 4, 2004).

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We are all surrounded by dates, some of which may be flexible but some of which are not. This is true not only in litigation but also in intellectual property practices, securities law practices and many other areas. In all likelihood, trusting each individual lawyer or legal assistant to remember all dates pertaining to her work is not the optimal approach.

Moreover, and depending in part upon the nature, significance and complexity of the matter and of the legal department, it may also be unsatisfactory to rely solely upon calendars or dates prepared by outside counsel. Granted that an outside law firm that misses a deadline can be sued for malpractice, such litigation is unlikely to provide a satisfactory alternative. Lawsuits take time and money to prosecute, their outcome is uncertain, and positive relationships with counsel that may have developed over years may easily be destroyed. In other words, corporate legal departments have a strong and independent interest in making sure that deadlines are not missed even when others may also be within the circle of blame.

There is also another dimension to the deadline problem besides blown deadlines. Nearly missed deadlines can be almost as bad. Assume, for example, that a corporate legal department assigns one of its own or outside counsel to handle a critical project that must be completed within six months. Assume further that the person ultimately responsible for the project hears nothing back during the first four months. Is it acceptable to wait and see whether a response is volunteered in month 5? With two weeks to go?

The answer in many cases will be “obviously not.” At the risk of mixing a metaphor, tickler systems with teeth are worth consideration. Businesses have milestone and reporting requirements for good reason. Their counsel should do no less.

Deadline-related problems are not the only problems that corporate legal departments share with their outside counsel. The management of workflow is clearly a critical issue. Many private law firms have learned, for example, that quality control is much better accomplished when practices or practice groups are managed or controlled firm-wide by subject matter rather than geographically by office and across subject matters. Corporate legal departments that are geographically separated can benefit from the same approach. So can corporate legal departments that are divided between parent, subsidiary and brother-sister companies.

Or consider the matter of individual incentives and the balancing of work between individuals. Although the “eat what you kill” mentality that appears to dominate some law firms should be substantially less prevalent within legal departments, the fact is that any group of individuals—lawyers included—can include individuals who hoard work, individuals whose overwork can lead to mistakes and individuals who may shirk some or all of their responsibilities.

Several of the deadline examples also point to an external dimension of corporate legal department risk management: making sure that outside counsel do not unnecessarily or unreasonably expose the corporation to risk. As with internal problems, however, more is involved than just deadlines.

Consider, for example, a corporate legal department that is presented with a conflicts waiver request. Some law firms seem to generate such requests as a matter of form and with little or no explanation to clients of what the waivers entail, and some corporate counsel may have no objection to receiving or signing off on such requests. Whether this is sometimes, generally or always in the corporation’s interest is, however, another matter. For example:

- Managerial personnel who subsequently learn that “their” law firm may be opposing them on a matter may be less than happy if they were not consulted in the first instance.
- The law firm that sought the waiver may later argue that the waiver covered additional circumstances beyond what corporate counsel thought it covered.
- If the corporation is relying upon a waiver from another client of the law firm to allow the firm to represent the corporation in a matter adversely to that other client, the corporation needs to assure itself that the other client’s waiver will stand up if subsequently challenged.
- Different circumstances require different analyses. Suppose, for example, that the waiver seeks to permit a law firm to represent multiple parties at the same time on different sides of a business or litigation matter. From the corporation’s view, the risks or consequences of a subsequent breakdown that could cause the corporation to need to retain separate counsel in mid-matter may be far more serious than they appear to outside counsel who wants or needs the work.
- There are steps that can be taken to make some waivers more palatable in some circumstances—e.g., requiring the use of different lawyers on different matters, a formal segregation of files or an express grant of permission limited to adverse negotiations but not including adverse litigation—that may be overlooked if corporate counsel do not consider their options.

In other words, corporate legal departments need to make sure that they understand what they are and are not getting themselves into when they are asked for conflict waivers.[2]

III. Responding to Legal Department Risk

There is no magic bullet to avoid all risk. Bad things happen even to the best prepared, and it is not always clear before the fact what constitutes the best preparation for a given risk. Moreover, taking calculated risks is often an inevitable part of what we all do.

On the other hand, much of what private law firms have learned about risk management in recent years is fairly directly applicable to corporate legal departments. This is true, for example, with respect to the docket and time management problems discussed above. By and large, cures exist; the question is who will use them.

[2]There is also a need to manage and review of outside legal fees and bills, but that subject goes beyond the scope of this article.

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Other problems will require more careful and thoughtful approaches. In principle, for example, one could argue that it should be easier to encourage effective mentoring of new lawyers in a legal department than in a firm because the drive to maximize billable hours does not exist in the same way. This difference may be attenuated, however, at corporate legal departments that have gone to far down the road of modeling themselves "as if" they were outside billable firms that must account for every fraction of an hour to an excessive and counterproductive extent. These kinds of problems are far from fully resolved at law firms and are unlikely to be fully subject to resolution in corporate legal departments. On the other hand, the unity of interest and of purpose that should exist within a corporate legal department should tend to make these kinds of problems more capable of resolution in-house than they are out-of-house.

IV. *Conclusion*.

In some ways, successful internal risk management is an unattractive field. One is far more likely to garner significant praise for that big victory over an arch-enemy or for saving someone else from danger than for the far less visible act of not placing oneself in danger. But while fighting fire with fire is dramatic, fighting fire with fire extinguishers will often be far more useful. And even if avoiding fire altogether through fire prevention techniques may be boring, temporary boredom is a lot more palatable than wringing one's hands after the fact. Corporate legal departments should icreasingly give greater consideration to internal and external risk management.

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INDEMNIFICATION AND INSURANCE COVERAGE FOR IN-HOUSE LAWYERS: What Companies are Doing

Part of an Ongoing Series of
ACC's "Leading Practices Profiles" SM
http://www.acca.com/vl/practiceprofiles.php

January, 2004

Are company protections for in-house lawyers in sync with such lawyers' changing roles and responsibilities, as well as stakeholder's and regulator's expectations, and recent court cases' prescriptions? In-house lawyers are in the line of fire in a way they've never been before. And in addition to prosecutions by regulators or lawsuits brought on behalf of the company for professional breaches, the addition of fiduciary breaches (as a responsible officer or manager of the company) to the mix means that in-house lawyers are increasingly at risk for lawsuits brought by non-clients.[1] This profile and its attendant resources are written to help you assess your emerging role in preventing corporate failures, the risks you face (personally and professionally) in representing your client in that capacity, and protections available to you in the in-house employment setting.

Much attention has focused on top lawyers for public companies being named as defendants in high-profile shareholder litigation and becoming targets of suits involving

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[1] See *"The Law of Inside Counsel"* by Saul, Ewing, Remick & Saul LLP (http://www.acca.com/protected/legres/program/newjersey/upl.html) (describing liability and insurance issues for in-house lawyers); see also "*Individual Liability for the Corporate Lawyer"* by Mark D. Nozette, Susan J. Lawshe, and John K. Villa (http://www.acca.com/education99/cm99/pdf/704.pdf) (containing excerpts from Chapter 6 of "*Corporate Counsel Guidelines"* by John K. Villa).

For articles describing increasing potential for suits naming in-hosue lawyers as defendants, see *"When You're the Target,"* by Anthony K. Greene (Chief Legal Executive, Spring 2003) (http://www.chieflegal exeuctive.com/sub_pages/publications/CLE/PDF/2002_SpringCLE_Spr03Greene_Final.pdf); see also *"Corporate Counsel: Attorneys Who represent companies Face Higher Possibility of Liability to Nonclients,"* by Joan C. Rogers (reproduced by Hinshaw & Culbertson from ABA/BNA's Lawyer's Manual on Professional Conduct, Vol. 9, No. 7 pp. 17-181 (March 26, 2003) (http://www.hinshawlaw.com/ArticlesPublciations/lmrm_corp_counsel_liability_non-clients.cfm).

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broader allegations of corporate misconduct.[2] In addition, attorney conduct standards pursuant to Sarbanes-Oxley and recent case law setting a new standard of personal liability on a corporate CLO may introduce a whole new set of exposures.[3]

However, in-house lawyer liability is not limited to lawyers for public companies. Lawyers for private companies and non-profit enterprises are also vulnerable to liability claims. Less publicized, but still very real, is the potential for in-house lawyer liability to third parties in a variety of contexts, including fiduciary breaches, matters involving opinion letters and certifications, joint venture work, pro bono matters, work for non-wholly owned subsidiaries, and others.[4]

[2] See Enron Bankruptcy Examiner Neal Batson's Report on the liabilities and roles of in-house and outside counsel representing Enron: full report is at http://www.acca.com/public/article/corpresp/basonreport.pdf (this is a 6 MB file); for the appendix report focusing on lawyer roles, go to http://www.acca.com/public/article/corpresp/batsonappendixc.pdf (this is a 12.2 MB file). See also, "*Naked As A Jaybird,*" by Eriq Gardner (Corporate Counsel, 9/1/03) (http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1061306535093) (discussing recent corporate scandals and lawsuits naming General Counsel as defendants, including lawsuits against top lawyers at Tyco International Ltd., Enron Corp., Arthur Anderson; Rite Aid Corp., and U.S. Wireless Corporation, and views on D&O Insurance coverage and other insurance impacts); see also "*Another GC Readies for Trial,*" by Jason Hoppin (Corporate Counsel, 12/1/03) (describing case against the ex-general counsel of HBO & Co.). For discussion on another recent case imposing personal liability exposure on a CLO, see "*Advocacy Alert: Latest Weapon of Plaintiffs' Bar, Personal Liability Exposure for CLOs: Effects and Implications of Pereira v. Cogan,*" (ACC Docket, January 2004) (http://www.acca.com/protected/pubs/docket/jan04/inbox.pdf); see also "*Post-Enron Jurisprudence,*" by John Coffee (New York Law Journal, July 17, 2003) (http://www.law.columbia.edu/media_inquiries/news/july_2003/coffee_nyljjuly) (describing the Periera case as one that "should particularly chill the hearts of inside general counsel").

[3] See infra fn. 2 "*Naked As A Jaybird;*" see also "*Comments of Chubb Group of Insurance Companies Re: SEC File No. 33-8150.wp; Implementation of Standards of Professional Conduct for Attorneys*" (Dec. 17, 2002) (http://www.sec.gov/rules/proposed/s74502/smfitzpatrick1.htm) (includes descriptions of insurance protections for lawyers and possible impacts, including addition of exclusions and higher premiums, of Sarbox proposed attorney conduct rule). For articles on the recent Pereira case setting new legal standards, see infra ACC Advocacy Alert article and New York Law Journal article referenced in fn. 2.

[4] See infra "*The Law of Inside Counsel*" at f.n.1; see also infra fn. 1 "*Individual Liability for the Corporate Lawyer*" at Section 6.05 (describing corporate counsel civil liability to third parties). For a description of third-party malpractice claims that might arise in connection with services performed by in-house lawyers for private companies (as well as public companies), see "*Cover Me*" by Laurie J. Sablak (Corporate Counsel) (http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1071719738502). For a discussion of why legal malpractice may be an issue for in-house lawyers doing pro bono work, see "*The CorporateProBono.Org Guide to Legal Malpractice Insurance Options for Corporate Attorneys Involved in Pro Bono Work*" at http://www.cpbo.org/resources/archive/resource1274.html.

For articles discussing potential attorney liability to non-clients, see "*Practicing Law Through The Rear View Mirror, Attorney Liability to Non-Clients in the Untied States,*" by James R. Walsh and Elizabeth E. Davies (California Business Litigation Legal Research Library, October 2000) (http://www.calbuslit.com/rearview.pdf); see also "*How to Avoid Having Strangers for Clients,*" by Phillip Feldman (ExpertLaw.com May 2003 (http://www.expertlaw.com/library/attyarticles/third_parties.html).

And, the insurance landscape is changing. Companies are facing shorter policy terms, increased premiums, shrinking coverage, and expanding exclusions.[5] Renewal efforts have been described as more rigorous and involving more detailed inquiries about company financials and operations. In addition, prospective carriers are including questions about corporate governance and internal controls programs as part of their due diligence. New questions are also being raised about the scope of Directors & Officers Liability Insurance coverage: does it cover claims against attorney-officers for professional services or legal advice?[6] These issues will likely be greatly affected by the results of the first several major liability actions currently in the courts against in-house counsel outside counsel. It is possible that major damage, penalty and defense costs – the likes of which are without previous precedent in terms of in-house counsel liability -- will adversely impact both the cost and coverage exclusions of employed lawyer liability insurance and corporate D&O and indemnification policies in the future.

What are companies and organizations doing to provide coverage against potential liability for in-house lawyers who are doing their jobs? This Profile provides some general background information on indemnification and insurance considerations for in-house lawyers, and summarizes information on related program initiatives gathered from responses to a recent Association of Corporate Counsel survey titled: *Emerging Liability/Indemnification/Insurance for In-House Counsel.*[7] Almost 500 companies responded to this survey, providing both an interesting and informative backdrop for our analysis.

This Profile also takes a closer look at combination indemnification and insurance programs at eight featured companies whose names we agreed not to reveal. These companies include public, private, and non-profit enterprises ranging in size from small to Fortune 100. Law departments for featured companies also range in size: from a solo in-house lawyer to a law department with more than 75 lawyers. Featured in this Profile are programs for the following: **Fortune 100 Retail Company; Major Specialty Retailer; Multinational Chemical Company; Large Non-profit Enterprise; Private Aerospace Company; Private Commercial Property & Casualty Insurance**

[5] See infra "*Naked As A Jaybird*" at fn. 2.

[6] For an article sharing views on whether D&O Liability Insurance covers in-house legal staff, see "*Does Your D&O Policy Cover Your In-house Legal Staff,*" (Willis Executive Risks Alert, October 2003) (http://www.willis.com/news/publications/ER_alert.pdf) (describes questions on coverage for role as lawyer and asserts that an attorney-officer's executive job responsibility is to provide legal advice to the corporation and that there shouldn't be a distinction in roles). For additional commentary on this issue see infra "*Naked As a Jaybird*" at fn. 2 (describing reviews of D&O policies and interviews with underwriting officers at insurance companies regarding coverage for legal services under D&O policies); see also infra fn. 3 "*Cover Me*" (describing employed lawyers professional liability insurance and views on D&O coverage).

[7] An Executive Summary of the survey results may be viewed via links to ACC's Virtual Library at http://www.acca.com/protected/Surveys/governance/indem_survey.pdf. For the raw survey results, email merklinger@acca.com or hackett@acca.com.

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Company; Private Manufacturing Company with less than 1000 Employees; and Public Technology Company.

Section I below summarizes background issues for your consideration. Section II overviews key themes and program insights gathered from discussions with representatives from the companies highlighted in this profile. Section III describes the programs of each of the eight companies in more detail. Section IV provides sample policies from profiled organizations as well as a list of resources identified by ACC or companies represented in this Profile that may be helpful to others as they evaluate their program efforts. We will continue to add new policies and examples we collect over time from additional companies.

I. BACKGROUND ISSUES—SOME GENERAL THOUGHTS ON INDEMNIFICATION AND INSURANCE PROGRAMS

Most companies have had some form of protection in place for many years. And, those companies would probably say that those protections would cover at least some actions of some in-house lawyers. Many of these protections are not formally communicated to in-house lawyers generally, but instead are on a shelf to be dusted off in the unfortunate event that cause for evaluating coverage under the indemnity or insurance policy arises. That may be too late.

Corporate scandals and bankruptcies, new regulations, emerging standards of liability, and huge damage awards are rapidly impacting the availability, cost, and scope of insurance and indemnification protections.[8] These external forces, together with the evolving roles of in-house lawyers, support taking action now to assess needs and risks and implement coverage programs to best address them.

RECENT ACC SURVEY ON EMERGING LIABILITY/ INDEMNIFICATION/ INSURANCE FOR IN-HOUSE LAWYERS

To help gather information on emerging liability issues and indemnification and insurance programs implemented by companies, the Association of Corporate Counsel contacted approximately 4,000 member companies in November 2003 to complete a short survey. 483 responses were received. An Executive Summary and the corresponding Survey results may be viewed via links to ACC's Virtual Library.[9]

[8] See "*General Counsel Symposium: Directors in the Spotlight: Heightened Scrutiny and developments in Insurance and Indemnification Arrangements,*" by Lois F. Herzeca, Robert E. Juceam, and William G. McGuinness of Fried, Frank, Harris, Shriver & Jacobson (Oct. 24, 2003) (http://www.ffhsj.com/Symposium_Material/GC_fall_03/spotlight_main.htm; click on titled article); see also "*Comments of Chubb Group of Insurance Companies Re: SEC File No. 33-8150.wp; Implementation of Standards of Professional Conduct for Attorneys*" (Dec. 17, 2002) (http://www.sec.gov/rules/proposed/s74502/smfitzpatrick1.htm) (includes descriptions of insurance protections for lawyers and possible impacts, including addition of exclusions and higher premiums, of Sarbox proposed attorney conduct rule).

[9] See infra fn. 7.

The recent Survey suggests that companies are doing many different things. Most companies said they have at least some form of indemnification or insurance protection (or combination) that would apply to at least some matters for some in-house lawyers. Some said that their companies do not have (or have not communicated) any indemnification or insurance programs that would cover them.

Indemnification practices include indemnifications required by some state laws, and indemnity provisions in company by-laws, indemnification policies, and individual indemnification agreements. Various forms of insurance protections were also identified, including Directors & Officers Liability Insurance, Errors & Omissions Insurance, and Employed Lawyers Professional Liability Insurance. Triggers, scope, and conditions of coverage also appear to be negotiable and vary broadly.

Distinctions in insurance coverage were noted: in some cases, only those in-house lawyers who are also officers of the company may be covered; in others, any in-house lawyers providing certain types of advice on SEC matters may be covered; in others, in-house lawyers specifically listed on endorsements may be covered. In addition, comments and concerns were raised about the scope of coverage for attorney-officers under Directors & Officers Liability Insurance: might services as a lawyer be excluded? Respondents also listed emerging liability issues of concern. Not surprisingly, many shared concerns regarding scope of their practice, new conduct expectations and exposures under Sarbanes-Oxley, and third party lawsuit exposures.

STEPS TO TAKE IN EVALUATING COVERAGE

Below are thoughts on five simple steps to take to facilitate evaluating coverage and matching fit. These steps and the associated discussion below are offered to help provide insights only and not as legal advice.

- **Step 1: Assess legal services provided by in-house lawyers:** An initial critical step in evaluating coverage is to assess legal services provided by in-house lawyers for the company. These may include services for the company and services for other entities undertaken at the request of the company.
- **Step 2: Evaluate areas of potential exposure:** Once roles are identified, a second important step is to evaluate areas of potential exposure and risk.
- **Step 3: Evaluate existing forms of protections:** This step requires an evaluation of existing forms of protections to determine if they provide acceptable risk management.
- **Step 4: Fill gaps:** Step four involves filling any gaps identified during the course of Step 3. Enlisting the help of an experienced insurance broker has been described as being very valuable in helping to assess insurance options that may help cover identified gaps where insurance is desired.
- **Step 5: Periodically review:** This step is part of the continuous improvement process to help ensure that as roles and risks change over time, coverage options are appropriately matched.

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TYPES OF COVERAGE

Two key types of coverage are indemnification and insurance. A key advantage to having some form of insurance in addition to an indemnification is having an external source of funding to help cover costs. This may be particularly important for in-house lawyers at companies that are start-up companies or that may not have the financial strength to back an indemnification commitment.[10] And if the underlying reason for your potential exposure involves a major financial debacle, it is likely that there will be trustees or others who will prioritize and adjudge the expenditure of scarce resources to defend those accused of wrongdoing.

However, the type and terms of insurance coverage that are most appropriate will depend on the nature of legal services provided and the terms of existing protections.[11]

- **Indemnification:** many Survey respondents said that indemnification protections were included in corporate by-laws. Additional forms of indemnification identified through discussions with companies featured in this Profile include: mandatory statutory indemnifications, individual indemnification agreements, and indemnification policies. Each indemnity will have its own language, and the express terms of the indemnity will define the scope of coverage. Here, evaluating definitions of covered persons, scope of the indemnity, scope of covered costs, provision on advancement of costs, statements about creating a contract right, and conditions and exclusions on coverage may be helpful starting points in assessing gaps.[12]

- **D&O Insurance:** generally written to cover directors and officers; may be expanded to cover additional individuals (such as expansions to cover employees or in-house lawyers generally, or in-house lawyers for certain types of SEC claims, or specifically listed individuals); typically exclude coverage for fines and penalties; may also contain language expressly excluding coverage for claims arising out of duties as attorneys or for professional services.[13]

- **Employed Lawyers Professional Liability Policies:** typically provide coverage for the purpose of providing legal services to the insured company; some policies may include coverage for defense costs incurred in defending disciplinary proceedings; coverage for fines, sanctions, and penalties is typically excluded; may also have broad SEC exclusions.[14] Among the factors to consider in evaluating the need for employed lawyers professional liability insurance are: ability of company to provide defense costs and indemnity; potential for shareholder litigation; potential for third party claims relating to nature of work; expectation regarding providing legal advice to joint ventures; expectation for providing opinion letters or certifications; provision of pro bono services, etc..[15]

II. SUMMARY OVERVIEW & THEMES FROM PROFILED COMPANIES

Each of the companies featured in this Profile described a combination of indemnification and insurance protections that would be available to provide coverage for at least some in-house lawyers. While many of the companies have indemnity protections in the company by-laws, the language, scope, and content of each provision varies. In addition, although all of the companies have D&O Liability Insurance policies, several companies have described expansions to the scope of coverage afforded by their policies.

PROGRAM MODELS

Below is a brief summary of some of the types of combinations identified by featured companies. Additional information on program elements, scope of coverage, and applicable conditions and exclusions may be found in the company program summaries in Section III of this Profile.

- **By-Law Indemnity / D&O Liability Insurance:** indemnity applies to officers, directors, and employees *to the extent required by* Delaware law (also goes beyond Delaware law and allows for indemnification even if not successful on the merits, with certain conditions including a condition that actions be taken in good faith); D&O Insurance applies to attorney-officers.
- **By-Law Indemnity / D&O Liability Insurance with added coverage:** indemnity applies to officers, directors, and employees *to the fullest extent authorized by General Corporation Law of State of Delaware* (also makes the indemnification a contract right and includes claims procedures); D&O Insurance applies to: (1) all in-house lawyers for certain types of SEC claims; (2) defined in-house lawyers who sign certifications related to Sarbanes-Oxley compliance; and (3) attorney-officers.
- **Indemnification Policy / D&O Liability Insurance:** indemnity applies to broad listing of individuals, including any employees; D&O Insurance applies to any employee working within the scope of employment or under management of an officer or director.

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[10] See *"Corporate Counsel Guidelines-Section 6.13,"* by John K. Villa (http://www.acca.com/protected/legres/ccguidelines/sect613.html).

[11] Id. See also infra fn. 3 *"Cover Me."* In addition, for an article on legal malpractice insurance for employed attorneys, see *"Legal Malpractice Liability of Employed Attorneys,"* by Dennis L. Frostic, Thomas A. Brusstar, and Suzanne Mitrovic (ACCA Docket, Fall 93) (http://www.acca.com/protected/pubs/docket/fall93/legalmal.html).

[12] See infra fn. 8 *"General Counsel Symposium: Directors in the Spotlight: Heightened Scrutiny and developments in Insurance and Indemnification Arrangements."*

[13] For thoughts on D&O Insurance strategies, see article titled *"Some thoughts on D&O Insurance Strategies—Post Enron,"* by Charles R. Lotter Executive VP, General Counsel & Secretary of J.C. Penney Corporation, Inc. See also infra f.n. 8 *"General Counsel Symposium: Directors in the Spotlight: Heightened Scrutiny and developments in Insurance and Indemnification Arrangements;"* see article titled *"Loss Prevention: Should a Nonprofit Carry D&O?"* by Hays Companies at http://nadco.haysaffinity.com/loss_prevention_1.aspx. In addition, for an overview on D&O Insurance, see *"Directors and Officers Liability Insurance Overview,"* by David M. Gische and Vicki E. Fishman at http://profs.lp.findlaw.com/insurance/insurance5.html.

