608:What to Do When the SEC Calls: Securities Investigations & Other Corporate Crises

Brackett B. Denniston, III
Vice President - Senior Counsel - Litigation & Legal Policy
General Electric Company

Karl A. Groskaufmanis
Partner
Fried, Frank, Harris, Shriver & Jacobson

John K. Villa
Partner
Williams & Connolly LLP

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).
Materials may not be reproduced without the consent of ACC.
Reprint permission requests should be directed to James Merklinger at ACCA: 202/293-4103, ext. 326; merklinger@acca.com

Faculty Biographies

Brackett B. Denniston, III

Brackett B. Denniston III is vice president and senior counsel for litigation and legal policy for General Electric. In 1999, he was named chairman of the company's Policy Compliance Review Board, the governing compliance board of the company. In his position, Mr. Denniston leads GE's worldwide litigation and compliance areas.

Prior to this position, he was chief legal counsel to Governor William F. Weld of Massachusetts, and was responsible for issues relating to judicial selection, criminal justice, and legal policy. He was also a partner, and earlier an associate, at Goodwin, Procter and Hoar in Boston, where he specialized in complex civil litigation, securities matters, and white collar crime cases throughout the United States.

Previously, Mr. Denniston was chief of the Major Frauds Unit of the U.S. Attorney's Office, responsible for white collar crime prosecutions. He was a member of the Attorney General's White Collar Crime Operations Committee. He was awarded the Department of Justice's Director's Award for Superior Performance for his role overseeing numerous successful prosecutions. Mr. Denniston served as a law clerk to the Honorable Herbert Y. Choy of the United States Court of Appeals for the Ninth Circuit.

He is a *summa cum laude* graduate of Kenyon College and a *magna cum laude* graduate of Harvard Law School, where he was an editor of the *Harvard Law Review.*

Karl A. Groskaufmanis

Karl A. Groskaufmanis is a corporate partner resident in Fried Frank's Washington, DC office. Mr. Groskaufmanis' securities practice includes U.S. Securities and Exchange Commission enforcement actions, civil and criminal insider trading investigations, corporate internal investigations, securities litigation, and corporate counseling.

Chairman of the Practising Law Institute's Advanced Securities Workshop, Mr. Groskaufmanis is also cochair of an ABA Business Law Section's Ad Hoc Committee on Public Company Information Practices. Mr. Groskaufmanis is an author or co-author of numerous articles and a frequent speaker on corporate and securities law issues. He has appeared as a guest lecturer at the University of Pennsylvania's Wharton School, University of Michigan Business School, Benjamin N. Cardozo Law School, Cornell University Law School, Georgetown University Law Center, Harvard Law School, Stanford Law School, and the University of Toronto Law School.
In 1998, Mr. Groskaufmanis was named one of the "40 Top Lawyers Under 40" by *Washingtonian Magazine.*

Mr. Groskaufmanis received his BS, *with honors,* from Cornell University, his JD from the University of Pennsylvania, and his LLB from the University of Toronto Law School.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

John K. Villa

John K. Villa, a partner at Williams & Connolly LLP in Washington, DC, focuses on corporate, financial services-related and securities litigation (both civil and criminal) and legal malpractice defense. He has been lead counsel in both trial and appellate proceedings involving the defense of financial institutions, directors and officers, and major law firms.

He was named to *National Law Journal's* list of "100 Most Influential Lawyers in America" as "the first lawyer that other attorneys and law firms turn to when caught up in the S&L and banking scandals." PLC's Global Counsel Handbooks 2002 gives Mr. Villa its highest rating in Washington, DC and describes him as an "exceptional banking, financial, and corporate governance litigator." The January 2002 *American Lawyer* described him as "perhaps the premier [legal] malpractice defense lawyer in the nation." His representation of MicroStrategy, Inc. in securities fraud and derivative litigation was selected by the *American Lawyer* as the case most reflecting the securities litigation arising out of the fall of the technology stocks in September 2000.

Mr. Villa authors a column in the *ACCA Docket* entitled "Ethics and Privilege" and is a member of the advisory board of Georgetown Law School's "Corporate Counsel Institute." He is also an adjunct professor at Georgetown University Law School, teaching a course entitled "Counseling the Corporation in Crisis" and has authored several treatises including "Corporate Counsel Guidelines," which is copublished by ACCA and West Publishing.

He received his AB from Duke University and his JD from the University of Michigan.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

T O O U R F R I E N D S A N D C L I E N T S

July 18, 2003

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

The SEC's "up-the-ladder" reporting requirement for attorneys becomes effective on August 5, 2003. With the effective date fast approaching, public companies in the U.S. should be considering how their internal and outside counsel will comply with the new regulation and should consider developing, or updating, an internal compliance program with respect to these rules.