[14] See infra fn. 8 *"Comments of Chubb Group of Insurance Companies Re: SEC File No. 33-8150.wp; Implementation of Standards of Professional Conduct for Attorney;"* see also infra fn. 3 *"Cover Me;"* and fn. 1 *"The Law of Inside Counsel."*

[15] See infra fn. 10; see also infra fn. 3 *"Cover Me."* In addition, for an article on legal malpractice insurance for employed attorneys, see infra fn. 11 *"Legal Malpractice Liability of Employed Attorney."*

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- **By-Law Indemnity / Indemnification Agreement / D&O Liability Insurance:** by-law indemnity applies to officers, and provides that Board of Directors may grant rights to indemnification and advancement of expenses to employees of the corporation or its subsidiaries who are non-officers; Indemnification Agreements apply to attorney-officers; D&O Insurance applies to in-house lawyers who are also officers.
- **Indemnification Agreement / Employed Lawyers Professional Liability Insurance / D&O Liability Insurance:** indemnification agreement applies to any officer, director or employee by reason of being such; D&O Insurance applies to managers or employees; Employed Lawyers Professional Liability Insurance is for the sole in-house lawyer.
- **By-law Indemnity / D&O Liability Insurance / Errors & Omissions Insurance:** by-law indemnity applies to officers, directors and employees *to the fullest extent permitted by cited sections of the applicable State's insurance code;* D&O Insurance applies to General Counsel and attorney-officers; Errors & Omissions Insurance is currently available for in-house lawyers who litigate claims on behalf of insureds.
- **By-Law Indemnity / Indemnification Agreements/ D&O Liability Insurance:** by-law indemnity applies to officers, directors, and employees *to the extent permitted by General Corporations Law of Delaware;* Individual Indemnification Agreements are provided to board members and to some officers; D&O Liability Insurance applies to attorney-officers.
- **By-Law Indemnity / D&O Liability Insurance with added coverage:** by-law indemnity applies to directors, officers, employees, and agents (also says indemnity is a contract right and allows for advancement of expenses to the fullest extent allowable under Del. General Corporation Law); D&O Insurance includes added coverage for all in-house lawyers in certain situations.

THEMES

Some themes emerged from discussions with companies about their programs:

- **Indemnification:** all of the companies described some form of indemnification provided by their company. Six of the eight companies have an indemnification provision in the company's by-laws. Two companies described stand-alone indemnification policies or agreements that cover broad categories of individuals. Two companies described additional indemnification agreements for officers.
- **Scope of Indemnification:** some company indemnification provisions provide that the indemnity is to the extent permitted by or the fullest extent allowable under a cited State's law; some indemnification provisions provide that the indemnity is to the extent required by a cited state's law; other indemnity provisions create different obligations depending on whether the person seeking the indemnity is an officer or an employee.
- **Persons Covered by Indemnity Provision:** companies described a range of provisions. Each company representative shared that in-house lawyers would likely be covered by virtue of their status as employees. Some company provisions extend indemnification to covered persons (former, current or future); some extend indemnifications to the heirs, executors or administrators of covered persons.
- **Indemnification Coverage for services provided to other corporations or organizations at the request of the corporation:** some indemnification provisions expressly stated that the indemnity would apply to services for other entities if the covered individual was serving at the request of the corporation.
- **Good Faith Conditions on Indemnity:** several companies described provisions that granted an indemnity provided that the covered person was acting in good faith and in a manner reasonably believed to be in or not opposed to the best interest of the company.
- **Advancement of Expenses Under Indemnity:** many described their indemnification provisions as allowing for advancement of costs or expenses; some said that undertakings might be required for at least some employees as a condition of advancement of expenses.
- **Costs Covered by Indemnity:** many indemnification provisions list a broad range of costs that would be covered. Coverage for fines and penalties is expressly included in several provisions.
- **Indemnity as a Contract Right:** some of the by-law provisions expressly state that the indemnity provision in the by-laws shall be deemed to be a contract.
- **Process for Obtaining Indemnity Coverage:** some of the indemnification provisions and policies define a process for invoking indemnification protection.
- **Insurance Protections:** all of the companies described having D&O Liability Insurance; one company also had Employed Lawyers Professional Liability Insurance; one company had an Errors & Omissions Insurance Policy in addition to the D&O.
- **D&O Insurance Covered Persons:** some companies described adding coverage for persons in addition to directors and officers. One company added protections for all in-house lawyers for certain types of securities claims, and for certain named attorneys providing internal certifications relating to the required financial statement certification under Sarbanes-Oxley. Another company added coverage for all in-house lawyers. Some companies described D&O policies that cover any employee, or managers and employees.
- **No professional services exclusions in D&O:** none of the company representatives identified express policy exclusions for professional services. However, one company shared that recent communications with the company's carrier have caused the company to evaluate and review this issue.
- **Insurance Process More Rigorous:** several companies described recent experiences bidding and renewing D&O Insurance as more rigorous than before and involving due diligence efforts that included providing information to prospective carriers on corporate governance programs.
- **Insurance Premiums Increasing:** several companies stated that insurance premiums have increased, and that it may be more difficult/costly to retain existing terms of coverage.
- **Insurance Coverage for Fines/Penalties Excluded:** most of the companies stated that D&O coverage excluded fines or penalties.

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- **Communications on Coverage:** most of the companies stated that there aren't formal programs or initiatives to communicate coverage to employees or in-house lawyers generally. Some companies stated that in-house lawyers have received communications about coverage as part of broader communications about Sarbanes-Oxley obligations.

III. PROGRAM SUMMARIES

Following are summaries from discussions with the eight companies about their programs.

Fortune 100 Retail Company

Organized under Delaware law, this Fortune 100 Retail Company has a combination of indemnification and insurance protections that would be available to in-house lawyers in the event that they are involved in a lawsuit or action relating to services performed for the company. More specifically, the company's By-Laws include an indemnification provision that states that the company will indemnify officers, directors, and employees for actions taken in good faith to the extent required by Delaware law. In addition, the company has a Directors & Officers (D&O) Insurance Policy that would be available to provide protections to in-house lawyers who are also officers of the company.

An Associate General Counsel for the company explains that the company recently went through an extensive effort to competitively bid its D&O Insurance Policy. The previous D&O Policy had been in place at a fixed price for five years. An RfP was prepared and an insurance broker was engaged to assist with the bidding process and validating market assumptions. The overall process was described as rigorous and involved due diligence requests for information on corporate governance and internal controls programs. The end result was that the company was able to maintain its existing insurance terms and obtain a one-year policy-- but at an increased cost.

Asked about emerging issues of concern regarding liability exposure for in-house lawyers, the company's Associate General Counsel explains her views on some statements by others regarding D&O insurance, and assertions regarding coverage for attorney-officers in their capacities as officers but not as in-house lawyers. More specifically, she emphasizes her view that "professional liability isn't a proper exclusion for a D & O Insurance Policy because officers who have professional expertise are officers primarily for such expertise. Our policy doesn't have an express professional services exclusion, and I doubt that such an exclusion would be inferred under insurance law precedents requiring any exclusions to be expressly stated."

Additional emerging issues identified by the company's Associate General Counsel include concerns about in-house lawyer liability for cases involving whistle-blowing lawyers with their own agendas. Another area of concern involves the notion that reasonable lawyers can disagree on interpretations of legal requirements, and the possibilities that in-house lawyers might find themselves subjects of suits or actions because of such reasonable disagreements.

INDEMNIFICATION IN BY-LAWS

As stated above, the company's By-Laws include an indemnification provision that extends an indemnity to all officers, directors and employees of the company for actions taken in good faith. The indemnity covers actual and reasonable expenses incurred in connection with civil or criminal claims, with some conditions. In addition, with the same conditions, the indemnity would cover liability even if the employee ultimately loses the suit, provided that the employee's actions were taken in good faith.

The company's Associate General Counsel notes that indemnification to the extent included in the company's By-Laws is discretionary pursuant to Delaware corporate law, but is not required. She shares that the company has had an indemnification provision included in its By-Laws for over 10 years, and that the provision is re-examined on a periodic basis.

D&O INSURANCE POLICY

The company's D&O Insurance Policy is administered by its Risk Management Group. As stated above, the company's previous D&O Policy had been in place for five years (a three-year policy with a 2-year renewal) at a fixed cost. That policy is described by the company's Associate General Counsel as "a good policy from the standpoint of the insured."

Within the past year, the company competitively bid its D&O Insurance and listed requested coverage criteria in its RfP materials. In-house counsel played a key role in developing the RfP documentation and advising the Risk Management Group on the process. Asked about the length of time to develop the RfP documentation, the company's Associate General Counsel shares that it took around 30 days to draft and finalize. A sample copy of the Table of Contents for the RfP document may be accessed via link in the Resource List in Section IV of this Profile. The overall competitive bid process took around an additional 60 days, and included a 30-day due diligence period during which the company had an opportunity to share information on compliance, corporate governance, and internal controls.

Key features of the D&O Insurance include:

- **Broad definition of insureds:** the definition includes coverage for directors and officers of the company and its subsidiaries against all losses incurred in actions brought against them by reason of their office. In addition, directors and officers of the company serving on external non-profit organizations are also covered if the company has asked them to provide these services. The policy does not contain an express professional services exclusion.

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- **Relatively narrow exclusions:** exclusions are generally limited to situations involving deliberate dishonesty. The policy also excludes damages relating to discharge of pollutants.
- **No deductibles for individual insureds**
- **Advancement of defense costs and right to select counsel**
- **Triggers:** events giving rise to claim may occur before or during the policy period
- **Choice of law and dispute resolution method addressed**

COMMUNICATIONS

Asked how the forms of coverage are communicated within the company, the Associate General Counsel explains that directors are periodically formally apprised of protections afforded by the company's D&O Insurance policy at meetings of the Board of Directors. In addition, information on D&O coverage is provided to company officers at the time they become officers, and updated information is provided if significant changes to coverage occur.

Asked whether more questions are being raised by in-house lawyers about company protections in light of recently publicized high-profile litigation involving other companies, the Associate General Counsel shares that there haven't been many questions specifically asking about company liability protections. However, the company recently provided information to executives, middle management and in-house lawyers as part of its broader Sarbanes-Oxley training initiatives, and included information on available forms of coverage during those sessions. In-house lawyers played a key role in helping to develop the Sarbox training sessions. "Our company has a robust SEC group, and our Sarbox programs were developed in-house."

Major Specialty Retailer

In-house lawyers at this publicly-traded major specialty retailer number around 30, with all lawyers ultimately reporting into the company's Chief Administrative and Legal Officer. The company has two forms of protections available to in-house lawyers in the event that they are involved in a lawsuit or action relating to services provided for the company: Indemnification from the company; and Insurance coverage pursuant to a Directors & Officers (D&O) Insurance Policy.

The company's Chief Administrative and Legal Officer (CLO) shares that the indemnification policy was put in place by the company's Board of Directors in 1996, and that covered persons include but are not limited to in-house lawyers. In addition, the CLO explains that the company's D&O Policy was amended three years ago at no additional premium to expressly include coverage for all in-house lawyers (an expansion from traditional policy provisions that might only cover in-house lawyers who are also officers). That D&O Policy was recently renewed in December 2003, and although some of the coverage at some levels may apply to all in-house lawyers, many of the insurance coverage provisions primarily apply to in-house lawyers only if they are also officers of the company. . The CLO explains that the rationale for eliminating express coverage at some levels for all in-house lawyers generally is due to the broad scope of the indemnity that would run to all in-house lawyers.

INDEMNIFICATION POLICY

The company's By-laws include a provision titled "Indemnification of Directors, Officers, Employees and Agents." The provision states that the indemnity is a contract right. Under this policy, indemnified costs include expenses (including attorney's fees), judgments, fines and amounts paid in settlement, actually or reasonably incurred, and allow for advancement of defense costs to any officer or director to the full extent allowable by Section 145 of Delaware Corporation Law. The CLO states that costs in connection with fraudulent or illegal activity would be excluded from the indemnity. A copy of the By-Law provision may be accessed via link in the Resource List included in Section IV of this Profile.

Asked whether the company communicates the Indemnification Policy to its in-house lawyers, the company's CLO explains that information on this protection is communicated as part of an individual's overall orientation to the company.

DIRECTORS & OFFICERS INSURANCE

As stated above, about three years ago the company amended its D&O Policy to expressly include coverage for all in-house lawyers. The company's CLO shares that the amendment didn't require a large premium increase. In December 2003, the company renewed its D&O Policy and amended a number of its terms. The CLO explains that marketplace conditions drove the company to re-evaluate some of the terms and conditions included in the previous D&O Policy, and that the renewed policy includes a number of revised terms.

OTHER CONSIDERATIONS; EMERGING ISSUES

Asked whether the company considered the possibility of obtaining employed lawyers insurance, the CLO shared that the company hasn't procured Employed Lawyers Professional Liability Insurance since the indemnification policy would address costs that may be incurred by in-house lawyers. As for any concerns about emerging liability issues and in-house lawyer liability, the CLO describes his company as diligent, with a strong culture of integrity, and as having one of the highest corporate governance ratings of any fortune 500 company. He explains that, while he doesn't have any specific concerns about issues for his company, he believes that in a broader sense "in-house lawyers should be more concerned about implications of recent litigation, and about confidentiality issues and issues that may relate to noisy withdrawal proposals if they are adopted."

Multinational Chemical Company

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This public company's indemnification and insurance protections for in-house lawyers include: an indemnity in the company's By-Laws; and insurance coverage pursuant to the company's Directors & Officers Insurance Policy. The company's By-Law indemnity provision is described by the company's Vice President General Counsel & Secretary (General Counsel) as "very broad, offering the fullest protections allowable under Delaware law." The Directors & Officers Insurance Policy also offers broader coverage than some traditional D&O Policies might provide. More specifically, the company's D&O Policy has been expanded to cover all in-house lawyers for certain types of securities claims. In addition, the Policy would cover certain defined in-house lawyers who sign internal certification statements relating to financial certifications under Sarbanes-Oxley.

The company recently renewed its D&O Policy. "The most recent renewal process was more rigorous than past annual renewals and included due diligence inquiries relating to corporate governance programs," explains the company's General Counsel. The company's D&O Policy is administered by its Risk Management Group, and efforts to renew the Policy were led by that group in coordination with the company's General Counsel.

INDEMNIFICATION IN BY-LAWS

The company's by-laws include an agreement to indemnify any officer, director or employee of the company for activities undertaken in the course of their employment when sued for work in their capacity as a company employee. The company's General Counsel explains that the indemnity provision is very broad and has been in place for at least 5 years. In-house lawyers providing services for the company would be able to seek protections pursuant to this provision. A copy of the indemnity provision included in the company's by-laws may be accessed via link in the Resource List in Section IV of this Profile.

Asked what types of costs would be covered pursuant to this indemnity, the General Counsel shares that it would cover all "expense, liability and loss (including attorneys' fees, judgments, fines, ERISA excise taxes or penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered." In addition, the General Counsel notes that defense costs could also be advanced. Coverage for actions, suits or proceedings relating to external services, such as pro bono services, performed at the request of the company or for the benefit of the company would also be covered. The indemnification provision in the By-Laws states that the right to indemnification pursuant to the By-laws shall be a contract right. The indemnity provision also establishes procedures for making claims, and enables a claimant to request that Independent Counsel be appointed to determine entitlement to indemnification.

DIRECTORS & OFFICERS INSURANCE POLICY

The company's D&O Policy consists of multiple "sides" that define various types of coverage. "Side A" coverage defines insurance protections directly available to covered individuals. Side B coverage allows the company to make claims against insurance for expenses in defending directors, officers, or employees. Side C coverage relates to securities issues. Side D coverage applies to fiduciary liabilities for employee benefit plans.

Are all in-house lawyers covered under the D&O Policy? All in-house lawyers who are also officers of the company would be considered covered persons under this policy. In addition, all in-house lawyers would be covered for certain types of securities claims. The policy also covers certain defined individuals that include in-house lawyers who sign internal certifications relating to the required financial statement certification under Sarbanes-Oxley. The company's General Counsel explains that the company is currently evaluating whether the scope of coverage may be expanded during the next renewal to include all in-house lawyers generally. Asked whether the policy excludes coverage for lawyers providing professional services to the company (e.g., providing services as lawyers), the General Counsel explained that the policy does not provide for such an exclusion.

What types of costs are covered? Covered costs include defense costs, settlements and judgments. Costs for fines and penalties or for punitive damages are not covered where they are not insurable by law. Asked whether successful adjudication on the merits is a pre-requisite for coverage, the response was "no; generally coverage applies unless there is a final adjudication as to conditions for which coverage is excluded."

The company's D&O Policy has been in place for a long time, and is currently renewable annually. The company's General Counsel shares that the most recent renewal process was more rigorous than in past years, and included inquiries from insurers about the company's corporate governance programs. In addition to increased interest in corporate governance, renewal costs also increased. And, the company's General Counsel shared that it may become harder and harder each year to renew on the same terms.

Large Non-Profit Enterprise

This large, non-profit enterprise (Enterprise) has an in-house law department of 9 lawyers reporting to its General Counsel. Asked about what forms of protection might be available to in-house lawyers if they are involved in a lawsuit or action relating to their services for the Enterprise, the General Counsel described two key forms of coverage: (1) an Indemnification Policy; and (2) a Directors & Officers Liability Insurance Policy.

Both the Indemnification Policy and the Directors & Officers Liability Insurance Policy (D&O Policy) apply to broad categories of individuals, including in-house lawyers. Both forms of coverage have been in place for many years (at least 22 years for the indemnification policy, and at least 15 for the D&O Policy), and are described as having evolved over time. Within the past three years, the General Counsel led an effort to evaluate the Indemnification Policy. This initiative resulted in some enhancements that are described as making broader protections available to covered individuals.

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The Enterprise's Office of General Counsel oversees matters relating to the Indemnification Policy, and also works closely with the Enterprise's Office of Risk Management on evaluating matters that may trigger protections under these programs.

INDEMNIFICATION POLICY

As stated above, the Enterprise's Indemnification Policy has been in place for many years. Several years ago, the Enterprise re-evaluated and enhanced its policy. The effort was led by the Enterprise's General Counsel, and included consulting with outside lawyers specializing in insurance and indemnification matters, and benchmarking programs at other non-profit enterprises to develop the enhanced and updated version of the Policy that exists today.

Some key features of the Indemnification Policy are highlighted below. (A copy of the Enterprise's Indemnification Policy may be accessed via link in the Resource List in Section IV of this Profile.)

- **Scope of Individuals Covered:** The scope of the individuals covered under the policy is very broad. It includes broad categories of individuals (including any employee) serving the company in various capacities. In addition, it covers persons who serve in various capacities on external enterprises or entities as part of their official company duties. The Enterprise's General Counsel explains that the latter portion of the definition regarding external services was added as part of the recent enhancement effort to help clarify that individuals who perform services for external organizations as part of official company duties are covered by the indemnification policy.
- **Indemnification:** The scope of the indemnity is also described as broad, applying to "any covered person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative, arbitrative or investigative…." In addition, indemnified expenses include "expenses (including attorneys' fees), judgments, fines, penalties, and amounts paid in settlement actually and reasonably incurred by him or her in connection with such action, suit or proceeding…."
- **Conditions:** The indemnity is available if the covered person "acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the company, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful." The General Counsel shares that the phrase "or not opposed to the best interests of the company" was added as part of the recent enhancement effort. In addition the indemnification section lists provisos stating that indemnification will not be made for actions involving intentional, willful or reckless misconduct or gross negligence in performing duties, unless and only if a court of competent jurisdiction determines that the covered person is fairly and reasonably entitled to the indemnity.
- **Additional indemnity if successful on the merits:** The policy also provides for indemnification, notwithstanding other provisions in the policy, if a covered person is successful on the merits or otherwise.
- **Procedure:** The policy includes a procedure for notifying the Office of General Counsel in order to benefit from the policy. The procedure requires that notifications be made within 5 business days of receipt of notice that the person is or is threatened to be made a party.
- **Advancement of Expenses:** The policy includes a provision on advancement of expenses.

DIRECTORS & OFFICERS LIABILITY INSURANCE POLICY

This form of coverage is principally administered by the Enterprise's Office of Risk Management. In the event of a claim or issue that may be made pursuant to this policy, the Enterprise's Acting Risk Manager explains that the Office of Risk Management would investigate claims under either the indemnification policy or the insurance policy and would coordinate with the Office of General Counsel to evaluate and administer appropriate coverage.

The Enterprise's Acting Risk Manager describes the scope of covered persons as "any employee who has been, now is or shall be working for the non-profit enterprise as long as the individual is/was/will be working within the scope of his or her employment or under the management of a Director or Officer of the Enterprise."

Asked whether the policy recites any exclusions for professional services, the Acting Risk Manager states that there are no such exclusions. Covered costs under the Enterprise's insurance policy would include defense costs and settlement costs. Costs for fines and penalties would also be covered.

COMMUNICATIONS ON COVERAGE

Asked how these policies are communicated, the General Counsel shares that they aren't formally and broadly communicated. However, both the General Counsel and the Acting Risk Manager explain that if an inquiry is made or an issue that may trigger the protection arises, the policies are communicated and, in the case of the indemnification policy, a copy of the policy is provided. As for in-house lawyers, the indemnification policy has been communicated to them since the Enterprise's Office of General Counsel administers the indemnification policy. In addition, the General Counsel shares that the law department has internal guidelines for administering the policy, and in-house lawyers have and work with these guidelines.

Private Aerospace Company

This private aerospace company has a small in-house law department of two lawyers, one of which is an officer of the company. Its liability protections for in-house lawyers are described as a combination of indemnification and insurance. The indemnity component

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stems from an indemnification provision in the company's By-Laws that extends to officers, directors and employees of the company. A Directors & Officers (D&O) Liability Insurance Policy provides coverage to officers of the company, which includes any in-house lawyers who are also officers.

The company's D&O Policy is renewable on an annual basis, and the premiums for comparable coverage increased last year by around 25%. In addition, the General Counsel says that the process for obtaining D&O coverage as "significantly more difficult" than in prior years. More specifically, the General Counsel explains that insurance underwriters are conducting rigorous due diligence and asking detailed questions that had never previously been asked.

INDEMNIFICATION

The By-Law indemnification provision is described as broad and having been in place for about 40 years. The indemnity states "[t]he corporation shall indemnify its officers, directors, employees and agents to the extent permitted by the General Corporation Law of Delaware." (A copy of the indemnification provision may also be accessed via link in the Resource List included in Section IV of this Profile.) Asked about the types of costs that would be covered, the General Counsel shares that the company has no policies or procedures that either give affected individuals notice of this indemnity protection or provide any more detail about which costs will be indemnified. Board Directors and one or two officers have individual agreements with the company that may include more detailed indemnity protection. The General Counsel shares that there haven't been requests from employees for information about protections generally, and that there isn't an organized formal program for communicating the indemnification coverage.

DIRECTORS AND OFFICERS INSURANCE

The company's D&O Liability Policy applies to claims for wrongful acts of a director or officer of the corporation while acting in their respective capacities as duly elected or appointed directors and officers. "Wrongful act" is defined to include "any breach of duty, neglect, error misstatement, misleading statement or omission by the insureds alleged by any third party claimant solely by reason of their being directors and officers of the corporation." Losses paid by the policy include defense expenses as well as judgments and settlements. Fines or penalties are excluded. Additional policy exclusions are enumerated within the policy. The policy does not expressly exclude coverage for professional services.

QUESTIONS ASKED DURING INSURANCE RENEWAL

As stated above, the company's most recent renewal efforts included due diligence on the part of underwriters, asking more detailed questions than had been asked in prior annual renewal efforts. Questions included:

- Request for information regarding layoffs/facility closings, including reasons for the foregoing and information on anticipated layoffs or closings. Additional details relating to whether labor counsel was consulted and release agreements were signed were also requested.
- Questions regarding profitability and losses
- Questions regarding major customers and material changes experienced or anticipated
- Questions regarding account receivables and reserves
- Questions regarding process for plant divestitures or closures, including use of counsel and governmental inquiries

CONSIDERATIONS; EMERGING ISSUES

Asked whether the company has considered adding Employed Lawyers Professional Liability Insurance to the forms of coverage available to in-house lawyers, the General Counsel shares that it has not.

<u>Private Commercial Property & Casualty Insurance Company</u>

This private company has two groups of in-house lawyers that ultimately report into its General Counsel: three lawyers are assigned to the company's corporate legal department, and ten lawyers are assigned to another department and litigate claims on behalf of policy-holders. Five of the company's lawyers, including the company's General Counsel, are also officers of the company.

Asked about the types of indemnification or insurance coverage that would be available to in-house lawyers if involved in a lawsuit or action regarding services for the company, the company's General Counsel explained that the company has had a combination of indemnification and insurance in place for more than 20 years. The company's By-Laws provide for indemnifications to officers, directors and employees. Insurance programs include: Directors & Officers Insurance; and Errors & Omissions Insurance.

INDEMNIFICATION

The company's By-Laws provide an indemnity for current and former Directors, officers, employees and agents to the fullest extent permitted by the State's insurance code. In addition, the By-Laws provide that the corporation will indemnify, to the fullest extent permitted by the State's insurance code, any person who is serving or who has served at the corporation's request as a Director officer, employee or agent of another corporation. As employees, in-house lawyers would benefit from these protections.

The scope of indemnification coverage applies to defense costs incurred in defending "a civil, criminal or administrative or investigative action, suit or proceeding (including all appeals) or threat thereof." The By-Laws provide that defense costs may be advanced as authorized by the Board of Directors and to the fullest extent permitted pursuant to the state's insurance code. An example of the indemnification provision from the company's By-Laws may be accessed via link in the Resource List included in Section IV of this Profile.

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FORMS OF INSURANCE

The company's General Counsel explains that the company has an Errors & Omissions ("E&O") insurance policy that would cover actions of the company's in-house lawyers who litigate claims on behalf of policyholders. Following recent communications with the company's Directors & Officers Insurance carrier, the company is also evaluating enhancing its existing E&O policy to add in-house lawyers from the company's corporate law group.

As stated above, the company's Directors & Officers Insurance Policy would apply to in-house lawyers who are also officers of the company. The insurance is described as covering the General Counsel's actions in the capacity of the company's General Counsel and as an officer. For other attorney-officers, while it is described as clear that their actions involving business and management responsibilities as officers would be covered, recent communications with the company's D&O insurance carrier have led to additional discussions about whether attorney-officers would be covered under the D&O Policy for providing legal services. In light of these discussions, the company is evaluating enhancing its Errors & Omissions policy to address any potential gaps.

COMMUNICATIONS

Although the company hasn't instituted a program to formally communicate these coverages to all employees, the General Counsel explains that information would be provided in response to any requests or inquiries by employees. An exception is that directors are provided with a copy of the D&O Insurance Policy. Asked whether she has noticed an increase in questions from in-house lawyers about coverage that might be available to them, the General Counsel explains that this has not been the case. She also adds that it is useful to find a good independent insurance agent to help negotiate provisions on a company's behalf.

Privately-held Manufacturing Company with 1,000 Employees

The General Counsel and sole in-house lawyer for this privately-held manufacturing company describes available liability coverage as a combination of indemnification and insurance. More specifically, coverage components include: Officer, Director and Employee Indemnification Agreement; Employed Lawyers Professional Liability Policy; and Directors & Officers (D&O) Liability Insurance Policy.

INDEMNIFICATION AGREEMENT

The General Counsel describes the company's indemnification policy for officers, directors, and employees as broad. The policy was developed in 2000, and key features are summarized below. A copy of the policy (identifying information redacted) may be accessed via link in the Resource List in Section IV of this Profile.

- **Indemnified party:** applies to "any former, present or future director, officer or employee of the company or the legal representative of [the same] …by reason of such person being or having been such director, officer or employee."
- **Types of Proceedings:** includes any civil, criminal, administrative, or arbitrative action (pending, threatened or completed) and any appeal or inquiry or investigation that could lead to the same.
- **Costs may be paid in advance:** may be paid in advance of final disposition if authorized by a majority of the board of directors not parties to the matter; provided that an undertaking is made to repay advanced costs unless it is ultimately determined that the party is entitled to the indemnity.
- **Types of costs:** defined broadly to include costs, disbursements, attorneys fees, amounts paid in satisfaction of settlements, judgments, fines and penalties.
- **Conditions:** person must have acted in good faith and in a matter reasonably believed to be in or not opposed to the best interests of the company (for criminal proceedings—had no reason to believe conduct was unlawful)
- **Exclusions:** for proceedings by or in the right of the company, no indemnity is available for person adjudged by any court to be liable for intentional or gross misconduct, except as and to the extent determined by the court.

D&O LIABILITY INSURANCE

The company's General Counsel is also an officer of the company. Asked whether the D&O Liability Insurance policy excludes coverage for services rendered in professional capacity as General Counsel (rather than as an officer), the General Counsel states that it does not. The General Counsel explains that the company has had a D&O policy in place for quite some time and that there has recently been a large premium increase for this coverage, so the company is currently evaluating options with other carriers.

The policy defines insureds as managers or employees. The policy lists a number of exclusions, including those of an insured person serving as a director, officer, trustee, regent, governor or equivalent executive, or as an employee of any other entity even if such service is at the direction or request of the insured entity. An exception to this exclusion is for services to outside entities that are specifically listed as an endorsement, or for services for a not-for-profit corporation, or certain other 501(c)(3) entities or religious or charitable not-for-profit organizations, provided that the outside service is at the request of or with knowledge and consent of the company.

Costs covered under the D&O Policy include defense costs (reasonable and necessary legal fees and expenses), investigation costs, damages, settlements, judgments, and pre- and post-judgment interest. Also covered are punitive and exemplary damages where insurable by law. Salary and wages are not covered. Also excluded are taxes, fines, or penalties imposed by law and non-monetary relief.

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EMPLOYED LAWYERS PROFESSIONAL LIABILITY INSURANCE

Another form of insurance coverage available to this General Counsel is Professional Liability Insurance. The General Counsel shares that the insurance has been in place for around 4 years, and that premiums have increased. Asked why the company has secured Employed Lawyers Professional Liability Insurance in addition to the D&O Liability Insurance and the Indemnification policy, the General Counsel explains that this coverage is a bit of "bootstrapping," but that it also would cover claims for professional services to officers or directors, for joint ventures, and for opinions to lenders. In addition, the General Counsel notes that the insurance provides an additional outside source of funding for liability claims.

The policy lists around 18 types of exclusions, including exclusions for securities-related violations under the '33 or '34 Acts. Claims for fines, sanctions, penalties, punitive damages, and for exemplary damages are also excluded.

Public Technology Company

The in-house law department for this public technology company includes around 75 lawyers. When asked about the forms of liability protections for in-house lawyers, the company's General Counsel identified three forms of protections that would be available to in-house lawyers who are also officers of the company, and an additional form of protection that would be available to any company employee or agent, including all of the company's in-house lawyers.

More specifically, lawyers who are also officers of the company would have the following types of liability protections: Directors & Officers (D&O) Insurance; Indemnification Agreements; and Indemnification described in company By-Law provisions. In addition, the company's General Counsel explains that all in-house lawyers may seek indemnification pursuant to protections available to company employees or agents generally pursuant to Section 78.7502 of Nevada's General Corporation Law.

FORMS OF COVERAGE FOR LAWYERS WHO ARE CORPORATE OFFICERS

As stated above, in-house lawyers who are also officers of the company have the following forms of coverage available to them: D&O Insurance; individual indemnification agreements; and indemnification pursuant to the company's by-laws.

- **D&O Insurance:** The company has a D&O insurance policy for directors and officers of the corporation. In-house lawyers who are also officers of the company may seek protection pursuant to this policy. The policy does not specifically exclude coverage for professional services or for claims against corporate officers arising out of their duties as attorneys. The policy allows for advancement of defense costs, and covers judgments, settlements and defense costs and expenses such as reasonable attorneys' fees. Excluded are coverage for fines and penalties, or for matters involving improper personal gain or involving any fraudulent or criminal act committed with actual knowledge of its wrongful nature or with intent to cause damage.
- **Indemnification Agreements:** Directors and Officers of the company may also have individual indemnification agreements in place. In-house lawyers who are also officers of the company have coverage under such an indemnification agreement. The General Counsel explained that these agreements typically include coverage for all claims arising from any act, omission or neglect or breach of duty, while acting in the capacity as an officer of the company or an affiliate, to the extent not covered by insurance or other indemnity. These agreements also exclude coverage for claims arising from dishonesty, improper personal gain or profits from short-swing securities trading violations. Costs and expenses of defense are advanced, upon the officer's written undertaking to repay same if ultimately determined not entitled to indemnification; provided, however, that no such advance occurs if disinterested Directors, or independent legal counsel, finds that it is more likely than not that the officer will be found not entitled to indemnification.
- **By-laws:** The company's by-laws expressly provide that officers shall be indemnified to the fullest extent allowable by applicable law. The indemnity covers all loss, liabilities and expenses, including judgments, fines, penalties, attorneys' fees and settlement amounts, reasonably incurred in connection with any suit or proceeding arising from actions allegedly taken or omitted in the capacity of an officer, or in any other capacity while serving as an officer. Expenses are to be paid as incurred, upon the officer's written undertaking to repay same if found not entitled to indemnification. The by-laws also allow the Board of Directors to grant rights to indemnification and advancement of expenses to employees of the corporation or its subsidiaries who are non-officers, such as other in-house attorneys.

FORMS OF COVERAGE FOR IN-HOUSE LAWYERS GENERALLY

All in-house lawyers, whether or not also officers of the corporation, may benefit from mandatory indemnification protections available to all company employees or agents pursuant to Nevada's General Corporation Law (Nevada Revised Statutes Section 78.7502; following is a link to the referenced section of the Nevada statutes: http://www.leg.state.nv.us/NRS/NRS-078.html#NRS078Sec7502). More specifically, Section 78.7502 titled: "Discretionary and mandatory indemnification of officers, directors, employees and agents" provides for permissive and mandatory indemnification under certain circumstances. The General Counsel of this company explains that the although the company's by-laws do not extend mandatory indemnification generally to company employees or in-house lawyers, such indemnification may be available pursuant to the relevant subsection of 78.7502 describing mandatory indemnifications.

The mandatory indemnification provisions of Section 78.7502 (3) provide for indemnification of expenses, including attorneys' fees and fines, if successful on the merits or otherwise, in defense of any action, suit or proceeding described in subsections

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(1) or (2) (e.g., the discretionary indemnification subsections) of Section 78.7502. For indemnification to be available, the individual seeking the indemnification must have "acted in good faith and in a manner which he or she reasonably believed to be in or not opposed to the best interest of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful". In addition, in the case of employees who are also officers, the indemnity shall not be available in actions by the corporation or in shareholders' derivative actions, if the officer is found liable to the corporation or its shareholders, for any act or failure to act in his capacity of an officer (See NRS 78.7502 NRS 78.138, which provides that officers are not liable to the corporation or shareholders for damages as a result of any act or failure to act unless the act or failure to act constituted a breach of the fiduciary duties of an officer, and the breach of those duties involved fraud, misconduct, or a knowing violation of law.).

COMMUNICATIONS ON FORMS OF COVERAGE

Asked how matters that may give rise to possible coverage may be communicated to in-house lawyers, the company's General Counsel explained that an email was recently sent to lawyers addressing expectations pursuant to Sarbanes-Oxley. In addition, the General Counsel shared that this issue was addressed globally around four years ago when the company studied its existing forms of coverage and evaluated the need for additional forms of coverage and determined that no additional coverage was warranted.

EMERGING LIABILITY ISSUES/CONCERNS

Asked about concerns regarding liability for in-house lawyers, the company's General Counsel shared that the Pereira case is of particular concern (See Pereira v. Cogan, 2003 U.S. Dist. LEXIS 7818 (S.D.N.Y. May 12, 2003). Remarking further, the General Counsel shared that the Pereira case ventures into dangerous waters in finding a company's General Counsel liable for matters involving improprieties by others which he may know nothing about.

LEADING PRACTICES

Asked which elements of the company's approach to establishing forms of protections the General Counsel would consider to be leading practices, the General Counsel explained that the indemnity protections guaranteed under Nevada law provide significant and meaningful protection for the in-house attorneys, and that the bylaws also permit the Board of Directors the flexibility to provide further indemnification.

****

ACC thanks Renee Dankner, former senior counsel to Mobil Oil Corporation, for her work on this profile.

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IV. RESOURCE LIST

Please note that this listing does not constitute a recommendation or endorsement for any product, service or company. Please find below a list of resources identified by companies or by ACC as possible resources that may be helpful or of interest in evaluating or developing coverage programs for in-house lawyers.

ACC Alliance Partner – Chubb Specialty Insurance
ACC has chosen Chubb to offer members the purchase employed lawyers liability insurance designed specifically for in-house counsel. For more information and contacts, please go to http://www.acca.com/practice/alliance.php#chubb.

EXAMPLES OF COMPANY INDEMNIFICATION PROVISIONS

Major Specialty Retailer: By-Law Indemnity
http://www.acca.com/protected/forms/governace/dol_rfp.pdf

Multinational Chemical Company: By-Law Indemnity
http://www.acca.com/protected/forms/governance/indem_chemical.pdf

Nonprofit Enterprise: Indemnification Policy
http://www.acca.com/protected/forms/governance/indem_nonprofit.pdf

Private Aerospace Company: By-Law Indemnity
http://www.acca.com/protected/forms/governance/indem_aerospace.pdf

Private Commercial Property & Casualty Insurance Company: By-Law Indemnity
http://www.acca.com/protected/forms/governance/indem_by-law.pdf

Private Manufacturing Company: Indemnification Policy
http://www.acca.com/protected/forms/governance/indem_manufactur.pdf

Additional By-Law Indemnification Policy:
http://www.acca.com/protected/forms/governance/indem_policy.pdf

ARTICLES; PUBLICATIONS

"*The Law of Inside Counsel"* by Saul, Ewing, Remick & Saul LLP
(http://www.acca.com/protected/legres/program/newjersey/upl.html)

"*Individual Liability for the Corporate Lawyer"* by Mark D. Nozette, Susan J. Lawshe, and John K. Villa
(http://www.acca.com/education99/cm99/pdf/704.pdf)

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"*Naked As A Jaybird,"* by Eriq Gardner (Corporate Counsel, 9/1/03)
(http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1061306535093)

"*Another GC Readies for Trial,"* by Jason Hoppin (Corporate Counsel, 12/1/03)

"*Advocacy Alert: Latest Weapon of Plaintiffs' Bar, personal Liabiity Exposure for CLOs: Effects and Implications of Pereira v. Cogan,"* (ACC Docket, January 2004).
(http://www.acca.com/protected/pubs/docket/jan04/inbox.pdf)

"*Post-Enron Jurisprudence,"* by John Coffee (New York Law Journal, July 17, 2003)
(http://www.law.columbia.edu/media_inquiries/news/july_2003/coffee_nyljjuly)

"*Cover Me"* by Laurie J. Sablak (Corporate Counsel)
(http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1071719738502).

"*Does Your D&O Policy Cover Your In-house Legal Staff,"* (Willis Executive Risks Alert, October 2003)
(http://www.willis.com/news/publications/ER_alert.pdf)

"*General Counsel Symposium: Directors in the Spotlight: Heightened Scrutiny and developments in Insurance and Indemnification Arrangements,"* by Lois F. Herzeca, Robert E. Juceam, and William G. McGuinness of Fried, Frank, Harris, Shriver & Jacobson (Oct. 24, 2003)
(http://www.ffhsj.com/Symposium_Material/GC_fall_03/spotlight_main.htm; click on titled article)

"*Corporate Counsel Guidelines-Section 6.13,"* by John K. Villa
(http://www.acca.com/protected/legres/ccguidelines/sect613.html).

"*Legal Malpractice Liability of Employed Attorneys,"* by Dennis L. Frostic, Thomas A. Brusstar, and Suzanne Mitrovic (ACCA Docket, Fall 93)
http://www.acca.com/protected/pubs/docket/fall93/legalmal.html

"*Loss Prevention: Should a Nonprofit Carry D&O?"* by Hays Companies at
http://nadco.haysaffinity.com/loss_prevention_1.aspx.

"*Directors and Officers Liability Insurance Overview,"* by David M. Gische and Vicki E. Fishman
http://profs.lp.findlaw.com/insurance/insurance5.html

"*The CorporateProBono.Org Guide to Lgal Malpractice Insurance Options for Corporate Attorneys Involved in Pro Bono Work"*
http://www.cpbo.org/resources/archive/resource1274.html.

MISCELLANEOUS

White Paper: "*Some thoughts on D&O Insurance Strategies—Post Enron,"* by Charles R. Lotter Executive VP, General Counsel & Secretary of J.C. Penney Corporation, Inc.
http://www.acca.com/protected /article/governance/dol_strategy.pdf

"*Comments of Chubb Group of Insurance Companies Re: SEC File No. 33-8150.wp; Implementation of Standards of Professional Conduct for Attorneys"* (Dec. 17, 2002)
(http://www.sec.gov/rules/proposed/s74502/smfitzpatrick1.htm)

Report of the Examiner, Neal Batson, Enron Bankruptcy Case:
Full report: http://www.acca.com/public/article/corpresp/batsonreport.pdf
(this file is 6 MB)
Appendix C regarding specific roles of lawyers:
http://www.acca.com/public/article/corpresp/batsonappendixc.pdf
(this file is 12.2 MB)

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SEC AND CRIMINAL PROCEEDINGS AGAINST INSIDE CORPORATE COUNSEL

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I. Introduction and Summary

Over the past four years, there has been a stream of news reports describing SEC enforcement actions and criminal prosecutions of inside corporate lawyers. Many in the corporate bar have questioned whether there are in fact a large number of such actions against corporate lawyers or whether the news coverage exaggerates the frequency of these cases. A related question is whether there are common factors that have prompted these proceedings. If there are, of course, inside lawyers could take preventive steps to reduce their risks.

This analysis undertakes to answer both of these questions. For the first time, to my knowledge, all or virtually all SEC proceedings against inside counsel and the criminal prosecutions of inside counsel since 1998 are collected and described, thus quantifying these such actions. Although the reader can draw his or her own conclusions from the descriptions, the paper also attempts to distill common elements and themes from the cases.

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A. SEC Actions

The SEC has taken a dramatically different approach to inside lawyers than it has to outside counsel. Since the early 1980's, the SEC has declined to initiate enforcement action against outside counsel unless the lawyer has either been held civilly or criminally liable, or has been disciplined by the bar.[1] The SEC, however, pursues inside counsel without regard to whether there has been an independent finding of misconduct. These actions against inside counsel are collected and described in detail in Part II and are summarized in the following paragraphs.

Rule #1: The Top Lawyer is Nearly Always the Target. The most obvious common element in the SEC actions is that nearly all of them are brought against the chief legal officer of the company. The occasional case brought against a lawyer other than the chief legal officer usually involves the most senior lawyer in charge of a project or a disclosure document.

Rule #2: Inside Lawyers Who Relied On Outside Counsel Advice are Seldom SEC Targets. The factor most notable by its absence is that there are very few SEC enforcement actions where the defendant/respondent relied upon the advice of an outside law firm. One can divine from this fact either that inside lawyers who rely upon outside counsel rarely make mistakes or, what's more likely, that where the SEC finds that inside counsel followed the advice of an outside law firm, successful enforcement action would be unlikely. We think the latter is surely the correct conclusion and that the inside lawyers' "advice-of-outside-counsel" defense must have a significant impact on the exercise of enforcement discretion.

Rule #3: Putting Money in Your Pocket is Not Necessary to Prompt SEC Enforcement. An unexpected observation is the relatively small role that financial rewards apparently plays in the SEC's exercise of discretion. One might have expected that the SEC would take enforcement action only where inside counsel received unreasonably high compensation or bonuses, or benefited through increased stock value. That does not prove to be accurate. Many inside lawyers appear to have been the target of enforcement action where it appears their only motive was, in the SEC's view, a misguided attempt to help their corporate employer.

Rule #4: Disclosures, Particularly Omissions in Disclosures, are Usually the Problem. Turning to the underlying conduct that has drawn enforcement attention, many of the cases against inside counsel involve allegedly false and misleading disclosures – more often than not, omissions. While there are some instances of outright fraud alleged – such as totally fictitious offshore operations or sham contracts – in others, the SEC has pursued inside lawyers on decisions that involve matters of professional judgment.

Rule #5: A Generalist Lawyer Serving as General Counsel Must Seek Out Sound Advice or Pay the Price. Although there are very few cases in which the SEC has brought an action where the inside lawyer appears to have relied on outside counsel,[2] the SEC has chosen to bring actions where the inside lawyer claimed not to be an expert on a technical issue and either relied, unjustifiably, on an inside technical expert or saw a red flag and failed to seek outside legal advice. Put another way, the SEC appears to be willing to impose on an inside lawyer the obligation to seek expert legal and technical advice, or, face enforcement action. The "I am just a generalist lawyer" defense is *not* well-received, especially if the general counsel is on notice of a potentially serious problem. The message seems to be that if one chooses to become the general counsel of a public company, one is obliged to learn the rules or seek guidance from those who do. There are echoes of the SEC's new attorney conduct regulations,[3] in which the SEC suggests that the question of whether counsel should have

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[1] See Edward F. Greene, General Counsel, Securities and Exchange Commission, Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission, Remarks to the New York County Lawyers' Ass'n (Jan. 18, 1982), reported in 14 Sec. Reg. & L. Rep. (BNA) (Jan. 20, 1982) (stating that the SEC would not pursue Rule 2(e) administrative proceedings against lawyers unless a federal court had first found the lawyer guilty of violating the securities laws); see generally Simon M. Lorne and W. Hardy Callcott, "Administrative Actions Against Lawyers Before the SEC," 50 Bus. Law. 1293 (August 1995).

[2] In the case of Franklin Brown of Rite-Aid, the SEC alleges that Brown obtained an opinion letter from outside counsel. According to the SEC, Brown convinced outside counsel to include in the letter the erroneous statement that a litigation settlement was binding and enforceable as of a prior date, even though Brown knew that it was not binding and enforceable as of that date because of its contingent nature. See n. 96 and n. 97, infra, and accompanying text.

[3] Pursuant to 17 C.F.R. § 205.3(b), an attorney's duty to report evidence of a material violation is triggered when the attorney "becomes aware" of such evidence, which is defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is

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been aware of evidence of a "material violation" so as to trigger the reporting obligations under the regulations may depend on whether there were other lawyers available with whom counsel could have consulted on the matter.[4]

Rule #6: If You Hold Several Corporate Offices, Your Company Failed, or You Sat on a Serious Problem You Could Have Taken to the Board, Your Risk Increases. There are a few factors that appear to increase the likelihood of enforcement action but the data is too limited to draw firm conclusions. For example, holding a position as inside counsel and director seems to increase the enforcement risk. In addition, large losses also increase the risk – probably because the SEC is more likely to investigate those matters than other situations where there are no losses. One can speculate that in the situations where the company has failed or nearly failed, and the inside counsel does not have the resources for vigorous representation and defense, the likelihood of consented-to enforcement action also increases. Finally, the SEC seems to attach significance to whether an inside lawyer raised troublesome issues with the Board; those who choose not to do so are judged more harshly.

B. Criminal Prosecutions

The criminal prosecutions are described in Part III. With only about a dozen prosecutions from which to draw, it is difficult to discern distinct patterns to the criminal prosecution of inside counsel in securities fraud and related cases. Some themes, however, emerge.

Rule #1: Chief Legal Officers are Criminal Targets, Too. The focus of criminal prosecutions seems to be almost entirely on the chief legal officers. There are no subordinate in-house counsel who have been charged with federal criminal violations.

reasonably likely that a material violation has occurred, is ongoing, or is about to occur." Id. at § 205.2(e).

[4] See 68 Fed. Reg. 6296, 6302 (Feb. 6, 2003) (discussing the definition of "evidence of a material violation," see n. 3, supra, and noting that one of the circumstances that may inform counsel as to whether he or she is obligated to report certain information up-the-ladder is "the availability of other lawyers with whom the lawyer may consult.").

Rule #2: Big Losses Increase Risk of Prosecution. No surprises here. The size of the losses sharply increases the likelihood of criminal prosecution, with several of the prosecutions resulting from the largest restatements and corporate failures in America.

Rule #3: Having Outside Counsel Can Make a Big Difference. Again, there is an almost total absence of outside counsel involvement in the conduct that led to criminal indictments. This is predictable as an inside lawyer could effectively deflect criminal criticism by showing reliance on a law firm – whose incentive to engage in or approve criminal conduct by a client is doubtful.

Rule #4: Perjury and Obstruction Often Become the Crime Charged. A recurring theme in the prosecution of lawyers is allegations of cover-ups – obstruction of justice and perjury. Obstruction came from directing employees to lie or mislead investigators.

Rule #5: Mere Knowledge of Conduct Later Deemed Criminal is Typically Not Enough. Perhaps the most important observation is that mere knowledge of the conduct and decisions that are later deemed to be financial fraud does not appear sufficient to charge in-house counsel with criminal conduct. One can discern this by examining many corporate failures and massive restatements that have occurred over the past four years and comparing that number to the small number of criminal indictments of inside counsel to reach this conclusion. Direct and active involvement of in-house counsel in the questionable conduct, with knowledge that the conduct is fraudulent, is necessary to bring federal charges.

Rule #6: Counsel Are Seldom Charged Where the Alleged Fraud is Complex and Its Propriety Debatable. Conversely, a criminal prosecution of an inside lawyer has never resulted where the alleged fraud is complex and its propriety is debatable. The indicted cases have all alleged (at least some were not proven) out-and-out frauds involving sham companies, hidden financial interests, and phony documents where the lawyer not only knew and understood that the conduct was fraudulent but was an essential participant in it.

Rule #7. The Prosecutors' True Goal: Undermine the Executive's Advice-of-Counsel Defense. Indeed, even in those cases where the in-house counsel is charged with broad misconduct, there are pleas to much lesser offenses with much lighter sentences. The most likely explanation for

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this is that in-house counsel are most often targeted in order to secure their cooperation against the real target – the CEO or very senior management. The presence of the in-house lawyer is a factor that many executives who are targets of investigations rely upon to argue that their conduct was presumptively not illegal. After all, the in-house lawyer knew everything but failed to object! One effective way to strip a potential defendant of this quasi-advice-of-counsel-defense is to pursue the lawyer and give him the option of cooperating against the targeted executive or becoming a defendant himself.