The first part of this memorandum is intended to provide practical suggestions for companies to consider in developing a compliance program for in-house lawyers. The second part describes some practical considerations relating to the establishment of a qualified legal compliance committee (QLCC). While there are both advantages and disadvantages to using a QLCC, companies who want to utilize a QLCC cannot form the committee in response to a specific incident, but must have previously formed the QLCC prior to an attorney's report of evidence of a violation. A more detailed description of the professional conduct rule is available in our memorandum dated February 10, 2003, which can be accessed at http://www.ffhsj.com/cmemos/030210_noisy_withdrawal.htm.

I Internal Compliance Policies

A number of issues need to be considered by companies in implementing a compliance policy for their in-house counsel. Each company will need to devise appropriate procedures based on its own culture, structure and needs and the size of its legal staff. In addition, any policies may need to be revised or modified as the new rules are interpreted over time. In this section we review certain questions that companies may want to consider in adopting their own procedures.

Who is covered?

The "up-the-ladder" reporting obligations apply to attorneys "appearing and practicing before the Commission" in the representation of an issuer. Attorneys "appear and practice before the Commission" if they (i) transact any business with the SEC, including any form of communication; (ii) represent an issuer in connection with an SEC administrative proceeding, investigation, information request, inquiry or subpoena; (iii) provide advice on U.S. securities

Copyright @ July 18, 2003 Fried, Frank, Harris, Shriver & Jacobson

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

laws, rules or regulations in connection with any document that the attorney has notice will be filed or submitted to the SEC, or incorporated in an SEC filing or submission; or (iv) advise an attorney whether an opinion or other writing needs to be filed with or submitted to the SEC, even if such a writing is not filed or submitted.

"Non-appearing foreign attorneys" are not covered by the rule. A foreign attorney will generally qualify as a "non-appearing foreign attorney" as long as (1) he or she is qualified as an attorney in a non-US jurisdiction, (2) he or she does not hold himself or herself out as giving US legal advice, and (3) either (a) he or she provides advice regarding U.S. law only in consultation with U.S. counsel or (b) he or she conducts activities that only incidentally involve appearing before the SEC in the ordinary course of his or her practice.

One question companies need to consider is whether their internal compliance policy should apply only to lawyers appearing and practicing before the Commission or to all of their in-house attorneys. In making this decision, companies should consider that even attorneys who do not normally "appear and practice before the Commission" may do so on occasion under the broad definition adopted by the SEC. Whether or not required by the rules, companies may want all attorneys to report evidence of material violations as a matter of company policy. Other companies may decide to adhere to the strict parameters of the SEC regulation, out of concern that a broader policy may create issues and even liabilities where none would otherwise exist.

Violations of which laws must be reported?

The new rules provide that attorneys must report evidence of (i) a material violation of United States federal or state securities laws, (ii) a material breach of fiduciary duty arising under United States federal or state law or (iii) a similar material violation of any United States federal or state law, in each case by the issuer or an officer, director, employee or agent of the issuer.

In adopting a compliance policy, companies need to consider whether they want violations of all laws reported or, again, whether to adhere to the specific requirements of the SEC's rule. Companies taking a broader approach also need to consider whether their policy should cover only U.S. law or also foreign law, since the SEC rules only cover violations of U.S. law.

How much evidence of a violation must an attorney have before reporting?

The final rules define "evidence of a material violation" as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

Companies need to consider whether their policy should adopt the SEC's standard for reporting or whether it should adopt a *lower threshold*, such as credible evidence suggesting, for example, a reasonable likelihood of a violation of law. Companies might also choose to require reporting of evidence without regard to the materiality of the violation. Using a lower threshold would permit reports to be received that do not yet reflect a firm conclusion by another lawyer that it meets the standard for "up-the-ladder" reporting.

To whom should reports be directed?

In the first instance, the new regulation requires internal and outside attorneys to report evidence of a material violation to the chief legal officer (CLO), or the CLO and the CEO. If an appropriate response is not forthcoming, the attorney is required to report further "up-the-ladder" to the audit committee, another committee of independent directors or to the full board of directors.

The rules have provided special provisions for subordinate attorneys. A "subordinate attorney" fulfills his or her obligations by reporting to a "supervisory attorney," who then assumes responsibility for reporting the evidence "up-the-ladder" where appropriate. A subordinate attorney is any attorney who is supervised by another attorney (other than the CLO).

An attorney's status as a "supervisory" or "subordinate" attorney, and the attendant reporting obligations, may vary from matter to matter. For example, a senior attorney acting under the supervision of another attorney on a particular matter may be a "subordinate attorney" with respect to that matter, while a junior attorney acting directly under the CLO would be considered a "supervisory attorney" (since an attorney working directly for the CLO cannot be a subordinate attorney under the rules).

In a large organization, it may be helpful for the company to adopt a formal chain of command in which "subordinate attorneys" clearly understand which senior attorneys would qualify as "supervisory attorneys" for reporting purposes. Particularly with respect to disclosure issues, a direct report to the CLO on every questionable issue may be overly cumbersome. In adopting a chain of command, however, "supervisory attorneys" must actually act in a supervisory role under the rule.