II. SEC Proceedings and Orders Against Inside Corporate Counsel

A. Introduction

The corporate financial failures of late 2001 and the subsequent enactment of corporate governance measures, such as the Sarbanes-Oxley Act of 2002,[5] have unquestionably resulted in an increase in SEC enforcement activity directed at inside counsel. In the past two years alone, the SEC has initiated more than 30 enforcement actions[6] against corporate attorneys, most of which have been directed at those working in-house.[7] And, according to Stephen Cutler, then Director of the SEC's Division of Enforcement, the number of new enforcement actions against corporate counsel is expected to increase, due primarily to the SEC's "stepped up" scrutiny of corporate counsel[8] in what has been characterized as their role as "gatekeepers" or "sentries of the marketplace."[9]

Even before the highly publicized corporate breakdowns of 2001, the SEC brought isolated enforcement actions against inside counsel. The SEC's admitted focus on corporate counsel explains the growth in the number of enforcement actions from 1998-2001 to 2002-04. Are there, however, any similarities in the actions from both periods, such as the role of the defendant lawyer, the nature of alleged violations, the theories of liability, or the gravity of the sanctions, that may inform counsel on how best to protect themselves against the threat of an SEC enforcement action? To address this question, the following discussion presents a chronological summary of the enforcement actions, with an emphasis on those elements that appear common or recurring in these actions.

Attempting to distill patterns from the enforcement actions is an imprecise and hazardous undertaking for several reasons. First, the descriptions of counsel's conduct is provided, in most instances, only by the SEC. There is, in nearly all *contested* cases, another and much more innocent side to the story that is not reflected in the SEC's complaint. So, we are looking at the facts only through the eyes of the regulators. While this view admittedly slants the facts, we must also recognize that the SEC's perception of the facts is nearly as important as the "true facts" because it reveals the issues that presumably prompted enforcement action.

Second, the descriptions of counsel's conduct in *consent* proceedings may also slant the facts but in the opposite direction:[10] defendants or respondents often negotiate for a less damaging description of the facts as a condition of consenting to the charges. For these two reasons, the allegations in a filed SEC proceeding may overstate or understate the nature of the underlying conduct that prompted regulatory action. This cautions against reading too much into the lessons

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[5]Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

[6] For purposes of this paper, an enforcement action includes both a civil injunctive action brought in federal district court, as well as a public administrative proceeding brought before the Commission.

[7] See Stephen M. Cutler, Director, Division of Enforcement, SEC, "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program," Speech before UCLA School of Law (September 20, 2004), available at www.sec.gov/news/speech/spch092004smc.htm.

[8] As explained by Cutler:

> [W]e have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate.
>
> . . . .
>
> Based on our current investigative docket, I think you can expect to see one or more actions against lawyers who, we believe, assisted their clients in engaging in illegal late trading or market timing arrangements that harmed mutual fund investors. We are also considering actions against lawyers . . . who assisted their companies or clients in covering up evidence of fraud, or prepared, or signed off on, misleading disclosures regarding the company's condition. One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies. We are concerned that, in some instances, lawyers may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations.

[9] Id.

[10] By consent proceedings, we mean proceedings where the SEC and the respondent reach a settlement before the filing of the complaint or notice of charges, Typically, one important aspect of the prefiling settlement is to "tone down" the allegations in the complaint or notice of charges in order to secure the defendant's agreement.

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of a single case and requires an observer to examine a large number of cases over a longer time period to identify accurately the underlying themes and trends.

Third, one must recognize that the SEC occasionally will bring a proceeding to raise the public awareness of its priorities – one could say it is "making an example" of one private party – but the standard applied in that case is not in fact being applied across-the-board to all similarly situated parties. This consciousness-raising proceeding is, nonetheless, important because it does identify issues of concern to the SEC and may signify changes in enforcement perspectives and approaches.

Fourth, and perhaps most significantly, the proceedings described below represent those where the SEC chose to act, thus prompting the question "what factors were present in the many matters where the SEC chose *not* to bring enforcement proceedings"? While this analysis necessarily involves some degree of speculation, there are some obvious factors that are notable by their absence which we will discuss below – for example, reliance upon the advice of outside counsel.

For purposes of this analysis, we are putting to one side conduct, such as insider trading, that is not integrally related to the function of an inside lawyer. In other words, any company insider who trades on material non-public information will find himself or herself subject to enforcement action and a review of those cases involving inside counsel is not likely to shed light on the SEC enforcement priorities.

B. Survey of Enforcement Actions

1. 1998-2001 Enforcement Actions

The SEC initiated enforcement actions against twelve inside counsel during the period of 1998 to 2001. Most of these actions were directed at the general counsel or the most senior legal officer directly involved in the preparation, approval, and/or signing of allegedly false financial statements or representations contained in SEC filings, securities offerings, and/or other publicly-disseminated documents. Most SEC actions were resolved by settlement. In five of the actions, inside counsel were either barred or suspended from appearing or practicing before the Commission.

In 1998, for example, the SEC filed two civil injunctive actions against inside counsel. In the first, in-house legal counsel for an infomercial marketing company was alleged to have engaged in a fraudulent financial reporting scheme, along with the company's CEO, CFO, and a member of the company's board of directors and its audit committee.[11] According to the SEC, the other defendants caused the recording of fictitious business revenues and receivables, which they supported with false and misleading sales documents and bank records showing payment by entities that were secretly owned by the defendants.[12] The payments allegedly consisted of over $23 million taken from the company, transferred to these private entities, and then funneled back to the company.[13] The in-house legal counsel also served as corporate secretary and had been a director and member of the audit committee. He was alleged to have knowingly or recklessly prepared documents that concealed the other officers' ownership of one of the private entities and to have arranged for the receipt by one of these entities of $1.6 million in company stock, which was sold and the proceeds used as payment for one of the fictitious receivables.[14] The SEC alleged that in-house counsel received undisclosed payments from these private entities.[15]

Without admitting or denying the allegations in the complaint, the in-house counsel consented to the entry of a judgment enjoining him from future violations of these reporting statutes and rules,[16] and ordering him to disgorge $131,000 in unlawfully-obtained profits.[17] Prior to the entry of judgment in the civil enforcement action, however, he was convicted of conspiracy to

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[11] The defendants were charged with knowingly or recklessly making materially false and misleading statements, and omitting to state material information in periodic filings and registration statements filed with the Commission, in violation of 15 USC §§77q(a), 78j(b), and 78m(b)(5), and 17 CFR §§240.10b-5, 13b2-1, and 13b2-2. In addition, they were charged with controlling person liability for the company's violation of these reporting statutes. See SEC v. Arthur L. Toll, Bruce B. Edmondson, Gerald Levinson, and Elliot S. Fisher, 98-CV-2325 (HH) (E.D. Pa.), Litigation Release No. 15731 ; Accounting and Auditing Enforcement Release No. 1033 (May 4, 1998).
[12] Id.
[13] Id.
[14] Id.
[15] Id.
[16] See n. 6, supra.
[17] SEC v. Arthur L. Toll, Bruce B. Edmondson, Gerald Levinson, and Elliot S. Fisher, 98-CV-2325 (HH) (E.D. Pa.), Litigation Release No. 17880; Accounting and Auditing Enforcement Release No. 1682 (Dec. 6, 2002).

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commit securities fraud and to make false and misleading statements to auditors,[18] and was subsequently suspended from appearing or practicing before the Commission as an attorney.[19]

In the second action, the SEC charged the vice-president and general counsel of a research and development company, with violating the antifraud and reporting provisions of the securities law by preparing materially false or misleading public statements in press releases, shareholder letters, and SEC filings relating to the nature and extent of the company's products and the status of the technologies being developed by the company.[20] According to the complaint, these statements represented that the company had developed certain technologies that were unqualified successes when, in fact, the technologies were only in the research and development stage.[21] The complaint further alleged that, after the dissemination of these public statements, the company's stock rose significantly in price.[22]

At the trial of the action in federal district court in New Mexico, the in-house contested the charges, but lost.[23] On appeal following the adverse judgment,[24] he disputed the district court's findings, arguing, inter alia, that he did not know that the statements were false or misleading, that he reasonably relied on information supplied by technology experts since he did not have a technological background, and that he had no reason to doubt the accuracy of the information and, therefore, did not attempt to verify it.[25] The Tenth Circuit rejected his contentions and affirmed the judgment of the district court.[26] In a related administrative proceeding, he was permanently barred from appearing or practicing before the Commission.[27] Between January and August of 1999, the SEC brought three administrative proceedings[28] and three civil injunctive actions against inside counsel. Three of the cases involved counsel who served in specialized positions within the corporation, such as bond or securities counsel; two of the cases involved the general counsel; and one case involved an attorney on the in-house counsel staff. With the exception of this latter case, a civil injunctive action for insider trading,[29] the conduct targeted in the 1999 cases dealt either with the preparation of allegedly false or misleading public statements, or with the drafting of agreements in connection with fraudulent accounting or securities' distribution schemes. One of these cases involved an administrative disciplinary proceeding instituted after counsel's conviction of securities and wire fraud.[30]

In the first of these enforcement actions in 1999, the SEC filed an administrative cease and desist proceeding against bond counsel for the County of Orange Investment Pools.[31] According to the SEC, in preparing or assisting in the preparation of the Official Statements for certain note offerings, the in-house lawyer failed to include material information concerning the investment

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[18] United States v. Elliot Fisher, No. 98-CR-63-3 (RFK) (E.D. Pa.) (judgment entered March 16, 2001).
[19] In the Matter of Eliot S. Fisher, Esq., Admin. Proc. Rel. No. 34-46954 (Dec. 6, 2002).
[20] SEC v. Solv-Ex Corp., et al., No. Civ. 98-860-LH (D. N.M.), Litig. Rel. No. 15817 (July 20, 1998) (charging Campbell with violations of Section 17(a) [15 USC § 77q(a)], and Section 10(b) [15 USC § 78j(b)] and Rule 10b-5, and with aiding and abetting Solv-Ex's violation of Section 13(a) [15 USC § 78m(a)]).
[21] Id. (the complaint also alleged that the statements reported that the company had successfully tested one of its products when, in fact, the test was a failure).
[22] Id.
[23] Id., Litig. Rel. No. 16502 (April 5, 2000).
[24] Id. (the district court found that Campbell had violated the anti-fraud provisions and had aided and abetted the company's violation of the reporting statutes, imposed a first-tier penalty of $5,000, and enjoined Campbell from future violations of Sections 17(a), 10(b), and 13(a)).
[25] See Opening Brief of Appellant Herbert M. Campbell, Solv-Ex Corp. v. SEC, No. 00-2339 (filed March 8, 2001), 2001 WL 34720835.
[26] SEC v. Solv-Ex Corp. et al., No. 00-2339, 2004 WL 813535 (10th Cir. April 15, 2004), cert. denied, Rendall v. SEC, 125 S. Ct. 432 (Nov. 1, 2004).
[27] In the Matter of Herbert M. Campbell II, Esq., Initial Dec. Rel. No. 266; Admin. Proc. File No. 3-10268 (Oct. 27, 2004).
[28] One of the injunctive actions discussed here is one which was dismissed but followed by the institution of an administrative cease and desist proceeding two years later. See SEC v. ICN Pharmaceuticals, Inc., Milan Panic, Nils O. Johannesson, and David C. Watt, No. 99-1016DOC (ANX) (C.D. Cal.), Litig. Rel. No. 16249 (Aug. 11, 1999), discussed infra.
[29] See SEC v. Brian Patrick Burns, Jr., No. 99CV1546 (GK) (D. D.C.), Litigation Release No. 16187 (June 15, 1999) (in-house attorney consented to entry of final judgment in action alleging violation of 15 USC § 77j(b) and Rule 10b-5 for tipping friends to possible acquisition of his company).
[30] In In the Matter of Robert D. Sichta, Admin. Proc. Rel. No. 34-41132 (March 3, 1999), Sichta, the securities counsel for U.S. Mint, pled guilty to charges that he prepared or assisted in the preparation of fraudulent statements relating to U.S. Mint's business as a provider of gaming tokens, and that he bribed registered representatives in exchange for their promotion of U.S. Mint stock, all in violation of 15 USC §§78j(b) and 78ff, and 18 USC § 1343. See United States v. Robert D. Sichta, No. 95-CR-212-S (D. Colo.) (judgment entered Jan. 29, 1997). Sichta settled the administrative proceeding, and consented to the imposition of the sanction barring him from participating in any offering of penny stock. In the Matter of Robert D. Sichta, In the Matter of Robert D. Sichta, supra.
[31] See In the Matter of Jean Costanza, Admin. Proc. Rel. No. 33-7621 (Jan. 6, 1999).

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strategy, its risks, and the losses sustained by the fund.[32] Although the SEC officials had previously suggested that only "egregious" behavior should support an administrative cease and desist proceeding against an attorney,[33] the SEC charged that bond counsel knew or should have known that the Official Statements omitted material information, "that she knew or reasonably should have known about the Pools, the Notes' interest rates, and [that] the tax exempt status of the Tax-Exempt Offerings could have been jeopardized."[34] Therefore, the SEC maintained that she had violated Sections 17(a)(2) and (3) [15 USC § 77q (a)(2), (3)] of the Securities Act.[35]

Without admitting or denying the allegations, she settled the matter and consented to the entry of a cease and desist order.[36] In press statements made after entry of the order, her attorney decried the SEC's decision to bring the action, stating that the SEC, by applying a "should have known" standard, had lowered the bar for imposing liability on attorneys under Section 17(a)(2) and (3).[37] Now, he argued, mere awareness of problems or a good faith mistake will subject counsel to SEC action.[38] The SEC responded that liability will be imposed whenever counsel has knowledge of a "red flag," but fails to investigate to ensure that any subsequent disclosure is proper.[39]

Several months later, the SEC brought a civil injunctive action against the general counsel of a pharmaceutical company, and against its president and the vice-president of research and development, alleging that their failure to disclose information in a press release concerning the FDA's non-approval of the company's new drug application constituted a violation of Section 10(b) [15 USC § 78j(b)] and Rule 10b-5.[40] In an amended complaint, the SEC alleged that in-house counsel had knowledge of the FDA's not-approvable letter, had discussed the letter with the other defendants, and had a primary role in drafting the offending press release.[41] The SEC dismissed the civil injunctive action against in-house counsel,[42] and subsequently instituted an administrative cease and desist proceeding for his conduct in causing the company's violation of Section 10(b) and Rule 10b-5 with respect to the press release.[43] The SEC alleged that he was a cause of the company's violation, because he allegedly participated in meetings involving the not-approvable letter and the company's public response to it, and participated in the drafting of the press release. In-house counsel, therefore, "should have known" that the release omitted important facts of material interest to investors.[44] The court further found that, because of his admitted lack of expertise with FDA procedures and policies, he should have consulted regulatory counsel "to assess the significance of the not approvable letter" and determine what disclosures were necessary.[45] Without admitting or denying the SEC's findings, he consented to the issuance of a cease and desist order.[46]

In the other enforcement actions of 1999, the SEC focused its attention on inside counsel's role in allegedly promoting or effectuating a fraudulent scheme engaged in by others who had an interest in, or position with, the corporation.

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[32] Id. at III(B)(1).
[33] See Norman S. Johnson, "Suits Against Lawyers," Speech before the Federal Securities Law Committee of the American Bar Association (Nov. 8, 1996) (stating the he "would hope that the cease and desist remedy would be limited to those situations where the attorney's conduct was so egregious that he could properly be deemed a principal actor."), available at www.sec.gov/news/speech/speecharchive/1996/spch137.txt.
[34] In the Matter of Costanza, supra, at III(C)(1)(b).
[35] Id. at III(C)(2).
[36] Id. at IV.
[37] "Municipal Bonds: Lawyers Have Duty to Investigate, Disclose 'Red Flags' in Offerings, SEC Official Says," 31 Sec. Reg. L. Rep. (BNA) 672 (May 21, 1999).
[38] Id.
[39] Id.
[40] See SEC v. ICN Pharmaceuticals, Inc., Milan Panic, Nils O. Johannesson, and David C. Watt, No. 99-1016DOC (ANX) (C.D. Cal.), Litig. Rel. No. 16249 (Aug. 11, 1999).
[41] The original complaint was dismissed as to Watt, but the SEC was granted leave to amend. Watt filed a motion to dismiss the amended complaint, arguing that the SEC failed to plead a "strong inference of scienter" as required by the Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (Dec. 22, 1995), and failed to provide specifics as to his alleged involvement in preparing the press release. The court denied the motion, finding that the PSLRA was not applicable to civil enforcement actions brought by the SEC. See SEC v. ICN Pharmaceuticals, Inc., et al., No. 99-1016 (C.D. Cal. Order issued Feb. 2, 2000), as reported in 15 No.9 Andrews Corp. Off. & Directors Liab. Litig. Rep. 13 (March 6, 2000).
[42] See SEC v. ICN Pharmaceuticals, Inc., Milan Panic, Nils O. Johannesson, and David C. Watt, No. 99-1016DOC (ANX) (C.D. Cal.), Litig. Rel. No. 17861 (Nov. 25, 2002).
[43] See In the Matter of David C. Watt, Admin. Proc. Rel. No. 34-46899 (Nov. 25, 2002).
[44] Id. at III.
[45] Id.
[46] Id. at II.

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The first case involved an allegedly fraudulent scheme to distribute unregistered securities of Market America, a direct-marketing company.[47] According to the SEC, the president of Market America and another individual, who controlled a shell corporation having no assets, entered into a sham "blank check" public offering for the shell corporation, making it appear that the shell corporation had shares that could be freely traded without registration when, in fact, the shares were owned by these two parties.[48] Afterwards, they completed a reverse merger between Market America and the shell corporation, resulting in their undisclosed ownership of most of Market America's outstanding stock.[49] Since their ownership was concealed, these individuals were able to obtain a NASD Bulletin Board listing for Market America and thereby distribute unregistered shares of its stock.[50] In a settled administrative cease and desist proceeding brought against counsel to the president of Market America,[51] the SEC alleged that in-house counsel provided substantial assistance to this fraudulent scheme in two ways: by negotiating and drafting the terms of the merger agreement, even though he was aware of the parties' oral agreement to sell their shares of Market America stock and to divide the proceeds between them on a dollar for dollar basis; and, by concealing the parties' ownership of the Market America stock from the NASD by failing to disclose this information upon inquiry by the broker-dealer sponsoring the application for the listing.[52] As a consequence, the SEC alleged that in-house counsel was a cause of the violations of the registration and antifraud provisions of the securities laws,[53] and ordered him to cease and desist from any further violations.[54]

The second case involved an allegedly fraudulent scheme to inflate reported revenues through the execution of undisclosed side agreements that required the company to repay amounts purportedly "paid" by the counter parties to transactions. In a settled civil injunctive action against the general counsel and secretary of the company, the SEC alleged that counsel acted in furtherance of the scheme by drafting some of these side agreements and/or by negotiating and finalizing these agreements with the legal representatives of the counter parties, all in violation of the antifraud, books and records, and internal controls provisions of the securities law.[55] The court enjoined in-house counsel from future violations of these provisions and assessed a civil penalty of $25,000.

In a related administrative proceeding, the same in-house counsel consented to the entry of an order denying him the privilege of appearing and practicing before the Commission for a period of five years.[56] In addition, he was ordered to comply with a cooperation agreement that he executed as part of his settlement with the SEC. The agreement not only imposed disclosure and document production requirements on him, but also prohibited him from asserting any evidentiary or other privilege if required to provide testimony in any proceeding.[57] Unlike the current approach in government investigations and prosecutions,[58] the in-house lawyer was not prohibited from asserting the attorney-client and work product privileges.[59]

[47] In the Matter of Market America, Inc. and Richard D. Hall, Jr., Admin. Proc. Rel. Nos. 33-7674; 34-41363 (May 4, 1999).
[48] Id. at III(B).
[49] Id.
[50] Id.
[51] The SEC brought a civil injunctive action against the actual parties to the fraudulent transactions, the president of Market America and the owner of the shell corporation, who consented to final judgments requiring them to pay over $2 million in disgorgement, interest, and civil penalties. See SEC v. Gilbert A. Zwetsch and James H. Ridinger, No. 99-1088 (LFO) (D. D.C.), Litig. Rel. No. 16131A (May 4, 1999).
[52] Id.
[53] Sections 5(a), (c) and 17(a) of the Securities Act [15 USC §§77e(a), (c); 77q(a)], Section 10(b) of the Exchange Act [15 USC § 78j(b)] and Rule 10b-5.
[54] In the Matter of Market America, Inc., Admin. Proc. Rel. Nos. 33-7674; 34-41363, at IV-V.
[55] SEC v. Jerald M. Banks, No. 99 Civ. 8855 (TPG) (S.D.N.Y.), Litig. Rel. No. 16251; Accounting and Auditing Enforcement Rel. No. 1153 (Aug. 12, 1999) (alleging that Banks' conduct constituted violations of Section 17(a) of the Securities Act [15 USC § 77q(a)], Sections 10(b) and 13(b)(5) of the Exchange Act [15 USC §§78j(b), 78m(b)(5)], and Rules 10b-5, 13b2-1, and 13b2-2).
[56] In the Matter of Jerald M. Banks, Admin. Proc. Rel. No. 34-41806; Accounting and Auditing Enforcement Rel. No. 1156 (Aug. 30, 1999).
[57] Id. at V.
[58] See generally, U.S. Department of Justice, Office of the Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003).
[59] In the Matter of Jerald M. Banks, Admin. Proc. Rel. No. 34-41806; Accounting and Auditing Enforcement Rel. No. 1156, at V.

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During the 2000-2001 period, four inside counsel were the subjects of SEC enforcement actions, together with their companies and/or other officers within the corporation.[60] In all of the actions, counsel held the top legal position, such as general counsel, and, with one exception,[61] also served in other capacities.[62]

Like the actions in previous years, these actions involved allegations of fraudulent reporting and accounting schemes engaged in by corporate officers; counsel were alleged to have assisted this conduct through knowing, reckless, or negligent preparation of materially false and misleading SEC filings, public statements, and/or undisclosed side agreements. More specifically, the complaints alleged the following wrongful conduct: knowingly or recklessly preparing documents relating to fraudulent real estate sales that had been included as assets on the company's SEC filings, and signing a Form 10-K reflecting these sales;[63] knowingly including an unauthorized audit report in a registration statement;[64] knowingly or recklessly engaging in a fraudulent financial reporting scheme by negotiating, drafting and concealing unlawful side agreements to customer contracts and by backdating documents;[65] and participating in the drafting of materially misleading press releases concerning the company's financial condition and results of operation.

[60]An administrative proceeding was also initiated against a fifth general counsel, Herbert Campbell, after judgment was entered against him in a civil injunctive action that had been commenced in 1998. See In the Matter of Herbert M. Campbell, Esq., Admin. Proc. File No. 34-43422 (Oct. 6, 2000) and SEC v. Solv-Ex Corp., et. al., Litig. Rel. No. 15817 (July 20, 1998), discussed supra.
[61] SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal.), Litig. Rel. No. 17189; Accounting and Auditing Enforcement Rel. No. 1467 (Oct. 15, 2001).
[62] See e.g., In the Matter of Steven Wolis, Admin. Proc. Rel. No. 34-43123; Accounting and Auditing Enforcement Rel. No. 1290 (Aug. 4, 2000) (general counsel and director); SEC v. Countryland Wellness Resorts, Inc., et al., No. CV-S-00-1160-PMP (RJJ) (D. Nev.), Litig. Rel. No. 16732; Accounting and Auditing Enforcement Release No. 1327 (Sept. 27, 2000) (general counsel and director).
[63] In the Matter of Steven Wolis, Admin. Proc. Rel. No. 34-43123; Accounting and Auditing Enforcement Rel. No. 1290 (Aug. 4, 2000) (charged with violating Sections 10(b), 13(b)(5), and 13(b)(2) of the Exchange Act [15 USC §§78j(b), 78m(b)(5), (b)(2)], and Rules 10b-5, 13b-1, and 13b2-2).
[64] SEC v. Countryland Wellness Resorts, Inc., et al., No. CV-S-00-1160-PMP (RJJ) (D. Nev.), Litig. Rel. No. 16732; Accounting and Auditing Enforcement Release No. 1327 (Sept. 27, 2000) (charged with violating Section 17(a) of the Securities Act [15 USC § 77q(a)], and Section 10(b) of the Exchange Act [15 USC § 78j(b)], and Rule 10b-5).
[65] SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal.), Litig. Rel. No. 17189; Accounting and Auditing Enforcement Rel. No. 1467 (Oct. 15, 2001) (charged with violating Section 10(b) and 13(b)(5) of the Exchange Act [15 USC §§78j(b), 78m(b)(5)] and Rules 10b-5 and 13b2-1, and with aiding and abetting the company's violation of the reporting requirements of Sections 13(a) and 13(b)(2)(A) of the Exchange Act [15 USC §§78m(a), (b)(2)(A)] and Rules 12b20 and 13a-13). See Complaint, SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal. filed Sept. 27, 2001).

Consistent with preceding years, there was considerable variation in the nature of the enforcement actions and the extent of the sanctions imposed. Of the three actions that have been concluded,[66] two involved related administrative disciplinary proceedings resulting in consent orders barring or suspending inside counsel from appearing and practicing before the Commission.[67] The third case involved a settled administrative proceeding in which the general counsel of a public company, after cooperating with the SEC at the outset of its investigation, agreed to cease and desist from committing or causing any further violations of Section 17(a)(3) of the Securities Act.[68]

In the one case from this period that remains pending as of this writing, a civil injunctive action against the former general counsel of McKesson/HBOC, Inc.,[69] the SEC seeks to impose a broad range of penalties and sanctions. The SEC alleged that he engaged in a massive accounting fraud scheme, together with members of top management, and was unjustly enriched because of his receipt of significant bonuses that were tied to the company's meeting projected earnings.[70] It seeks

[66]The enforcement action against Jay Lapine, the former general counsel of McKesson/HBOC, remains pending. See SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal.), Litig. Rel. No. 17189; Accounting and Auditing Enforcement Rel. No. 1467 (Oct. 15, 2001).
[67] In the Matter of Steven Wolis, Admin. Proc. Rel. No. 34-43123; Accounting and Auditing Enforcement Rel. No. 1290 (Aug. 4, 2000) (In 2000, Wolis consented to the entry of a permanent injunction in a civil injunctive action brought by the SEC in 1995, and, in 1998, pled guilty in a related criminal action to an obstruction of justice charge); In the Matter of Donald E. Studer, Admin. Proc. Rel. No. 34-43532; Accounting and Auditing Enforcement Rel. No. 1342 (Nov. 8, 2000) (general counsel for Countryland Wellness Resorts, Inc.).
[68] The general counsel was charged with participating in the preparation of materially misleading press releases, while other members of top management were charged as principal actors in the fraudulent "cookie jar" scheme to misrepresent the company's results of operation.
[69]SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal.), Litig. Rel. No. 17189; Accounting and Auditing Enforcement Rel. No. 1467 (Oct. 15, 2001). Lapine is also subject to a pending criminal action. See United States v. Albert J. Bergonzi, Charles W. McCall, and Jay Lapine, No. CR 00-0505-MJJ (N.D. Cal.) (Second Superseding Indictment, June 3, 2003), available at www.usdoj.gov/usao/can/press/html/2003_06_04_mckesson.html

[70] See n. 66 and accompanying text, supra.

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both an injunction against future violations of the securities laws and disgorgement of any wrongfully-received profits, in addition to the imposition of civil penalties and a permanent injunction against serving as an officer or director of a publicly traded company.[71] In his defense, in-house counsel has asserted, in part, that he acted in "honest and reasonable reliance" on the advice and expertise of accounting and business professionals.[72]

2. Post 2001 Enforcement Actions

Because of the highly publicized corporate failures that began in the fall of 2001, the SEC has increasingly focused its attention on the role of inside counsel. This increased attention has resulted in a corresponding increase in the number of enforcement actions directed at inside counsel: since the beginning of 2001, approximately 19 inside counsel have been the targets of SEC enforcement actions. And, as indicated by the SEC's saber-rattling statements[73] and its issuance of Wells notices,[74] others may find themselves defendants in the near future.

In 2002, five civil injunctive actions were filed against inside counsel, all of whom served as the top attorney within the corporation.[75] Four of the attorneys also served in other capacities, such as vice-president and secretary,[76] vice-president and chairman of the board,[77] or just vice-president.

[71] Complaint, SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal.) (filed Sept. 27, 2001); Litig. Rel. No. 17189; Accounting and Auditing Enforcement Rel. No. 1467 (Oct. 15, 2001).
[72] Answer to Complaint, SEC v. Jay Lapine, No. C-01-3650 (VRW) (N.D. Cal.) (filed Oct. 7, 2002).
[73] See n. 9, supra.
[74] See, e.g., "Stock Markets: SEC Investigating AMEX Execs With Respect To Options Trading Probe," 36 Sec. Reg. L. Rep. (BNA) 2056 (Nov. 22, 2004) (noting that the SEC had sent Wells notices to three executives of the American Stock Exchange, including its general counsel, warning that civil enforcement proceedings could be brought against them).
[75] See e.g., SEC v. Dean L. Buntrock et. al., No. 02C 2180 (N.D. Ill.), Litig. Rel. No. 17435; Accounting and Auditing Enforcement Rel. No. 1532 (March 26, 2002) (general counsel); SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, No. 1:CV02-1084 (M.D. Pa.), Litig. Rel. No. 17577; Accounting and Auditing Enforcement Rel. No. 1581 (June 21, 2002) (chief legal officer); SEC v. Bruce Hill, et al., No. 02-CV-11244 (D. Mass.), Litig. Rel. No. 17578; Accounting and Auditing Enforcement Rel. No. 1582 (June 21, 2002) (general counsel); SEC v. Andrew S. Marks, No. 02 CV 12325 (JLT) (D. Mass.), Litig. Rel. No. 17871 (Dec. 3, 2002) (chief patent counsel – highest ranking attorney within company).
[76] Herbert Getz was also a senior vice-president and secretary of Waste Management. See SEC v. Dean L. Buntrock et. al., No. 02C 2180 (N.D. Ill.), Litig. Rel. No. 17435; Accounting and Auditing Enforcement Rel. No. 1532 (March 26, 2002). Bruce Hill served as a vice-president and secretary of Inso Corporation, now known as eBT International, Inc. See SEC v. Bruce Hill, et al., No. 02-CV-11244 (D. Mass.), Litig. Rel. No. 17578; Accounting and Auditing Enforcement Rel. No. 1582 (June 21, 2002).
[77] Franklin Brown first served as both chief legal officer and executive vice-president of Rite-Aid Corporation, and then became its chairman of the board. SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, No. 1:CV02-1084 (M.D. Pa.), Litig. Rel. No. 17577; Accounting and Auditing Enforcement Rel. No. 1581 (June 21, 2002).

Many of the attorneys are, or have been, defendants in well-publicized criminal proceedings brought in connection with the same conduct that is the subject of the enforcement actions.[78]

As in prior enforcement actions, the 2002 actions involve allegations that inside counsel, usually in concert with other corporate officers,[79] committed securities fraud and violated, or aided and abetted the violation of, the recordkeeping and/or reporting obligations of the securities laws through fraudulent accounting[80] and revenue recognition schemes,[81] undisclosed self-dealing

[78] United States v. Martin L. Grass, Franklin C. Brown, Franklyn M. Bergonzi, and Eric S. Sorkin, No. 1:CR-02-146 (M.D. Pa.); United States v. Graham Marshall and Bruce Hill, Crim. Action No. 03-10344 (DPW) (D. Mass.), Litig. Rel. No. 18699 (May 7, 2004); United States v. Marks, Crim. Action No. 03-10297 (DPW) (D. Mass.), Litig. Rel. No. 18360 (Sept. 24, 2003). For more discussion of the criminal proceedings, see infra at Part III.
[79] The sole exception is Andrew Marks, the chief patent counsel for a pharmaceutical company, who was charged with insider trading for liquidating all of his company stock immediately before the company's issuance of a press release announcing the suspension of a clinical trial of one of its drugs. See SEC v. Andrew S. Marks, No. 02 CV 12325 (JLT) (D. Mass.), Litig. Rel. No. 17871 (Dec. 3, 2002).
[80] See SEC v. Dean L. Buntrock, et al, No. 02C 2180 (N.D. Ill.), Litig. Rel. No. 17435; Accounting and Auditing Enforcement Rel. No. 1532 (March 26, 2002)(violations of Section 17(a) of the Securities Act [15 USC § 77q(a)], Sections 10(b) and 13(a) of the Exchange Act [15 USC §§78j(b), 78m(a)], and Rules 10b-5, 12b-20, 13a-1, and 13a-13); SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, No. 1:CV02-1084 (M.D. Pa.), Litig. Rel. No. 17577; Accounting and Auditing Enforcement Rel. No. 1581 (June 21, 2002)(violations of Section 17(a) of the Securities Act [15 USC § 77q(a)], Sections 10(b) and 13(b)(5) of the Exchange Act [15 USC §§78j(b), 78m(b)(5)], Rules 10b-5 and 13b2-1, 13b2-2, and controlling person liability under Section 20(a) of the Exchange Act [15 USC § 78t(a)] for the company's violations of the periodic and current reporting obligations, proxy statement requirements, and corporate recordkeeping and internal controls statutes).
[81] See SEC v. Bruce Hill, et al., No. 02-CV-11244 (D. Mass.), Litig. Rel. No. 17578; Accounting and Auditing Enforcement Rel. No. 1582 (June 21, 2002)(violations of Section 17(a) of the Securities Act [15 USC § 77q(a)], Section 10(b) of the Exchange Act [15 USC § 78j(b)] and Rule 10b-5, Section 13(b)(5) of the Exchange Act [15 USC § 78m(b)(5)] and Rules 13b2-1 and 13b2-2, and aiding and abetting the company's violations of the periodic reporting and recordkeeping requirements).

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transactions, and insider trading.[82] Two of the actions were precipitated by what, at the time, were the largest corporate restatements of revenue in history.[83]

Unlike the complaints in most of the prior actions, however, the SEC's complaints in the 2002 actions focus more on financial incentive, such as inside counsel's receipt of substantial performance-based bonuses, as a motivating force for the underlying conduct.[84] In the case of Waste Management's officers, including its then general counsel, the SEC begins its complaint by specifically alleging that the financial fraud "[was] motivated by greed and a desire to preserve professional and social status."[85] According to the SEC, because of the performance-based bonus program for senior officers, the defendants manipulated the Company's reported results in order to meet targeted earnings and thereby collect substantial bonuses in return.[86] Similar allegations are included in the complaint against the general counsel and the other officers of Rite-Aid with respect to their alleged scheme to misrepresent the company's financial condition.[87] In another complaint against the general counsel of a software company, the SEC also suggests that financial incentives influenced him to engage in a fraudulent revenue recognition scheme.[88] And, in other cases,

[82] See SEC v. Andrew S. Marks, No. 02 CV 12325 (JLT) (D. Mass.), Litig. Rel. No. 17871 (Dec. 3, 2002)(violations of Section 10(b) of the Exchange Act [15 USC § 78j(b)] and Rule 10b-5, and Section 17(a) of the Securities Act [15 USC § 77q(a)].

[83] See Complaint, SEC v. Dean L. Buntrock, et al, No. 02C 2180 (N.D. Ill. filed March 26, 2002), at ¶ 1 (alleging that company's restatement showed that profits had been overstated by $1.7 billion dollars); Complaint, SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, No. 1:CV02-1084 (M.D. Pa. filed June 20, 2002), at ¶ 1 (alleging that company was forced to restate its cumulative pre-tax income by $2.3 billion dollars, and its cumulative net income by $1.6 billion dollars).

[84] In its 2001 complaint against Jay Lapine, the general counsel of McKesson/HBOC, the SEC also alleges that Lapine was unjustly enriched through the unlawful revenue recognition scheme by his receipt of significant bonuses that were tied to meeting expected earnings. See n. 71 and accompanying text, supra.

[85] Complaint, SEC v. Dean L. Buntrock, et al, No. 02C 2180 (N.D. Ill. filed March 26, 2002), at ¶ 1.

[86] Id. at ¶¶1, 337.

[87] Complaint, SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, No. 1:CV02-1084 (M.D. Pa. filed June 20, 2002), at ¶¶1, 67-68 (noting that the scheme was implemented "with the intent to enrich themselves through performance-based bonuses of stock and cash," and itemizing the amounts actually realized in cash bonuses and the amounts that could have been realized in stock options and long-term incentive plans had the fraud not been discovered).

[88] Complaint, SEC v. Bruce Hill, et al., No. 02-CV-11244 (D. Mass. filed June 21, 2002), at ¶¶20-21 (noting that "senior management had substantial financial incentives to meet revenue goals," and that Hill could earn a bonus of approximately 30% of his salary if company revenue goals were met, but would not receive a bonus if these goals were not met; also alleging that Hill "experienced firsthand significant repercussions" when the goals were not met, including the drop in stock prices, job restructuring and job cuts, and no bonuses).

allegations of "looting" and "egregious self-dealing transactions" are sprinkled through the SEC's complaint.

With respect to counsel's specific role in the underlying schemes, the allegations vary in their characterization of the degree of counsel's complicity.

For example, the SEC alleged a fraudulent scheme orchestrated by the CEOs, CFO, and CAO of Waste Management, involving misrepresenting financial results by improperly eliminating or deferring current expenses. The SEC describes the general counsel as having questioned the practices,[89] but then as having "blessed the Company's fraudulent disclosures."[90] Throughout the complaint the SEC alleges that the other officers engaged in a variety of improper accounting practices "with the [general counsel's] knowledge."[91] Because he attended periodic meetings with the company's outside auditor to discuss auditing issues, such as the company's lack of progress in implementing a new accounting plan (due to the fraudulent scheme of which the general counsel is alleged to have had knowledge), and because he attended all audit committee meetings, the SEC alleges that the general counsel "had the full picture of the accounting irregularities and misstatements."[92] Accordingly, since he drafted, reviewed, and authorized the disclosures in the company's periodic reports, registration statements, and press releases, the general counsel knew or recklessly disregarded facts indicating that the financial information contained or incorporated in these documents was false or misleading and omitted material information.[93]

In another case, the SEC has alleged that senior executives defrauded the company by granting themselves numerous unauthorized loans from the company and causing their forgiveness, in directing others to falsify the books and records to conceal the loans, and in engaging in other

[89] Complaint, SEC v. Dean L. Buntrock, et al, No. 02C 2180 (N.D. Ill. filed March 26, 2002), at ¶ 9.

[90] Id., at ¶ 18.

[91] See, e.g., id., at ¶¶50-73.

[92] Id., at ¶ 330.

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undisclosed related-party transactions with the company. Separately, it sets forth its allegations against inside counsel: that he demanded and received a loan from the company for which he was ineligible; that he allegedly failed to disclose these loans on internal questionnaires when he knew, or was reckless in not knowing, that disclosure was required; and, that, he knowingly or recklessly sold large amount of company stock. The complaint further alleges that counsel was responsible for supervising the company's corporate disclosure, and that, as a result of the fraudulent misrepresentations and omissions discussed in the entire complaint, the company filed false and misleading reports and proxy statements with the Commission.

In contrast to the complaints in the two foregoing SEC actions, the complaints in several other 2002 actions allege direct participation by inside counsel in the fraudulent schemes. In the case of Rite-Aid, for example, the SEC alleges that in-house counsel "originated" the idea to report the proceeds of litigation settlement prematurely in order "to help plug . . . a $100 million shortfall that otherwise would have to be reported for FY 1999."[94] He is alleged to have "convinced outside counsel to provide an opinion letter that erroneously stated that the litigation settlement was binding and enforceable" as of a prior date, when he knew that it was not yet binding because of its contingent nature,[95] and then later provided this opinion letter to the company's auditors to support the recording of the settlement in the fourth quarter (even though he allegedly knew, or recklessly disregarded, that such recording was improper because of the highly contingent nature of the deal).[96] With respect to certain related-party transactions engaged in by the CEO, in-house counsel is also alleged to have used a false email and a back-dated document in an attempt to conceal one of these transactions.[97] Similar allegations of active participation in the fraudulent scheme appear in the complaint against the general counsel of Inso Corporation.[98]

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93 Id., at ¶¶ 330-332.
94 Complaint, SEC v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, No. 1:CV02-1084 (M.D. Pa. filed June 20, 2002), at ¶ 45.
95 Id. at ¶ 46.
96 Id. at ¶ 61.
97 Id. at ¶ 56.
98 See Complaint, SEC v. Bruce Hill, et al., No. 02-CV-11244 (D. Mass. filed June 21, 2002), at ¶¶3-4 (in order to recognize revenue within the quarter from a failed sale of software

Turning to the issue of sanctions, the SEC sought similar sanctions in 2002 as it had in prior actions: permanent injunctions against future violations, disgorgement of ill-gotten gains, and the imposition of civil monetary penalties. An additional sanction pursued with more frequently in 2002 is a prohibition against serving as an officer or director of a publicly traded company.[99]

2003 saw five SEC enforcement actions brought against inside counsel, one of which was a settled administrative cease and desist proceeding. In all of the actions, inside counsel held the position of general counsel and also served in other capacities, such as vice-president and secretary,[100] president[101] and/or CEO,[102] and compliance officer.[103] Two of the attorneys were also directors of the corporation.[104] One of these attorneys has been indicted for the same conduct giving rise to the enforcement action.[105]

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licenses, Hill entered into a transaction with a third party knowing, or recklessly disregarding facts indicating the existence of an oral side agreement relieving the purported purchaser of any obligation to pay; "orchestrated" the provision of letters of credit to the purported purchaser to finance the transaction; "caused" the making of a false board resolution authorizing the letters of credit; provided false information to the CFO and outside auditors).
99 See, e.g., SEC v. Andrew S. Marks, No. 02 CV 12325 (JLT) (D. Mass.), Litig. Rel. No. 18956 (Nov. 2, 2004) (announcing entry of consent judgment in insider trading case, enjoining Marks from future violations of the antifraud provisions and barring him from acting as an officer or director of a publicly traded company).
100 SEC v. Michael J. Pietrzak, Maurice W. Furlong, and Donald E. Jordan, No. 03C-1507 (N.D. Ill.), Litig. Rel. No. 18016 (March 6, 2003); SEC v. Oliver Hilsenrath and David S. Klarman, No. C-03-3252 (N.D. Cal.), Litig. Rel. No. 18275; Accounting and Auditing Enforcement Rel. No. 1831 (Aug. 6, 2003); SEC v. Heartland Advisors, Inc., et. al., No. 03 C-1427 (E.D. Wis.), Litig. Rel. No. 18505 (Dec. 12, 2003).
101 In the Matter of Steven L. Hunt, Esq., Admin. Proc. Rel. No. 34-48330; Accounting and Auditing Enforcement Rel. No. 1840 (Aug. 13, 2003). In the Matter of Steven L. Hunt, Esq., Admin. Proc. Rel. No. 34-48330; Accounting and Auditing Enforcement Rel. No. 1840 (Aug. 13, 2003).
102 SEC v. Tecumseh Holdings Corp., et. al., No. 03 Civ. 5490 (SAS) (S.D.N.Y.), Litig. Rel. No. 18251 (July 25, 2003).
103 SEC v. Heartland Advisors, Inc., et. al., No. 03 C-1427 (E.D. Wis.), Litig. Rel. No. 18505 (Dec. 12, 2003).
104 SEC v. Michael J. Pietrzak, Maurice W. Furlong, and Donald E. Jordan, No. 03C-1507 (N.D. Ill.), Litig. Rel. No. 18016 (March 6, 2003); SEC v. Tecumseh Holdings Corp., et. al., No. 03 Civ. 5490 (SAS) (S.D.N.Y.), Litig. Rel. No. 18251 (July 25, 2003).
105 See United States v. Oliver Hilsenrath and David Scott Klarman, CR 03-0213 WH (N.D. Cal.). Klarman pled guilty to mail fraud and money laundering for his part in the fraudulent scheme. See J. Chorney, "U.S. Wireless GC Admits Fraud," The Recorder at 10 (Jan. 27, 2004).

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Like the allegations in previous enforcement actions, the allegations in the complaints filed against inside counsel in 2003 involve material misrepresentations and omissions in company records, SEC filings, press releases, and other documents disseminated to the public. With the exception of one case, the complaints allege that counsel, together with other officers and employees, engaged in this conduct in furtherance of a fraudulent scheme to inflate stock prices,[106] offer unregistered or overpriced securities or bonds[107] or extract assets from the company for personal gain.[108] In the sole exception, the administrative cease and desist proceeding, no underlying scheme was alleged; instead, the SEC found that inside counsel's omission of material information concerning disciplinary action taken against an affiliate of the company was a willful act, done in violation of various provisions of the Investment Advisors Act,[109] and warranted the issuance of a cease and desist order and a temporary suspension from appearing and practicing before the SEC as an attorney.[110]

In one of the more publicized cases in 2003, the SEC charged both the general counsel, and the CEO of U.S. Wireless, with "egregious securities fraud" that allegedly led to the company's bankruptcy after a restatement of its financial results showed a $6.3 million increase in losses.[111] According to the complaint, the general counsel set up offshore entities under his ownership and control and transferred company cash and stock to these entities as purported compensation for services or as purported sales of stock for valid consideration.[112] With respect to one entity, for example, the complaint alleges that the in-house counsel signed a consulting agreement on behalf of U.S. Wireless, which stated that the entity would provide legal services to the company regarding its overseas operations; however, no services or other consideration was provided by the entity in exchange for the cash and stock.[113] The complaint further alleges that he signed a legal opinion letter in support of a registration statement that contained false information; drafted or reviewed periodic reports from which he intentionally or recklessly omitted the fact that the company received no consideration for the cash and stock transferred to the offshore entities; drafted or reviewed periodic reports containing material statements that he knew, or was reckless in not knowing, were false; intentionally caused the recording of false information in the company's books and records; and, made statements to the company's auditors regarding related-party transactions which he knew, or was reckless in not knowing, were false.[114]

Without admitting or denying the SEC's allegations, the general counsel of U.S. Wireless has consented to the issuance of an order by the federal district court holding him liable for $3.9 million,[115] permanently enjoining him from violating or aiding and abetting violations of the antifraud and other provisions of the securities laws,[116] and prohibiting him for 10 years from serving as an officer or director of any issuer with securities registered under Section 12 of the Exchange Act or with reporting obligations under Section 15(d) of the Exchange Act.[117] In a related administrative proceeding, the SEC has accepted the general counsel's offer of settlement and has suspended him from appearing and practicing before the Commission as an attorney.[118]

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[106] See Complaint, SEC v. Michael J. Pietrzak, Maurice W. Furlong, and Donald E. Jordan, No. 03C-1507 (N.D. Ill. filed March 6, 2003).
[107] See Complaint, SEC v. Tecumseh Holdings Corp., et. al., No. 03 Civ. 5490 (SAS) (S.D.N.Y. filed July 24, 2003) (securities offerings); Complaint, SEC v. Heartland Advisors, Inc., et. al., No. 03 C-1427 (E.D. Wis.) (bond offerings).
[108] See Complaint, SEC v. Oliver Hilsenrath and David S. Klarman, No. C-03-3252 (N.D. Cal. filed July 14, 2003).
[109] 15 USC § 80b-7.
[110] In the Matter of Steven L. Hunt, Esq., Admin. Proc. Rel. No. 34-48330; Accounting and Auditing Enforcement Rel. No. 1840 (Aug. 13, 2003).
[111] Complaint, SEC v. Oliver Hilsenrath and David S. Klarman, No. C-03-3252 (N.D. Cal. filed July 14, 2003), at ¶¶1, 35-36.
[112] Id. at ¶ 2.
[113] Id. at ¶¶11-13.
[114] Id. at ¶¶27-33. Klarman was charged with violating Section 17(a) of the Securities Act (15 USC § 77q(a)), Section 10(b) of the Exchange Act (15 USC § 78j(b)) and Rule 10b-5, and Section 13(b)(5) of the Exchange Act (15 USC § 78m(b)(5)) and Rules 13b2-1 and 13b2-2, and with aiding and abetting the company's violations of Section 13(a) of the Exchange Act (15 USC § 78m(a)) and Rules 12b-20, 13a-1, and 13a-13, and Section 13(b)(2)(A) of the Exchange Act (15 USC § 78m(b)(2)(A)). See id., at ¶¶37-56.
[115] See SEC v. Oliver Hilsenrath and David S. Klarman, No. C-03-3252 (N.D. Cal. filed July 14, 2003), Litig. Rel. No. 19286; Accounting and Auditing Enforcement Rel. No. 2267 (June 27, 2005). This amount represents $3.2 million in disgorgement of ill-gotten gains, and $700,000 in prejudgment interest. Id.
[116] Id. As to the specific provisions of the securities laws to which the injunction applies, see n. 115, supra.
[117] Id. (referencing 15 U.S.C. §§78l and 78o, respectively).
[118] See In the Matter of David S. Klarman, Esq., Admin. Proc. Rel. No. 34-51927; Accounting and Auditing Enforcement Rel. No. 2266 (June 27, 2005).

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In the remaining enforcement actions for 2003, the SEC makes similar allegations with respect to inside counsel's direct participation in the underlying scheme. For example, in its action against the general counsel of a financial services company as well as its president and CEO, the SEC alleges that he was responsible for the management and operation of the company and was aware of all aspects of the company, including its accounting and financial issues.[119] The complaint further alleges that as a lawyer, he devoted all of his professional time to the company's legal work and wrote, or directed the writing of all of the company's offering memoranda as well as its newsletters and other investor communications.[120] Notwithstanding his knowledge of the company's history of losses and lack of profits, he is alleged to have knowingly or recklessly prepared offering memoranda and other public releases containing materially false and misleading statements and omissions pertaining to a variety of matters, such as anticipated profits, the payment of dividends, the return on investments, the use of investment funds, and NASD's approval of the company's acquisition of a broker-dealer.[121] Because of his role in the company, he was charged with violations of the securities laws both directly and as a controlling person.[122]

In its complaint against the general counsel of what the SEC describes as a company "professed to be in various businesses . . . none [of which] were ever operational,"[123] the SEC alleges that he and the company's CEO shared responsibility for keeping the company's books, records, and accounts, and for maintaining its internal controls.[124] In order to inflate the price of its stock and the value of the company, the complaint alleges that the general counsel participated in the following wrongful conduct: recording, as assets, several transactions having no basis on which to assign a value;[125] recording certain real estate as an asset, even though he knew that the company never controlled the property, never derived an economic benefit from the property, never obtained legal title to the property, never obtained an appraisal of the property, and knew that the property was the subject of litigation;[126] recognizing and valuing advertising credit without obtaining the requisite support for the valuation from a broker or other qualified individual;[127]failing to ensure that the company's internal controls prevented certain assets from being recorded in a manner that did not conform to GAAP;[128] recognizing and valuing notes receivable when he had no basis to believe that the notes were collectible;[129] preparing false and misleading press releases relating to assets that had been improperly recognized and valued;[130] selling company stock knowing, or recklessly disregarding the fact, that the registration statements, reports, press releases and shareholder letters contained inflated values of the company's assets;[131] and, failing to properly file certain periodic reports with the SEC.[132] As a consequence of these allegations, the complaint charges in-house counsel with a range of securities law violations.[133]

The final enforcement action against inside counsel in 2003 involves the general counsel of an investment company, whom the SEC alleges engaged in a scheme to sell municipal bond mutual funds at a fraudulently overvalued price. According to the SEC, the in-house counsel shared responsibility for assuring that the bonds were priced at fair value, and was "integral" in preparing SEC filings and promotional materials since she was responsible for reviewing all prospectuses,

[119] Complaint, SEC v. Tecumseh Holdings Corp., et. al., No. 03 Civ. 5490 (SAS) (S.D.N.Y. filed July 24, 2003), at ¶ 51.
[120] Id.
[121] Id., at ¶¶2, 28-50.
[122]See id., at ¶¶54-60, 64-66, and 71-73 (charging Milling directly and as a controlling person with violating Section 17(a) of the Securities Act (15 USC § 77q(a)), Section 10(b) of the Exchange Act (15 USC § 78j(b)), and Rule 10b-5, with violating Sections 5(a) and 5(c) of the Securities Act (15 USC § 77e(a), (c)), and with aiding and abetting the company's violation of Section 17(a) of the Securities Act and Rules 17a-3 and 17a-4).
[123] Complaint, SEC v. Michael J. Pietrzak, Maurice W. Furlong, and Donald E. Jordan, No. 03C-1507 (N.D. Ill. filed March 6, 2003), at ¶ 28.
[124] Id. at ¶ 50.

[125] Id. at ¶¶4, 50-51, 61-63.
[126] Id. at ¶¶87-91
[127] Id. at ¶¶104-106.
[128] Id. at ¶ 107.
[129] Id. at ¶¶117-118.
[130] Id. at ¶¶125-128.
[131] Id. at ¶¶163-166.
[132] Id. at ¶¶170-177.
[133] See id., at ¶¶180-187, 193-197, 202-209 (charging Pietrzak with violations of Section 17(a) of the Securities Act (15 USC § 77q(a)), Section 10(b) of the Exchange Act (15 USC § 78j(b)) and Rule 10b-5, and Section 13(b)(5) of the Exchange Act (15 USC § 78m(b)(5)) and Rules 13b2-1, and with aiding and abetting the company's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act (15 USC §§78m(a), 78m(b)(2)(A) and (B)) and Rules 12b-20, 13a-1, 13a-11, 13a-13, and 13b2-1).

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statements, and sales literature concerning the funds prior to their dissemination to the public.[134] In its complaint, the SEC alleges that the lawyer, together with others, knowingly or recklessly made material misrepresentations and omissions in these documents concerning a number of matters, including the risks of investing and the efforts undertaken to minimize the risks.[135] With respect to the overvaluation of the funds, the complaint alleges that she knew that the price of the funds were inflated, but failed to take corrective action to ensure that the prices reflected the bonds' fair value.[136] Instead, the SEC alleges that counsel attempted to conceal the pricing fraud by urging the other defendants to eliminate certain materials, including any materials dealing with valuation issues.[137]

Consistent with prior civil injunctive actions, the sanctions sought in 2003 included permanent injunctions against future violations, as well as disgorgement and the payment of civil monetary penalties. In two of the actions, the SEC also seeks an order barring participation in any penny stock offering,[138] and, in one action, the SEC sought the imposition of a permanent officer and director bar.[139] The SEC also obtained preliminary injunctive relief that included an asset-freeze order.[140]

[134]Complaint, SEC v. Heartland Advisors, Inc., et. al., No. 03 C-1427 (E.D. Wis. Filed Dec. 11, 2003), at ¶¶29, 36.

[135] Id. at ¶¶37-40.

[136] Id. at ¶¶52-60.

[137] Id. at ¶ 59. The SEC alleges that Bauer's activities violated Sections 17(a)(1) – (a)(3) of the Securities Act (15 USC § 77q(a)(1)-(a)(3)), Section 10(b) of the Exchange Act (15 USC § 78j(b)) and Rule 10b-5, and Sections 34(b) and 36(a) of the Investment Company Act (15 USC §§80a-33b, 80a-35b), and aided and abetted the company's violations of Sections 206(1) and 206(2) of the Advisers Act (15 USC §§80b-6(1), (2)). Bauer was also charged with insider trading for selling her shares in one of the funds in order to avoid losses upon the funds' devaluation. Id. at ¶¶90-100.

[138] See Complaint, SEC v. Michael J. Pietrzak, Maurice W. Furlong, and Donald E. Jordan, No. 03C-1507 (N.D. Ill. filed March 6, 2003); Complaint, SEC v. Tecumseh Holdings Corp., et. al., No. 03 Civ. 5490 (SAS) (S.D.N.Y. filed July 24, 2003).

[139] Complaint, SEC v. Oliver Hilsenrath and David S. Klarman, No. C-03-3252 (N.D. Cal. filed July 14, 2003).

[140] SEC v. v. Tecumseh Holdings Corp., et. al., No. 03 Civ. 5490 (SAS) (S.D.N.Y.), Litig. Rel. No. 18353 (Sept. 17, 2003).

During 2004, the SEC initiated six enforcement actions against inside counsel, all of whom appear to have held the top legal position within the corporations.[141] Four inside counsel also served in other capacities within the corporation, such as vice-president and secretary,[142] or just vice-president,[143] and one inside counsel had been a member of the board of directors.[144] In two of the cases, criminal actions were brought against inside counsel for conduct related to the subject of the civil enforcement action.[145]

Most of the actions in 2004 involve inside counsel's alleged complicity in securities law violations allegedly engaged in by others within the corporation. Like actions in preceding years, these actions reflect varying degrees of alleged participation by counsel in conduct targeted by the SEC in these actions, which ranges from the alleged failure to disclose material information or to correct materially false and misleading information in company reports and filings, to the drafting of opinion letters or transactional documents containing allegedly false or misleading information.

[141] Chris Gunderson is referred to as his company's in-house counsel, suggesting that he is the legal officer within the company. See SEC v. Universal Express, Inc., et. al., No. 04 CV 02322 (S.D.N.Y.), Litig. Rel. No. 18636 (March 24, 2004).

[142] See e.g., SEC v. Henry C. Yuen, et al., No. CV 03-4376 NM (MANx) (C.D. Cal.), Litig. Rel. No. 18530; Accounting and Auditing Enforcement Rel. No. 1937 (Jan. 6, 2004) (Jonathan Orlick was general counsel, executive vice-president, and secretary of Gemstar-TV Guide); SEC v. Symbol Technologies, Inc., et. al., No. CV 04 2276 (LDW) (WDW) (E.D.N.Y.), Litig. Rel. No. 18743; Accounting and Auditing Enforcement Rel. No. 2029 (June 3, 2004) (Leonard Goldner served as executive vice-president, secretary, and general counsel).

[143] SEC v. Steven Woghin, No. 04 Civ. 4087 (E.D.N.Y.), Litig. Rel. No. 18891; Accounting and Auditing Enforcement Rel. No. 2106 (Sept. 22, 2004).

[144] SEC v. Henry C. Yuen, et al., No. CV 03-4376 NM (MANx) (C.D. Cal.), Litig. Rel. No. 18530; Accounting and Auditing Enforcement Rel. No. 1937 (Jan. 6, 2004) (Jonathan Orlick).

[145] Steven Woghin is one of the attorneys, see Press Release of October 6, 2004, United States Attorney's Office for the Eastern District of New York, "Former Computer Associates Executives Indicted on Securities Fraud, Obstruction Charges, Former General Counsel Pleads Guilty, Company Enters into Cooperation Agreement," available at www.usdoj.gov/usao/nye/pr/2004oct06a.htm, and Leonard Goldner is the other attorney. See Press Release of October 27, 2004, United States Attorney's Office for the Eastern District of New York, "Former General Counsel of Symbol Technologies Pleads Guilty to Conspiring to Obstruct the Internal Revenue Service in the Collection of Income Tax," available at www.usdoj.gov/usao/nye/pr/2004oct27a.htm.

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In its first enforcement action for the year, for example, the SEC charged the former general counsel of Gemstar-TV Guide,[146] with securities fraud in connection with a scheme to inflate licensing and advertising revenue that resulted in an overstatement of revenue in the amount of approximately $248 million.[147] According to the SEC, he participated in the company's manipulation of its financial results in the following ways: he knew that the company was improperly recognizing and recording licensing revenue from two companies, but omitted to disclose that information; he repeatedly signed management representation letters to the company's auditors that contained false information regarding the status of negotiations with one of the companies; and, he failed to disclose material information relating to certain revenue.[148] The SEC also charged him with lying to the company's auditors.[149] Without admitting or denying the allegations, the in-house counsel consented to the issuance of an order permanently enjoining him from future violations of the securities laws.[150] In a related administrative disciplinary proceeding, he consented to an order suspending him from appearing or practicing before the SEC as an attorney.[151]

In another action, the SEC instituted an administrative cease and desist proceeding against the chief legal officer of a public company. According to the SEC, the in-house counsel became aware that certain corporate assets were significantly overvalued and he was advised by the auditors that the company would therefore be required to restate its financial statements. The company restated but allegedly mischaracterized the reasons in its SEC filings. The SEC alleged that the inside counsel effectively approved the filing when he knew or should have known that the filing mischaracterized the reason for the restatement. The SEC alleged that the in-house counsel reviewed and signed another SEC filing that he knew or should have known did not accurately reflect the company's cash and debt. Without admitting or denying the SEC's findings that the lawyer aided and abetted the company's violation of the reporting statutes, the lawyer consented to the entry of the cease and desist order, and agreed to refrain from preparing, reviewing, or signing any filings for a two-year period.

The three following enforcement actions allege active roles by inside counsel in the alleged fraudulent schemes.

In its enforcement action against the in-house counsel for a developmental stage company, the SEC alleges he engaged in the company's fraudulent stock distribution scheme by disguising the nature of the transactions through the preparation of false documentation, including the following: consulting agreements purporting to obligate the re-sellers of unlawfully-issued stock to perform services in exchange for the stock; legal opinions containing false assertions as to coverage of the stock under the company's registrations for its common shares; and fraudulent stock purchase agreements.[152] He is also alleged to have provided the company's auditors with misleading information about the stock issuances and with backdated stock purchase letters.[153] To underscore its view as to the severity of the charges, the SEC seeks third-tier civil monetary penalties against all of participants in the scheme, including in-house counsel.[154] Thus, in-house counsel faces a civil money penalty not to exceed the greater of $100,000, or the gross amount of pecuniary gain

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[146] Orlick was fired from Gemstar "for cause" in June of 2003, just before the SEC filed its first action against Gemstar executives. Subsequently, he filed a defamation against Gemstar, claiming that the "for cause" designation indicated that he had been convicted of a felony or had been found guilty of fraud or embezzlement . See "Former Gemstar counsel sues for defamation," Los Angeles Business from bizjournals (July 9, 2003), available at http://losangeles.bizjournals.com/losangeles/stories/2003/07/07/daily30.html.
[147] See SEC v. Henry C. Yuen, et al., No. CV 03-4376 NM (MANx) (C.D. Cal.), Litig. Rel. No. 18530; Accounting and Auditing Enforcement Rel. No. 1937 (Jan. 6, 2004).
[148] Id.
[149] Id. In all, Orlick was charged with violations of Section 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act (15 USC §§78j(b), 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)), and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2. Id.
[150] Id., Litig. Rel. No. 19047 (Jan. 21, 2005) (also ordering him to pay disgorgement of $150,000, reflecting a portion of bonuses received during the course of the scheme, interest of $5,510, and a civil penalty of $150,000).
[151] In the Matter of Jonathan B. Orlick, Esq., Admin. Proc. Rel. No. 34-51081; Accounting and Auditing Enforcement Rel. No. 2177 (Jan. 26, 2005).
[152] Complaint, SEC v. Universal Express, Inc., et. al., No. 04 CV 02322 (S.D.N.Y. filed March 24, 2004), at ¶¶23-28.
[153] Id. at ¶¶36, 38.
[154] Gunderson is charged with the following violations: Sections 5(a) and (c) of the Securities Act (15 USC § 77e(a) and (c), Section 17(a)(1), (a)(2), and (a)(3) of the Securities Act (15 USC § 77q(a)(1), (a)(2), and (a)(3)), Section 10(b) of the Exchange Act (15 USC § 78j(b)) and Rule 10b-5, Section 13(b)(5) of the Exchange Act (15 USC § 78m(b)(5)) and Rule 13b2-1, and aiding and abetting the company's violations of Sections 13(a) and 13(b)(2) of the Exchange Act (15 USC §§78m(a), (b)(2)), and Rules 12b-20, 13a-1, and 13a-3. See id. at ¶¶86-109.

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received from his wrongful conduct if it "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and . . . directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons."[155]

Similarly, with respect to a fraudulent revenue recognition scheme engaged in by the top executives at a large software company, the SEC alleged that the company's general counsel participated in the scheme by signing SEC filings when he knew, or recklessly disregarded the fact, that they contained materially false and misleading information concerning the company's prior revenue and earnings per share; by approving backdated contracts and drafting contracts with misleading dates; and, by permitting the legal department, which he oversaw, to approve contracts when he knew, or recklessly disregarded the fact, that the contracts contained false and misleading signature dates and that the company would recognize revenue from those contracts in the wrong quarter.[156] Additional allegations included charges that he obstructed internal and government investigations by instructing employees as to the manner in which they were to respond to questions when interviewed by outside counsel or the government.[157] As in its action against the in-house lawyer of the developmental stage company,[158] the SEC sought the imposition of third-tier civil monetary penalties for his violations of the securities laws[159] – i.e., a maximum penalty of either $100,000, or the gross amount received from his wrongful conduct if warranted by the nature of the violation and the extent of the losses sustained by others as a result of the conduct.[160] Without admitting or denying the allegations, he consented to the entry of an order permanently enjoining him from future violations, and, in a related administrative disciplinary proceeding, he consented to an order suspending him from appearing and practicing before the SEC as an attorney.[161]

And, in its enforcement action against Symbol Technologies and several of its former officers, the SEC has alleged that its then general counsel, "devised and directed" a fraudulent practice with respect to the company's stock option program during the course of a fraudulent accounting scheme.[162] Without connecting the lawyer to the accounting scheme, the SEC alleges that he manipulated stock option dates by calculating the cost of the exercise on the basis of a date that was more advantageous than the actual exercise date.[163] To conceal this "look-back" practice, the SEC alleges that he instructed his staff to backdate the requisite transactional documents and to use the false exercise dates on the forms on which the executives reported their acquisitions to the SEC.[164] The SEC further alleges that, in registration statements filed with the SEC, in-house counsel failed to disclose the "look-back" practice, and, therefore, filed false and misleading statements.[165] In addition to a permanent injunction against future violations of the securities laws,[166] the SEC also seeks an order requiring the payment of third-tier civil monetary penalties.[167]

The final enforcement action for 2004 represents a significant departure from all prior actions against inside counsel. Although acknowledging that the in-house counsel did not have any involvement in a fraudulent financial reporting scheme engaged in by his company and some of its senior executives, such as the CFO, the SEC has alleged that he violated one of the reporting

[155] 15 U.S.C. §§77t(d)(2)(C), 78u(d)(3)(B)(iii).
[156] Complaint, SEC v. Steven Woghin, No. 04 Civ. 4087 (E.D.N.Y. filed Sept. 21, 2004), at ¶¶24-34.
[157] Id., at ¶¶35-36.
[158] See n. 153, supra.
[159] Woghin was charged with violating Section 17(a) of the Securities Act (15 USC § 77q(a)), Sections 10(b) and 13(b)(5) of the Exchange Act (15 USC §§78j(b), 78m(b)(5)) and Rules 10b-5 and 13b2-1, and with aiding and abetting the company's violation of Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act (15 USC §§78j(b), 78m(a), 78m(b)(2)(A), and (2)(B)) and Rules 10b-5, 12b-20, 13a-1, and 13a-13. Id. at ¶¶37-54.
[160] See n. 156, supra.
[161] In the Matter of Steven Woghin, Esq., Admin. Proc. Rel. No. 34-50653; Accounting and Auditing Enforcement Rel. No. 2133 (Nov. 10, 2004).
[162] Complaint, SEC v. Symbol Technologies, Inc., et. al., No. CV 04 2276 (LDW)(WDW) (E.D.N.Y. filed June 3, 2004), at ¶ 122.
[163] Id.
[164] Id.
[165] Id. at 125-128.
[166] The complaint charges Goldner with violations of Sections 10(b), 13(a), 13(b)(2), 13(b)(5), 14(a), 16(a), of the Exchange Act (15 USC §§78j(b), 78m(a), 78m(b)(2), 78m(b)(5), 78n(a), 78p(a)), Section 17(a) of the Securities Act (15 USC § 77q(a)), and Rules 10b-5, 12b-20, 13a-1, 13a-13, 14a-3, 14a-9, and 16a-3.
[167] See n. 156 and accompanying text, supra.

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regulations by failing to fulfill his role as corporate gatekeeper.[168] According to the SEC, he failed to provide important information to the company's audit committee, Board of Directors, and independent auditors concerning an accounting transaction that resulted in the recording of a profit rather than a loss. The SEC alleges that at a meeting regarding the transaction, the elimination of benefits for the company's Asian employees, he failed to question the CFO's false statement that legal counsel had reviewed the decision to terminate the benefits. When he subsequently learned that the CFO's decision was not legally supportable, contrary to what had been told to the audit committee and outside auditors, the SEC alleges that in-house counsel failed to convey this information to the audit committee, outside auditors, or the board. The fact of the elimination of benefits was subsequently included in the company's quarterly report which he reviewed. For this reason, the SEC alleges, he was a cause of the company's filing of a false or misleading report.[169]

Without admitting or denying the allegations, the inside counsel settled the enforcement action and consented to an injunction against similar violations and to an agreement to pay a civil penalty of $50,000.[170] In statements made after settlement of the action, he expressed surprise at the charges against him, saying that, as general counsel, he was a "generalist" who covered a variety of areas, and did not understand accounting issues but relied on the accountants and auditors to spot issues for him.[171] As noted by his lawyer, the SEC has essentially created a strict liability offense, with no need for the SEC to establish intent or negligence.[172]

In January 2005, the SEC continued its close scrutiny of inside counsel by charging the general counsel of Google, Inc., with aiding and abetting Google's violation of Section 5(a) and 5(c)

[168] Complaint, SEC v. John E. Isselmann, Jr., No. CV 04-1350 MO (D. Ore. Filed Sept. 21, 2004), at ¶¶1, 18-21 (charging violations of Rule 13b2-2); see Litig. Rel. No. 18896; Accounting and Auditing Enforcement Rel. No. 2109 (Sept. 24, 2004).
[169] Complaint, SEC v. John E. Isselmann, Jr., No. CV 04-1350 MO (D. Ore. Filed Sept. 21, 2004), at ¶¶7-17.
[170] See Litig. Rel. No. 18896; Accounting and Auditing Enforcement Rel. No. 2109 (Sept. 24, 2004). In a related administrative proceeding, Issellman consented to the issuance of a cease and desist order. In the Matter of John E. Issellman, Jr., Admin. Proc. Rel. No. 34-50428; Accounting and Auditing Enforcement Rel. No. 2108 (Sept. 23, 2004).
[171] T. Loomis, "SEC Gores GC in Sarbanes-Oxley Dust-Up," Legal Times, p. 18 (Jan. 24, 2005).
[172] Id.

of the Securities Act [15 U.S.C. § 77e(a), (c)], by failing to register the issuance of stock option grants to employees or to provide certain information to the option recipients, as required by the securities laws.[173]

The SEC alleged that Google had granted stock options to its employees as a form of compensation since its inception, and did not register those securities with the SEC, relying on the exemption provided in Rule 701[174] for securities that are issued under compensatory benefit plans and whose value does not exceed $5 million over a one-year period.[175] When Google became aware that its issuances might exceed the $5 million threshold in September of 2002, the SEC alleges that Google temporarily stopped issuing the stock options because it "viewed the public disclosure of its detailed financial information as strategically disadvantageous" and was concerned that the information could reach its competitors.[176]

Several months later, however, Google reconsidered the issue of compensatory stock option benefits. As alleged by the SEC, the general counsel upon learning that the options being considered might exceed $5 million, thereby triggering the registration and disclosure requirements of Rule 701, consulted with outside counsel and personnel within Google's legal department, and determined that other exemptions applied that permitted issuance of the options without having to comply with the registration and disclosure requirements.[177] Even if his analysis of the applicable exemptions was found to be incorrect, the SEC states that the inside lawyer determined that the company counsel could make an offer of rescission.[178] Accordingly, the SEC alleges that in-house counsel advised the Board to approve a new stock option plan, but did not report that the issuances might exceed the $5 million threshold of Rule 701, and that other exemptions, such as the one provided in Rule

[173] SEC News Digest, "SEC Charges Google, General Counsel for Illegally Issuing Over $80 Million in Stock Options," Issue 2005-9 (Jan. 13, 2005), available at www.sec.gov/news/digest/dig011305.txt.
[174] 17 C.F.R. § 230.701.
[175] In the Matter of Google, Inc. and David C. Drummond, Admin. Proc. Rel. No. 33-8523 (Jan. 13, 2005) at III(C)(6).
[176] Id. at III(C)(7).
[177] Id. at III(C)(8).
[178] Id.

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506,[179] would be relied upon to preclude application of the registration and disclosure requirements.[180] Subsequently, the in-house lawyer is alleged to have learned that Google "probably" had exceeded the threshold amount and that the Rule 506 exemption did not apply, but believed that the options might be exempt under Section 4(2) of the Securities Act.[181] The SEC further alleges that at a meeting in June of 2003, during which the Board adopted two new stock option plans, he did not advise the Board that the additional option grants would exceed the $5 million threshold, or that there was a risk that the exemptions he believed applied would not apply.[182] In August of 2004, Google filed Form S 1 with the SEC, registering its offer to rescind the stock option grants and the purchases of shares in exercise of these options that were made between September of 2001 and June 2004.[183]

Without admitting or denying the SEC's findings, Google's inside lawyer settled the matter and consented to the issuance of a cease and desist order.[184] In public statements following disclosure of his settlement, SEC officials stated that he caused Google's violations "[b]y deciding Google could escape its disclosure requirements, and [by] failing to inform the Board of the legal risks of his determination."[185] The SEC disputed that it pursued him because of the advice that he provided to Google; instead, it pursued him because of his conduct.[186] The SEC also warned attorneys that "where [they] become actors in transactions, their conduct will be subject to sanctions, just as other participants' conduct."[187]

In February of 2005, the SEC initiated civil enforcement proceedings against the general counsel/chief financial officer of a corporation that owns and operates convenience stores and gas stations.[188] According to the SEC's complaint, outside auditors concluded in December of 2001 that the credit card receivables account was potentially overstated and recommended a review of the account.[189] The SEC alleges that, upon an initial review of the account for the period of January and February of 2002, the controller concluded that the account was overstated by almost $2 million, but, in order to close the books for 2001, he provisionally entered the balance of the account as $1.964 million and notified the general counsel/CFO of this entry.[190] The SEC alleges that in March of 2002, the controller initiated an extensive review of the account which, in mid-April, resulted in a finding that faulty bookkeeping resulted in both an overstatement in the credit card receivables account as well as an overstatement of net income affecting 1999, 2000, and the first three quarters of 2001.[191]

The complaint further alleges that in late March of 2002, the general counsel/CFO realized that the company would not be able to meet the Form 10-K filing deadline due to the ongoing review of the credit card receivables account, and, therefore, he prepared, signed, and caused the company to file a notice of late-filing (Form 12b-25) with the SEC on April 1, 2002.[192] According to the SEC, this notice was false and misleading in the following particulars: first, the notice fraudulently omitted to disclose that the cause of the delay in filing the periodic reports was due to an internal review into the credit card receivables account that appeared to be overstated by more that $1.9 million;[193] and second, the notices falsely attributed anticipated losses to certain business conditions, rather than to the write-down of credit card receivables recorded by the controller and

[179] 17 C.F.R. § 230.506.
[180] In the Matter of Google, Inc. and David C. Drummond, supra, at III(C)(10).
[181] Id. at III(C)(13) (referring to 15 U.S.C. § 4(2)).
[182] Id. at III(C)(15).
[183] Id. at III(C)(18).
[184] Id. at II.
[185] SEC News Release, No. 2005-6, "SEC Charges Google and its General Counsel David C. Drummond with Failure to Register over $80 Million in Employee Stock Options Prior to IPO."
[186] Pamela Atkins, "Attorneys: SEC Officials Warn Lawyers of Going Beyond Advisory Role," 20 Corp. Counsel Weekly Newsletter (BNA) 07 d3 (Feb. 16, 2005).
[187] Id.
[188] See SEC v. Craig Scott, Civil Action No. 3-05 CV 0302 P (N.D. Tex.), Litig. Rel. No. 19077 (Feb. 14, 2005).
[189] Complaint, SEC v. Craig Scott, Civil Action No. 3-05 CV 0302 P (N.D. Tex. Filed Feb. 14, 2005), at ¶ 7.
[190] Id. at ¶ 8.
[191] Id. at ¶ 9.
[192] Id. at ¶ 10.
[193] Id. at ¶ 12. Instead, the SEC alleges that the general counsel/CFO stated that reason the company could not make a timely filing of its Form 10-K was based on its inability to obtain the requisite financial and other data prior to the filing date. Id. at ¶ 11.

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reported to the general counsel/CFO at the end of February.[194] In addition, the SEC alleges that the general counsel/CFO prepared, signed, and caused the company to file another late-filing notice on May 15, 2002, in connection with its inability to file a timely Form 10-Q.[195] According to the SEC, this notice failed to disclose that the company would be restating its financial statements, even though the general counsel/CFO was aware of this fact at the time he prepared, signed, and caused the company to file the notice.[196] Because of his conduct with respect to the preparation, signing, and filing of these two notices (Form 12b-25), the SEC alleges that the general counsel/CFO committed securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5, and aided and abetted the company's violation of the reporting requirements under Rules 12b-20 and 12b-5.[197]

Without admitting or denying the SEC's allegations, the general counsel/CFO has settled the enforcement action and has agreed to pay a civil money penalty of $25,000.[198] In a related administrative proceeding,[199] the general counsel/CFO has consented to the issuance of a cease and desist order[200] as well as to an order denying him the privilege of appearing and practicing before the Commission either as an attorney or as an accountant.[201] After three years, however, he may seek renewal of the privilege of appearing and practicing before the Commission as an accountant and as an attorney.[202]

In April of 2005, the SEC instituted administrative and cease and desist proceedings against a beverage corporation and two of its officers, including its general counsel who also serves as vice-president, secretary, and director.[203] According to the SEC, the company had registered with the SEC as a transfer agent in 2002, and, in the fall of 2003, the SEC's Office of Compliance Inspection and Examination (OCIE) commenced a cause examination of the company's transfer agent activities.[204] The SEC alleges that the company refused to provide documents to the OCIE pursuant to a document request, and that the company's general counsel told the OCIE that the company could not make its transfer agent books and records available for examination.[205] The SEC further alleges that the company has failed to make periodic filings with the SEC.[206] Because of its conduct in connection with its transfer agent obligations, the SEC alleges that the company has violated Sections 17A(d)(1) and 17(b)(1) of the Exchange Act[207] and Rules 17Ad-2 and 17Ad-5, and that the general counsel has willfully aided and abetted and caused the company's violations of these statutes and regulations.[208] The action remains pending.

In late June of 2005, the SEC filed a civil injunctive action against the general counsel and several top officers of busybox.com, Inc., a now defunct company that sold photographs, film footage and video over the Internet, in connection with an allegedly fraudulent scheme to close an IPO.[209] The general counsel also served as a vice-president, secretary, and a director of the company.[210] According to the complaint, the defendants entered into an underwriting agreement with a firm, pursuant to which the firm agreed to purchase all of the shares of the offering at an underwriter's discount of 9% and the company agreed to pay the firm an expense allowance of 3%

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[194] Id. at ¶ 15. According to the SEC, reasons given for the anticipated losses included a decrease in gross margin on retail sales of motor fuels and on sales of merchandise, and an increase in general and administrative expenses. Id. at ¶ 14.
[195] Id. at ¶ 16.
[196] Id.
[197] Id. at ¶¶17-23.
[198] See Litig. Rel. No. 19077 (Feb. 14, 2005).
[199] See In the Matter of FFP Marketing Company, Inc., Warner Williams, and Craig Scott, CPA, Admin. Proc. Rel. No. 34-51198; Accounting and Auditing Enforcement Rel. No. 2185 (Feb. 14, 2005).
[200] Id. at Part IV(C). The only other individual subject to an administrative cease and desist order in connection with this matter is the controller of the company, Warner Williams, who supervised the accounting department. See id. at Part IV(B).
[201] Id. at Part IV(D).
[202] Id. at Part IV(E) – (G).
[203] See In the Matter of Phlo Corp., James B. Hovis, and Anne P. Hovis, Admin. Proc. File No. 3-11909 (April 21, 2005).
[204] Id. at ¶ 7. The complaint alleges that several months after registering as a transfer agent, the company sought to withdraw all of the company's shares held by an entity that was responsible for retaining custody of two million securities issues. The entity refused to release the shares since only shareholders of record were permitted to withdraw the shares. Subsequently, the company failed to fulfill its obligations as a transfer agent with respect to share certificates sent to the company by the entity. Id. at ¶¶5-6.
[205] Id. at ¶¶7-8.
[206] Id. at ¶ 9 (noting that the company's president and CEO was the sole signatory on all periodic reports, and was responsible for overall management of the company).
[207] 15 U.S.C. §§78q-1(d)(1) and 78q(b)(b)(1), respectively.
[208] In the Matter of Phlo Corp., James B. Hovis, and Anne P. Hovis, supra, at ¶¶10, 11.
[209] See Complaint, SEC v. Patrick A. Grotto, Mark B. Leffers, and Jon M. Bloodworth, No. O5 CV 5880 (GEL) (S.D.N.Y. filed June 24, 2005).

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of the gross proceeds.[211] When the defendants learned through the company's outside counsel and the president of the underwriting firm that the firm could not sell all of the IPO securities to bona fide investors, the SEC alleges that the defendants devised a scheme to close the IPO.[212] Under this alleged scheme, the defendants agreed to purchase the unsold IPO securities by using unearned and undisclosed payments from the company, which they characterized as "bonuses."[213] In addition, the SEC alleges that the defendants agreed to pay their outside counsel an inflated and undisclosed legal fee using the unsold IPO securities.[214] The complaint further alleges that the underwriting firm financed these transactions and the defendants caused the company to repay the firm out of its IPO proceeds.[215] None of the defendants, the SEC alleges, used any of their own funds for the purchase of these securities.[216] As a consequence of their undisclosed purchase of the IPO securities, the SEC charges that the defendants received approximately 20% of all the securities offered in the IPO,[217] which they used to benefit themselves at the expense of the company.[218]

According to the SEC, all of the defendants participated in the preparation of the registration statements filed in connection with the IPO.[219] The SEC alleges, therefore, that all of the defendants knew, or were reckless in not knowing, that the registration statements were materially false and misleading in that they failed to disclose several matters, including the following: (i) the actual nature of the underwriting agreement; (ii) the fact that the defendants would be acquiring company stock in order to close the IPO; (iii) the fact that the company would be paying out unearned "bonuses" in order to compensate the defendants for purchasing the stock; (iv) the fact that the company would be paying outside counsel in company stock in order to close the IPO; (v) the fact that the net IPO proceeds available to the company would be reduced by $2.1 million; and (vi) the fact that the net proceeds would be further reduced by $2.8 million due to planned but undisclosed expenditures within one week of the closing of the IPO.[220] The SEC further alleges that on the day after their receipt of the undisclosed IPO securities, the defendants certified that the registration statements were truthful in all material respects and that there had been no development that would materially affect their accuracy.[221]

Because of the allegedly fraudulent scheme to close the IPO, the SEC has charged the general counsel and all of the other defendant officers with violations of Section 17(a) of the Securities Act,[222] and with violations of Section 10(b) of the Exchange Act[223] and Rule 10b-5.[224] In its prayer for relief, the SEC seeks a permanent injunction against further violations of these statutes, an order requiring the defendants to disgorge all ill-gotten gains, and an order requiring the payment of civil money penalties.[225]

In July of 2005, an administrative law judge issued an initial decision in a matter involving four officers of an Internet company, including the general counsel who also served as a treasurer and as a director of the company.[226] The SEC alleged that the officers sold millions of dollars worth of the company's stock without registering the stock and without making the requisite disclosures concerning the sales; in addition, the SEC alleged that certain officers, including the general counsel, failed to file beneficial ownership reports as required by the securities laws.[227] The judge found, *inter*

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[210] Id. at ¶ 13.
[211] Id. at ¶ 20.
[212] Id. at ¶¶3, 24.
[213] Id. The SEC alleges that, in order to facilitate the scheme, the defendants opened cash brokerage accounts at the underwriting firm which were used solely for accepting the IPO securities. Id. at ¶ 25.
[214] Id. at ¶¶3, 24, 28. Outside counsel has been subject to both civil and criminal sanctions for his role in this scheme, see SEC v. Thomas T. Prousalis, Jr. and Robert T. Kirk, Jr., No. 04 Civ. 0081 (S.D.N.Y.), Litig. Rel. No. 19150 (March 22, 2005) (announcing the entry of judgment against the defendants in the SEC's civil injunctive action, and noting that Prousalis is serving a term of imprisonment after having pled guilty to related criminal charges), and has been barred from appearing and practicing before the Commission. See In the Matter of Thomas T. Prousalis, Jr., Admin. Proc. Rel. No. 34-50986 (Jan. 6, 2005).
[215] Id.
[216] Id.
[217] Id. at ¶¶3, 27.
[218] Id. at ¶ 6.
[219] Id. at ¶¶5, 36.
[220] Id. at ¶¶4, 37-42.
[221] Id. at ¶¶5, 36.
[222] 15 U.S.C. §77q(a).
[223] 15 U.S.C. § 78j(b).
[224] SEC v. Patrick A. Grotto, Mark B. Leffers, and Jon M. Bloodworth, supra, at ¶¶43-50.
[225] Id.
[226] See Initial Decision, In the Matter of John A. Carley, et al., Admin. Proc. File No. 3-11626 (July 18, 2005).
[227] See "John Carley Initial Decision," SEC News Digest, Issue 2005-137 (July 19, 2005).

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alia, that the general counsel violated Sections 5(a), 5(c), and 17(a) of the Securities Act,[228] Sections 10(b), 13(a), and 16(a) of the Exchange Act,[229] and Rules 10b-5, 12b-20, 13a-1, 13a-11, and 16a-3, and ordered him to cease and desist from further violations of these statutes and rules.[230] The judge also ordered the general counsel to disgorge approximately $1.4 million of ill-gotten gains.[231]

As the foregoing summary shows, the SEC has increased its actions against inside counsel but, for the most part, has relied on traditional theories for imposing liability. The two exceptions to date are its 2004 action, predicated on the gatekeeper concept of Sarbanes-Oxley, and its 2005 action against the general counsel of Google.[232] Whether this new theory suggests the beginning of a new trend in enforcement actions remains to be seen, but inside counsel has been put on notice that the SEC is focusing its enforcement activity on their conduct within the corporation.[233]

III. CRIMINAL PROSECUTIONS OF INSIDE CORPORATE COUNSEL

A. Introduction

Prior to the creation of the Corporate Fraud Task Force ("Task Force") in July of 2002,[234] the Justice Department did not have a unit devoted to the pursuit of corporations or their executives for criminal violations of the securities laws.[235] According to one former prosecutor, the Justice Department deferred to the SEC with respect to securities fraud cases, and focused its attention on "terrorism, money laundering, [and] drugs."[236] The establishment by Executive Order of the Task Force changed the priorities.[237] As a consequence, there has been a sharp increase in the number of executives including in-house counsel who have been indicted and/or convicted of corporate fraud since the inception of the Task Force almost three years ago.[238] Although each prosecution of an in-house counsel has attracted nationwide attention, the numbers remain surprisingly low even after the Task Force's inception. This section will examine the Task Force–era prosecutions as well as the pre-2002 prosecutions. Note that nearly all in-house counsel who were prosecuted were also subject to SEC administrative sanctions.[239]

B. Survey of Criminal Prosecutions of Inside Corporate Counsel

1. Pre-2002 Prosecutions

In the six years immediately preceding the creation of the Task Force, the Justice Department brought approximately five criminal actions against in-house counsel for their role in fraudulent securities schemes engaged in by other officers or employees of their respective corporations.[240] Many of these defendants were originally indicted for substantive securities law

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[228] 15 U.S.C. §§77e(a), (c), 77q(a).
[229] 15 U.S.C. §§78j(b), 78m(a), and 78p(a).
[230] Initial Decision, supra, at 82.
[231] Id. at 82-83.
[232] The SEC has reportedly advised attorneys to look at the Drummond case if they are unclear about their gatekeeper obligations under the Sarbanes-Oxley rules. See Michael Bologna, "SEC Enforcement: Officials Cite 'Gatekeeper' Duties of Lawyers for Public Companies," Sec. L. Daily (BNA) d10 (April 18, 2005).
[233] See n. 9, supra.
[234] Exec. Order No. 13,271, 67 Fed. Reg. 46,089 (July 11, 2002).
[235] See Tamara Loomis, "The Fraud Squad," Corporate Counsel (Jan. 12, 2005).
[236] Id. (quoting Jacob Frenkel, now in private practice).
[237] Exec. Order No. 13,271, supra, 67 Fed. Reg. at 46,091 (directing the Attorney General to establish the Task Force, the purpose of which is "to strengthen the efforts of the Department of Justice and Federal, State, and local agencies to investigate and prosecute significant financial crimes, recover the proceeds of such crimes, and ensure just and effective punishment of those who perpetrate financial crimes.").

[238] See Loomis, supra (noting that, since creation of the Task Force, the government has obtained convictions or guilty pleas of 4 former general counsels); see generally Corporate Fraud Task Force, Second Year Report to the President at 2.2 (July 20, 2004) (noting that, through the end of May of 2004, the Task Force had indicted over 900 defendants, and had obtained over 500 corporate fraud convictions). The financial failures of 2001 may also have generated an increase in state prosecutions of corporations and their top executives, especially in New York. See Jonathan C. Dickey, "Current Trends in Federal Securities Litigation," SK027 ALI-ABA 241, 245 (2004) (noting that other states have also become more active in this area, including California, which has recently granted its attorney general broader powers to investigate and prosecute securities fraud).
[239] These attorneys have also been made defendants in SEC enforcement actions, most of which are discussed in Part II(B), supra.
[240] Another action that may be of interest but is not included in this discussion due to the nature of the charges is the prosecution of Charles Spadoni, the former general counsel of a Boston investment firm, for bribery and racketeering in connection with a scheme involving the Connecticut state treasurer and the state's pension fund. See United States v. Triumph Capital Group, Inc., et al., Crim. No. 3:00CR-217 (BBB) (D. Conn.) (indicted October 10, 2000; convicted, July 16, 2003). In a subsequent administrative proceeding brought by the SEC, Spadoni was barred from associating with any broker, dealer, or investment adviser. See In the Matter of Charles B. Spadoni, Admin. Proc. Rel. No. 34-50300; Investment Adviser's Act of 1940 Rel. No. 2291 (Sept. 1, 2004).

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violations,[241] and pled guilty to conspiracy to commit securities fraud. Several defendants also pled guilty to obstruction of justice -- an increasingly frequent addition to the indictment at the urging of the SEC.[242] One might conclude that the nature of the charges reflects the government's view that the in-house lawyers' blameworthy conduct prevented disclosure of primary criminal conduct by others.

One of the first prosecutions for this period represents a departure from the general overview given above. In 1995, the securities counsel for U.S. Mint, Inc., was indicted for the substantive offense of securities fraud arising out of his role in causing the collapse of the company which allegedly damaged more than 1000 small investors.[243] According to the indictment, he prepared or assisted in the preparation of fraudulent statements relating to the extent of U.S. Mint's business, including statements claiming that the company was the largest supplier of gaming tokens in the United States.[244] In addition, the indictment alleged that he bribed registered representatives in exchange for their promotion and sale of U.S. Mint stock.[245] He pled guilty to one count of securities fraud in violation of Sections 10(b) and 32 of the Exchange Act,[246] and to one count of wire fraud in violation of 18 U.S.C. § 1343.[247] Although he faced 10 years imprisonment and a fine of almost $1 million, Sichta's cooperation with the government led prosecutors to recommend a reduced sentence.[248] Based on his fraud conviction, Sichta was subsequently disbarred by the Colorado Supreme Court.[249]

[241] Not all indictments are available in these particular actions; therefore, information pertaining to the exact charges alleged against an in-house counsel, as opposed to the charges to which counsel pled guilty, is based either on SEC releases or on media reports.
[242] Lisa I. Fried, "SEC Swats at Fraud; Faster Enforcement and Deterrence are Sought," 221 N.Y. L. J. 5 (March 4, 1999).
[243] United States v. Sichta, No. 95-CR-212-S (D. Colo.); see John Accola, "Attorney Pleads Guilty to Fraud in Stock Scam; Sichta Sold Insider Shares to the Public," Rocky Mountain News 3B (Aug. 23, 1996).
[244] See In the Matter of Robert D. Sichta, Admin. Proc. Rel. No. 34-41132, at ¶ III(C) (March 3, 1999).
[245] Id.
[246] 15 U.S.C. §§78j(b) and 78ff, respectively.
[247] In the Matter of Robert D. Sichta, supra, at ¶ III(B).
[248] Accola, supra, n. 244.
[249] "Court Suspends One Lawyer, Disbars 2 More," Rocky Mountain News (Dec. 3, 1997).

In 1996, the government indicted the general counsel of a publicly traded Florida company in connection with a scheme to misrepresent the financial condition of the company by falsely reporting that the company had earned a profit of almost $5 million on the sale of certain real estate parcels.[250] As related by the SEC, he was alleged to have assisted in the scheme by preparing fraudulent real estate documents that reflected these purported sales and by signing a SEC filing that also reflected these sales.[251] For his role in the scheme, he was charged with multiple securities law violations, including conspiracy to defraud the SEC, to file false reports, and to commit securities, mail, and wire fraud, as well as with four counts of filing false reports with the SEC, and with perjury and obstruction of justice.[252] He subsequently pled guilty to one count of obstruction of justice,[253] alleging, inter alia, that he made false and misleading statements while testifying as a witness in a formal SEC investigation, and was sentenced to one year of probation conditioned upon 60 days of home confinement.[254] Because dishonesty and personal gain underscored the conduct giving rise to the offense to which he pled guilty, he was disbarred by the Florida Supreme Court.[255]

In 1997, an in-house lawyer was indicted in the Southern District of New York for his participation in a scheme involving the fraudulent sale of promissory notes that defrauded investors of more than $470 million.[256] According to the indictment, the in-house attorney of a bill collection company assisted in drafting financial statements that falsely represented that the company was in sound financial condition when, in fact, it had sustained enormous losses.[257] The

[250] See United States v. Hugh Keith and Steven Wolis, No. 96-5204-CRIM-ZLOCH (S.D. Fla.), SEC Litig. Rel. No. 15186 (Dec. 12, 1996).
[251] Id.
[252] Id.; see also Florida Bar v. Wolis, 783 So. 2d 1057, 1058 (Fla. 2001).
[253] Wolis pled guilty to a violation of 18 U.S.C. § 1505, which proscribes misrepresenting or falsifying oral testimony before a government department or agency with the intent to avoid, evade, prevent, or obstruct compliance with any civil investigation.
[254] See Florida Bar v. Wolis, 783 So. 2d at 1058; see generally "Attorneys: Florida High Court Disbars Lawyer in Wake of Guilty Plea over Stock Scam," 33 Sec. Reg. & L. Rep. (BNA) 696 (May 7, 2001).
[255] Fla. Bar v. Wolis, 783 So. 2d at 1060.
[256] See "Two Ex-Executives of Towers Financial Indicted in Fraud Case," Wall Street Journal (April 18, 1997), at A5A; see also Fried, supra, 221 N.Y.L.J. at 5.
[257] See Wall Street Journal, supra; see also SEC v. Michael Rosoff, 96 Civ. 7064 (WK) (S.D.N.Y.), SEC Litig. Rel. No. 15053; Accounting and Auditing Enforcement Rel. No. 816 (Sept. 17, 1996).

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indictment charged him with several offenses, including conspiracy to commit securities fraud, perjury, and obstruction of justice, and, upon conviction, he was sentenced to 87 months imprisonment.[258]

In December of 1998, the in-house counsel of a Pennsylvania infomercial company, together with the company's CEO and CFO, was indicted for his role in a scheme to inflate the company's stock through the false reporting of revenue from bogus transactions with entities secretly controlled by the CEO and CFO.[259] Counsel, who also served as corporate secretary and had been a director and member of the audit committee, had previously been charged by the SEC with knowingly and recklessly preparing documents that concealed the other officers' ownership of these entities and with arranging the transfer of company stock to one of these entities, which was then funneled back to the company as purported payment for a sales transaction.[260] In the indictment, he was charged with conspiracy to commit securities fraud and to make false and misleading statements,[261] while the CEO and CFO were charged with the substantive offenses of securities fraud as well as mail and wire fraud.[262] According to media reports of the case, he pled guilty to the conspiracy charges and agreed to cooperate with the government's continued investigation.[263] A judgment of conviction was entered almost two years later, at which time he was sentenced to six months in prison, with three years of supervised release, and was ordered to pay a criminal fine of $10,000, and restitution of $340,000.[264]

[258] See In the Matter of Michael Rosoff, Admin. Proc. Rel. No. 34-50556 at II(B) (Oct. 18, 2004); see also Fried, supra, 221 N.Y.L.J. at 5 (noting that Rosoff was also convicted of two substantive counts of securities fraud involving the company's fraudulent sale of more than $270 million in promissory notes).
[259] See Shannon P. Duffy, "Fraud Indictment Charges In-House Counsel, Execs," 219 The Legal Intelligencer 5 (Dec. 4, 1998).
[260] See SEC v. Arthur L. Toll, Bruce B. Edmondson, Gerald Levinson, and Elliot Fisher, 98-CV-2325 (HH) (E.D. Pa.), Litig. Rel. No. 15731; Accounting and Auditing Enforcement Rel. No. 1033 (May 4, 1998). See discussion of this case, Part II(B), supra.
[261] See United States v. Fisher, No. 98-CR-63-3 (RFK) (E.D. Pa.), as noted in In the Matter of Elliot S. Fisher, Esq., Admin. Proc. Rel. No. 34-46954 at II(B) (Dec. 6, 2002).
[262] See Duffy, supra, 219 The Legal Intelligencer at 5.
[263] Shannon P. Duffy, "Former Infomercial Co. CEO Pleads Guilty; Defendant Charged in Stock Scheme to Defraud Public," 221 The Legal Intelligencer 3 (Aug. 9, 1999).
[264] In the Matter of Elliot S. Fisher, Esq., Admin. Proc. Rel. No. 34-46954 at II(B)-(C).

The final criminal action in this period involved the in-house counsel of a professional sports agency business who, along with the owner and several other individuals, was indicted for participation in a Ponzi scheme in which money purportedly invested with the company by professional sports player-clients was channeled into an illegal car-title loan company.[265] The inside lawyer pled guilty to one count of conspiring to commit wire fraud and to obstruct the SEC's parallel investigation, and one count of conspiring to commit money laundering.[266] The court sentenced him to a 54 month term of imprisonment, which was to be served concurrently with a 32 month sentence imposed by another federal court for a money laundering conviction in a related criminal action, and ordered him to pay$12 million in restitution.[267] According to the SEC, the court's sentence represented a substantial downward departure from federal sentencing guidelines due to Franklin's post-indictment cooperation.[268]

2. Post-2001 Prosecutions

Since the beginning of 2002, at least eight criminal actions have been brought against in-house counsel for various violations of the securities law, which represents a significant increase over the number brought in the preceding six-year period. Most of these actions have received considerable publicity due to the magnitude of the losses sustained by the companies and their investors, and the extent of the personal profits realized by the parties to the wrongful conduct. With one exception, all of the actions involve fraudulent securities and accounting schemes engaged in both by in-house counsel and by other officers and/or employees.[269] One of the actions remains pending; the rest have been resolved through one acquittal, two convictions, and four pleas of guilty.

[265] United States v. William H. Black, et al., No. 1:00CR15 SPM (N.D. Fla.), SEC Litig. Rel. No. 17604 (July 9, 2002) (announcing sentence imposed by court).
[266] United States v. William H. Black, et al., supra, SEC Litig. Rel. No. 17604.
[267] Id.
[268] Id.
[269] The one exception is Andrew Marks, the chief patent counsel for Vertex Pharmaceuticals, a biotechnology company, who was charged in a one-count information with insider trading in violation of Sections 10(b) and 32 of the Exchange Act (15 U.S.C. §§78j(b) and 78ff), and Rule 10b-5. See United States v. Marks, No. 03 CR 10297 (DPW) (D. Mass.) (Information filed Sept. 9, 2003). Marks pled guilty to the charge, see id., SEC Litig. Rel. No. 18409 (Oct. 14, 2003), and was sentenced to one year plus one day in prison

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The first of the high-profile criminal actions to be commenced during this period involved the chief legal officer of Rite-Aid, who was indicted in June of 2002 in the Middle District of Pennsylvania.[270] According to the indictment, Rite-Aid had been portrayed in its financial statements as a profitable company but, due to a fraudulent accounting scheme "devised, organized, and implemented" by inside counsel and the company's CEO and CFO, the company's expenses were significantly understated and its income overstated by hundreds of millions of dollars.[271] Because of the fraud, the company was forced to restate its financial results by $1.6 billion, which, at the time, was reportedly the largest restatement in history.[272] In addition to the accounting fraud scheme, the indictment alleged that inside counsel and his co-defendants engaged in schemes to defraud vendors and financial institutions, and schemes designed for personal enrichment.[273] Specific charges against him included conspiracy to commit,[274] and the commission of, the substantive offenses of fraud in the purchase and sale of securities in violation of Sections 10(b) and 32 of the Exchange Act, 15 U.S.C. §§78j(b) and 78ff, and Rule 10b-5;[275] false statements to the SEC in violation of 18 U.S.C. § 1001;[276] mail and wire fraud in violation of 18 U.S.C. §§1341 and 1343;[277] obstruction of grand jury proceedings and government agency proceedings in violation of 18 U.S.C. §§1503 and 1505;[278] and, tampering with a witness in violation of 18 U.S.C. § 1512(b)(1)(2).[279]

and to two years of supervised release, and was ordered to pay a fine of $3,000. See id., SEC Litig. Rel. No. 18548 (Jan. 21, 2004).

[270] See Indictment, United States v. Martin L. Grass, Franklin C. Brown, Franklyn M. Bergonzi, and Eric S. Sorkin, No. 1:CR-02-146 (M.D. Pa. filed June 21, 2002).

[271] Id. at ¶ 31.

[272] Id. at ¶ 48.

[273] Id. at ¶ 49. In addition to receiving annual bonuses which they would not have received if the true earnings of the company had been revealed, Id. at Count I, ¶ 17, the defendants allegedly devised schemes to increase the amounts awarded under the company's long term incentive plan, id. at ¶¶25-28 and Brown allegedly executed a deferred compensation agreement that was not disclosed in Rite-Aid's proxy statements. Id. at ¶ 32-34.

[274] The conspiracy charges are set forth in Counts 1 and 33.

[275] Id. at Count 2.

[276] Id. at Counts 3-15.

[277] Id. at Counts 16-31.

[278] Id. at Counts 34 and 35.

[279] Id. at Count 36.

Unlike his co-defendants who pled guilty, inside counsel went to trial. Although portrayed by his attorney as a "zealous company lawyer"[280] who "did nothing wrong" but, instead, engaged in what would ordinarily have been considered normal business transactions in a different environment,[281] a jury convicted him of conspiracy to defraud, conspiracy to obstruct justice, obstruction of grand jury proceedings, obstruction of government-agency proceedings, witness tampering and five counts of lying to the SEC.[282] He was subsequently sentenced to 10 years in prison and fined $21,000.[283]

In 2003, the year following the creation of the Task Force, the top legal officers of three corporations became defendants in highly-publicized criminal actions alleging their complicity in fraudulent accounting and securities schemes.[284]

One, a state prosecution, involved a general counsel who was charged with grand larceny, securities fraud, and falsifying business records in connection with receipt of interest-free loans from the company, receipt of large special bonuses, and receipt of millions in profits from the sale of his shares. The indictment alleged that both the CEO and the CFO engaged in this scheme and received similar benefits which were concealed from investors and the board. According to the prosecution, the general counsel received the loans and bonuses because of his assistance in covering up the CEO's and CFO's misconduct.

At trial, the defense asserted that the company had a reputation for awarding performance and that the general counsel had earned his bonus. It further argued that the general counsel relied

[280] Stephen Taub, "Jury Conviction for Former Rite-Aid Exec," CFO.com (Oct. 21, 2003).

[281] "Ex-Lawyer for Rite Aid Is Found Guilty," New York Times, Sec. C (Oct. 18, 2003). With respect to certain claims relating to accounting and securities fraud, the defendant has argued in post-trial motions that he had no accounting experience and was not an expert in securities law. See Memorandum of Law in Support of Defendant's Motion for Judgment of Acquittal and for a New Trial, United States v. Martin L. Grass, Franklin C. Brown, Franklyn M. Bergonzi, and Eric S. Sorkin, No. 1:CR-02-146 (M.D. Pa.).

[282] See id. (also noting that he was acquitted of wire fraud).

[283] See "Sentence Handed Down for Rite Aid Exec," abc27 (Oct. 14, 2004) (www.abc.27.com).

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upon the CEO's representation that the CEO had authority with respect to setting compensation. Moreover, since the general counsel was a litigator rather than a securities lawyer, the defense argued that he deferred to the CFO on issues relating to the disclosure of loans or bonuses on proxy statements. As summarized in one analysis of the case, "the central argument of the defense throughout the case . . . was that the prosecution's case was built on a fundamental misunderstanding of the general counsel's role in ferreting out corporate fraud."[285] The jury apparently agreed with the defense and acquitted the general counsel of all charges.

In June of 2003, the general counsel of McKesson/HBOC was indicted for his role in a fraudulent scheme to inflate revenue and earnings that was discovered after the merger of McKesson and HBOC and resulted in a substantial loss in value of the company's stock.[286] According to one of the cooperating defendants, the general counsel and other executives agreed to inflate reported revenues in the following manner: by recording revenue on contracts subject to undisclosed side agreements that permitted customer cancellations; by backdating contracts in order to record revenue in a prior quarter; and, by recording revenue as sales that were, in fact, exchanges of cash and inventory.[287] In addition to conspiracy to commit securities fraud, he has been charged with substantive securities fraud in violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, filing false SEC reports in violation of Section 32 of the Exchange Act, 15 U.S.C. § 78ff, falsifying the books, records, and accounts of HBOC and McKesson/HBOC in violation of pertinent provisions of Sections 13 and 32 of the Exchange Act, 15 U.S.C. §§78m(b)(2)(A), 78m(b)(5), 78ff, and Rule 13b2-1, circumventing internal controls in violation of pertinent provisions of Sections 13 and 32 of the Exchange Act, 15 U.S.C. §§78m(b)(2)(B), 78m(b)(5), and 78ff, and falsifying a registration statement in violation of Sections 17(a) of the Securities Act, 15 U.S.C. § 77q(a).[288]

Although this prosecution remains pending at the time of this writing, several co-defendants have pled guilty with respect to their respective roles in the fraudulent accounting scheme and have agreed to cooperate with the government in its prosecution of the general counsel and the other remaining defendant, the former chairman of the board of McKesson/HBOC.[289] One of the hotly contested preliminary issues that has been raised in this case is the right of the defendants to the release of an investigative report that was prepared by the company's outside lawyers and shared with the government pursuant to a confidentiality agreement.[290] While the district court has found that the report is not protected by the attorney-client privilege and should be shared with the defendants,[291] the company, as intervenor, has appealed that decision.[292]

The third criminal action in 2003 involved the general counsel of U.S. Wireless, whose alleged participation in a fraudulent scheme resulted in the bankruptcy of U.S. Wireless after a restatement of its financial condition disclosed a $6.3 million increase in losses.[293] The indictment alleges that he, together with the CEO of U.S. Wireless, caused the company to issue stock options, stock shares, and cash payments to offshore entities under their ownership and control as purported consideration for services under bogus consulting agreements.[294] The indictment further alleges that

[284] In a fourth prosecution commenced in 2003, the highest ranking attorney within the corporation was charged with insider trading. See United States v. Marks, No. No. 03 CR 10297 (DPW) (D. Mass.) (Information filed Sept. 9, 2003), discussed at n. 270, supra.
[285] Jay K. Musoff and Adam S. Zimmerman "Ethics and Off-Switches: What Next?" ¶ 2 N.Y.L.J. (Sept. 20, 2004), available at www.law.com.
[286] Press Release (June 4, 2003), Office of the United States Attorney for the Northern District of California, available at www.justice.gov/usao/can/press/html/2003_06_04_mckesson.html. See Second Superceding Indictment, United States v. Charles W. McCall, Albert J. Bergonzi, and Jay Lapine, No. CR-00-0505-MJJ (N.D. Cal. filed June 3, 2003).
[287] Press Release (June 4, 2003), Office of the United States Attorney for the Northern District of California, available at www.justice.gov/usao/can/press/html/2003_06_04_mckesson.html (paraphrasing statement of Jay Gilbertson, the former CFO of HBOC, who pled guilty to charges that he conspired with Lapine and other defendants to inflate HBOC's revenues and earnings).
[288] Second Superceding Indictment, supra, Counts 1-2, 4-8.
[289] See Jason Hoppin, "Another GC Readies for Trial," 3 Corp. Counsel 17 (Dec. 2003).
[290] Id.
[291] United States v. Bergonzi, et al., 216 F.R.D. 487 (N.D. Cal. 2003).
[292] United States v. Bergonzi , No. 03-10511 (9th Cir. appeal filed Sept. 2004); see Hoppin, supra; see also Eriq Gardner, "Share and Share Alike Rule Likely in Scandal Audits," The Legal Intelligencer 4 (Sept. 17, 2004).
[293] Press Release (July 14, 2003), Office of the United States Attorney for the Northern District of California, available at www.justice.gov/usao/can/press/html/2003_07_14_uswireless.html.
[294] See Indictment, United States v. Oliver Hilsenrath and David Scott Klarman, No. CR-03-0213 WH (N.D. Cal. filed July 14, 2003), at ¶¶4-11.

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these options, shares, and wire transfers of cash were issued and sent without board approval or knowledge, and were concealed by the defendants from the company and from the SEC through materially false and misleading statements in financial reports and filings.[295] Following receipt of the options and shares, the indictment alleges that the defendants caused the offshore entities to sell the stock and to transfer the proceeds to themselves, their families, and third parties.[296]

In addition to three counts securities fraud in violation of Section 32 of the Exchange Act, 15 U.S.C. § 78ff, he was charged with 16 counts of wire fraud in violation of 18 U.S.C. §§1343 and 1346.[297] He subsequently entered a plea agreement with federal prosecutors in which he pled guilty to mail fraud and money laundering for his role in the fraudulent scheme,[298] and agreed to cooperate with the government.[299] While awaiting sentencing, he also agreed to place $5 million in an escrow account.[300]

During 2004, federal prosecutors indicted three former in-house counsel for various securities law violations. All of the defendants held the position of general counsel, and were implicated in a fraudulent scheme involving other executives of the corporation.

In the first indictment issued in May of 2004 the general counsel for a now defunct software company known as Inso Corporation was charged with multiple offenses arising out of a fraudulent revenue recognition scheme.[301] According to the indictment, his co-defendant, a vice-president of the company, arranged a sham transaction with a Malaysian distributor for the purchase of software licenses for approximately $3 million dollars.[302] The purpose of the transaction was to create the false appearance that Inso had sold the software and realized the revenue from the sale during the third quarter of 1998 in order to meet targeted revenue projections.[303] In order to create this appearance and conceal the circumstances surrounding the purported transaction, the general counsel allegedly executed a series of agreements with the distributor and arranged for Inso to provide $4 million in letters of credit in exchange for the $ 3 million payment for the software.[304] The letters of credit were obtained through false documentation prepared by Inso employees under the alleged direction of the general counsel.[305] Following a drop in share price in January of 1999 and the announcement that Inso would have to restate its revenues, the SEC began an investigation, during the course of which he is alleged to have provided false testimony as to the Malaysian transaction.[306]

In addition to securities fraud in violation of Sections 10(b) and 32 of the Exchange Act, 15 U.S.C. §§78j(b) and 78ff, and Rule 10b-5, he has been charged with wire fraud in violation of 18 U.S.C. § 1341, false statements to accountants in violation of Sections 13(b)(5) and 32 of the Exchange Act, 15 U.S.C. §§78m(b)(5) and 78ff, and Rules 13b2-1 and 13b2-2, and two counts of perjury in connection with an SEC investigation in violation of 18 U.S.C. § 1621.[307] According to some commentators, his alleged perjury may have prompted the government's decision to prosecute him for his involvement in the underlying scheme.[308] Following a jury trial in a federal district court in Massachusetts, the general counsel was convicted of only one count of perjury in connection with his testimony before the SEC during its investigation into whether fraud was committed with respect to the company's decision to restate its revenues.[309] As to the remaining counts – one count

[295] Id. at ¶¶12, 14.
[296] Id. at ¶ 13.
[297] Id. at ¶¶15-23, 26-27.
[298] Jeff Chorney, "U.S. Wireless GC Admits Fraud," The Recorder (San Francisco) (Jan. 27, 2004), at 10; "High-Tech Exec Pleads Guilty to Mail Fraud, Money Laundering," Silicon Valley/San Jose Bus. J. (Jan. 27, 2004), available at www.bizjournals.com/sanjose/stories/2004/01/26/daily32.html.
[299] "High-Tech Exec Pleads Guilty to Mail Fraud, Money Laundering," Silicon Valley/San Jose Bus. J., supra.
[300] Chorney, supra.
[301] See Superseding Indictment, United States v. Graham James Marshall and Bruce Gordon Hill, No. 03-10344-DPW (D. Mass. filed May 5, 2004); see also SEC Litig. Rel. No. 18699; Accounting and Auditing Enforcement Rel. No. 2003 (May 7, 2004).
[302] Superseding Indictment, supra, at ¶¶14-18.
[303] Id. at ¶ 15.
[304] Id. at ¶¶17, 58-75.
[305] Id. at ¶ 75.
[306] SEC Litig. Rel. No. 18699, supra, n. 302.
[307] Superseding Indictment, supra, at ¶¶1, 4, 6, 8, 9.
[308] See Tamara Loomis, "Tangled Web," Corp. Counsel (July 2004), at 26.
[309] See United States v. Graham James Marshall and Bruce Gordon Hill, No. 03-10344-DPW (D. Mass.), SEC Litig. Rel. No. 19253; Accounting and Auditing Enforcement Rel. No. 2256 (June 7, 2005). According to the SEC, federal prosecutors presented evidence that contravened Hill's sworn investigative testimony and showed that Hill personally directed the preparation of fraudulent certificates purportedly reflecting the Inso board's approval of the issuance of $4 million in letters of credit, thereby creating the appearance

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of securities fraud, two counts of wire fraud, one count of false statements to accountants, and a second count of perjury – the jury deadlocked and the court declared a mistrial.[310] The general counsel now faces a maximum penalty of 5 years imprisonment, followed by 3 years of supervised release, and a fine of $250,000.[311]

In June of 2004, federal prosecutors indicted the general counsel of Symbol Technologies, in connection with a widespread accounting fraud scheme engaged in by top executives of the company, a leading manufacturer of wireless and mobile computing devices.[312] The indictment alleged that the CEO, the CFO, the CAO, and other officers of the company employed an array of fraudulent accounting manipulations in order to allow the company to meet performance targets that were established, and aggressively enforced, by the CEO.[313] These manipulations included the premature recognition of revenue, "tango adjustments" or top-side journal entries in the corporate books and records, the fabrication and use of improper restructuring expenses and the creation of "cookie jar" reserves, and the creation of fraudulent accounting entries in the customer service accounts of the company's books and records.[314] As a consequence of the accounting fraud, Symbol was required to restate its revenues which, for a three-year period, totaled approximately $4.1 billion.[315]

In a separate scheme, not expressly linked to the overall accounting scheme, the indictment alleged that he devised and carried out a scheme to defraud Symbol and evade the payment of income tax through the improper exercise of stock options granted by the company.[316] According to the indictment, he manipulated stock option exercise dates for certain executives who were given a "look-back" period of 30 days from which to choose an advantageous exercise date based on the price of the stock on that day.[317] This practice allowed the executive to minimize the tax paid or maximize the profit made upon their exercise of the option,[318] and caused the company to receive a smaller tax deduction than it would otherwise receive.[319] Because the "look-back" scheme was prohibited under the terms of the stock option plans, the indictment alleged that he took steps to conceal the practice, such as by failing to disclose it in SEC filings, and to hinder its discovery.[320]

The in-house counsel was charged with the following offenses: conspiracy to commit, and the commission of, the substantive offenses of mail and wire fraud in violation of 18 U.S.C. §§371, 1341, and 1343; conspiracy to impair, impede, obstruct, and defeat the Internal Revenue Service in violation of 18 U.S.C. §§371 and 3551 et seq.; income tax evasion in violation of 26 U.S.C. § 7201 and 18 U.S.C. §§3551 et seq.; and false filing in violation of 26 U.S.C. § 7206(1) and 18 U.S.C. §§3551 et seq.[321] After initially pleading not guilty,[322] he eventually pled guilty but only to the charge of conspiring to obstruct the IRS in the collection of income tax.[323] He faces a sentence of up to five years imprisonment and a maximum fine of $250,000 or a fine amounting to twice the loss that he caused, whichever is greater.[324]

In the final criminal action brought against in-house counsel in 2004, the United States Attorney for the Eastern District of New York charged the general counsel, president, and senior vice-president of Computer Associates, for his role in a fraudulent revenue recognition scheme.[325]

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of Inso's receipt of $3 million in payment of the reported third quarter sale of software. Id.
[310] Id.
[311] Id.
[312] See Press Release (June 3, 2004), Office of the United States Attorney for the Eastern District of New York, available at www.usdoj.gov/usao/nye/pr/2004jun3.htm.
[313] Indictment, United States v. Tomo Razmilovic, et al., Cr. No. CR04519 (E.D.N.Y. filed June 3, 2004), at ¶ 23 (alleging that the CEO would reward those divisions that met these targets, and punish those divisions that failed to meet them, and further noting that many of the executive's bonuses and salaries were tied to meeting these targets).
[314] Id. at ¶ 24.
[315] Id. at ¶ 1.
[316] Id. at ¶ 77.
[317] Id. at ¶ 88.
[318] Id. at ¶¶88-89.
[319] Id. at ¶ 90.
[320] Id. at ¶¶94-95 (alleging, for example, that Goldner encouraged other officers to prevent the expansion of the investigation into the accounting fraud scheme so as to avoid discovery of the "look-back" scheme).
[321] Id., Counts 15-24.
[322] See "Ex-Symbol Counsel Pleads Not Guilty to Fraud Charge," available at www.nysscpa.org/printversions/nysscpa/2004/604/2week/printversion34.htm.
[323] Press Release (Oct. 27, 2004), Office of the United States Attorney for the Eastern District of New York, available at www.usdoj.gov/usao/nye/pr/2004oct27a.htm.
[324] Id.
[325] Information, United States v. Steven Woghin, Cr. No. 04-847 (E.D.N.Y. filed Sept. 22, 2004); see also Press Release (Sept. 22, 2004), Office of the United States Attorney for the Eastern District of New York, available at www.usdoj.gov/usao/nye/pr/2004oct06a.htm.

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According to the information, numerous officers and executives at the company, which was one of the largest suppliers of computer software for business use,[326] engaged in a practice of falsely and fraudulently recording and reporting revenue from certain license agreements, even though the agreements had not been finalized or signed within the quarter.[327] Known as the "35-day month" practice because it extended the reporting month beyond the end of the month, its purpose was to meet or exceed projected quarterly revenues and earnings.[328] The general counsel, it is alleged, participated in the scheme by negotiating, drafting, and approving agreements after the calendar-end of a fiscal quarter and backdating their execution dates to a date within the quarter.[329] The information further alleges that he obstructed internal and governmental investigations into the "35-day month" practice by failing to disclose or falsely denying the existence of the practice, and by instructing employees as to how they should respond to questions posed by the government during the investigation.[330]

Based on the allegations in the information, the general counsel was charged with several conspiracy offenses, including conspiracy to commit securities fraud in violation of Sections 10(b) and 32 of the Exchange Act, 15 U.S.C. §§78j(b) and 78ff, and Rule 10b-5; conspiracy to falsify the company's books and records in violation of Section 13 of the Exchange Act, 15 U.S.C. §§78m(b)(2)(A), 78m(b)(5), 78ff and Rule 13b2-1; and conspiracy to circumvent internal accounting controls in violation of Section 13 of the Exchange Act, 15 U.S.C. §§78m(b)(2)(B), 78m(b)(5), and 78ff.[331] In addition, he was charged with obstruction of justice in violation of 18 U.S.C. §§1512(c)(2) and 3551 et seq.[332] At the time of the unsealing of the information, he pled guilty to these charges.[333]

[326] Information, supra, at ¶ 1.
[327] Id. at ¶ 12.
[328] Id. at ¶¶13-14.
[329] Id. at ¶¶15-16.
[330] Id. at ¶¶17-22.
[331] Id., Count One.
[332] Id., Count Two.
[333] Press Release (Sept. 22, 2004), Office of the United States Attorney for the Eastern District of New York, supra.

In a recent indictment involving officers of PurchasePro.com ("PurchasePro"), a federal grand jury has charged the general counsel of PurchasePro in connection with a scheme designed, inter alia, to fraudulently increase the reported revenue of PurchasePro.[334] According to the indictment, PurchasePro had formed a strategic partnership for the development of a business-to-business Internet marketplace that would generate revenue for it and a business partner.[335] When revenue was not realized,[336] the indictment alleges that the defendants conspired, to conceal the true financial condition of PurchasePro through various types of transactions, arrangements, and devices.[337] The general counsel is alleged to have participated in the fraudulent scheme in several ways, including: by making, or authorizing others to make, undisclosed side deals with other purchasers of its marketplace software license; by recording sales in the wrong quarter; by creating, or authorizing others to create, a back-dated contract reflecting payment by others to PurchasePro for work purportedly undertaken in a prior quarter; by issuing materially false and misleading statements to the public and to PurchasePro's auditors, and by making false statements to the FBI.[338] With respect to this latter conduct, the indictment alleges that he asked a member of PurchasePro's technology department to delete his e-mails, but falsely stated otherwise in an interview with the FBI.[339]

In response to these charges, his lawyer contends that he was not involved in the fraudulent scheme; instead, he was a whistleblower who tried to expose the fraud to the government and

[334] News Release (Jan. 10, 2005), Office of the United States Attorney for the Eastern District of Virginia, available at www.usdoj.gov/usao/vae/ArchivePress/JanuaryPDFArchive/05/11005AOLPR.pdf.
[335] Indictment, United States v. Christopher J. Benyo, and Scott E. Wiegand et al., Crim. No. 1:05CR12 (E.D. Va. Filed Jan. 10, 2005), at ¶ 30.
[336] Id. at ¶ 33
[337] Id. at Count I.
[338] Id. at Counts One-Five, Twenty-Nine and Thirty (charging Wiegand with conspiracy in violation of 18 U.S.C. § 371, with two counts of securities fraud in violation of Sections 10(b) and 32 of the Exchange Act, 15 U.S.C. §§78j(b) and 78ff, and Rule 10b-5, with two counts of making false statements to auditors in violation of Sections 32 and 13 of the Exchange Act, 15 U.S.C. §§78ff and 78m(a), (b), and Rule 13b2-2, and with two counts of making false statements to the FBI in violation of 18 U.S.C. §§1001(a)(2) and 3551 et seq.).
[339] Id. at Count Thirty.

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cooperated in its investigation of the company.[340] Perhaps the SEC concurs, since it has brought related civil enforcement proceedings against all of the defendants – with the exception of the general counsel.[341] In prior criminal actions against in-house counsel, cooperation by the corporate entity itself appears to have resulted in fewer trials and more pleas.[342]

[340] Heidi Moore, "No Credit for Whistle-Blowing," Corp. Counsel (March 2005).
[341] See SEC v. Charles Johnson, Jr., Chris Benyo, Michael Kennedy, John Tull, and Kent Wakeford, No. 1:05 CV-0036-GK (D. D.C.), Litig. Rel. No. 19029 (Jan. 10, 2005).
[342] See Michael Bobelian, "Symbolic Victory," 4 Corp. Counsel 28 (Dec. 2004).

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The following resources are included within these course materials:

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http://www.acca.com/protected/article/attyclient/crosshair.pdf

Indemnification & Insurance Coverage for In-House Lawyers (Leading Practice Profile)
http://www.acca.com/protected/article/insurance/lead_liability.pdf

Paradise Tarnished: Today's Sources of Liability Exposure for Corporate Counsel
http://www.acca.com/resource/v4960

For additional reading, consider the following resources available via ACC's Virtual Library:

State-by-State Mandatory Insurance Disclosure Rules
http://www.acca.com/php/cms/index.php?id=268

In-House Counsel as Targets: Fact or Fiction (Archived Webcast)
http://www.acca.com/resource/v6024

Hidden Insurance Issues Behind Sarbanes-Oxley and Recent Governance Reform
http://www.acca.com/protected/pubs/docket/apr05/ladder.pdf

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