The compliance policy could also state (consistent with the new rules) that if an attorney reasonably believes that reporting to the CEO or CLO would be futile, the attorney may make a report directly to the appropriate committee of the board of directors.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

In what form should the report be made?

The new rules do not specify the precise format (*e.g.,* oral, written or e-mail) pursuant to which reports should be made. Companies should consider whether they want to specify a particular format for reports, and whether they prefer all reports to be made orally or in writing.

Should the policy specify the steps that the CLO should take upon receiving a report?

Once the CLO becomes aware of evidence of a material violation, under the new rules he or she has a duty to conduct an inquiry. If the CLO determines that no material violation exists, the CLO must inform the reporting attorney of the basis for that conclusion. If a material violation does exist, the CLO must take all appropriate steps to insure that the company adopts an "appropriate response" and inform the reporting attorney of such steps. Alternatively, the CLO may refer the matter to a qualified legal compliance committee (QLCC), as discussed in the second part of this memorandum. If such a referral is made, the CLO must inform the reporting attorney.

Companies should consider whether their policy should require that the CLO prepare a written document memorializing the facts of each report, the steps taken to investigate it, and conclusions reached and actions taken.

What is an "appropriate response"?

Under the rules, an "appropriate response" is a response which leads the reporting attorney reasonably to believe:

- that no material violation has occurred, is ongoing, or is about to occur;
- that the issuer has adopted appropriate remedial measures to prevent any material violation that has yet to occur, and to remedy any material violation that has already occurred; or
- that the issuer, with the consent of the board of directors, audit committee or committee of independent directors, or a QLCC, has retained or directed another lawyer to review the evidence and either:

    (i) has substantially implemented any remedial recommendations made by such lawyer after a reasonable investigation; or

    (ii) has been advised that such lawyer may, consistent with his or her professional obligations, assert a "colorable defense" on behalf of the issuer (or the issuer's officer, director, employee, or agent).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

How should reports be documented?

The rules do not mandate documentation of an attorney's initial report or the response to that report. However, companies should consider whether they wish to establish internal documentation procedures. Such procedures might require documentation by the reporting attorney and CLO that a report or response has been made. In this way, companies may seek to avoid an appearance of inconsistency in how reported matters are handled.

How should internal counsel learn about the rules?

A company should insure that each of its in-house attorneys is familiar with the professional conduct rules and the company's internal compliance policy. Companies should consider conducting training programs for both newly hired and existing attorneys explaining their obligations under the "up-the-ladder" reporting rules. The company could also consider designating a contact person for any questions or concerns relating to the rules. Companies might also consider whether all attorneys should, each year, sign a certificate certifying that they have not violated the "up-the-ladder" reporting system (similar to the confidentiality certificate which many companies use).

Companies may include in their policy a statement that legal consequences exist for attorneys who fail to fulfill their reporting obligations, such as SEC enforcement actions. In addition, if the company has also adopted internal disciplinary procedures for failure to comply with the "up-the-ladder" reporting rules, those may be stated as well.

The company should also consider including a statement that any attorney who complies in good faith with the requirements of the rule will not be subject to any form of company discipline or dismissal. The policy may also describe what steps should be taken internally for attorneys who believe they were dismissed for making a report under the rule.

What steps, if any, should be taken with regard to the company's outside lawyers?

An issuer's outside counsel will often appear and practice before the Commission in the representation of an issuer and is also bound by the "up-the-ladder" reporting rules. Companies may wish to discuss their compliance policies and reporting procedures with their outside counsel. Companies should consider whether outside lawyers should be instructed as to a specific form and procedure for making reports. Companies should also consider whether their outside lawyers should be informed in writing that the company expects them to meet their obligations. Alternatively, companies may be guided by the fact that outside counsel are subject to the SEC rule regardless of any action that companies may take and, thus, decide not to communicate with outside counsel.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

II The Qualified Legal Compliance Committee (QLCC) Alternative

As an alternative to reporting to the CLO and/or the CEO, the rules allow both inside counsel and outside attorneys to report evidence of a material violation to a pre-existing qualified legal compliance committee (QLCC). Once an attorney reports to a QLCC, he or she is not obligated to assess the response to the report of evidence of a material violation and has no other "up-the-ladder" reporting obligations. As discussed above, a CLO may also report any evidence of a material violation to the QLCC in lieu of conducting an investigation.

To satisfy the requirements of the rule, the QLCC must be formed <u>prior</u> to the attorney's report of a material violation (and not in response to a specific incident). Consequently, issuers that wish to avail themselves of the QLCC option would need to have a preexisting QLCC.

Attached to this memorandum are samples of a draft QLCC charter and draft QLCC procedures. These examples may not be appropriate for all companies and, if a QLCC is used, each company will need to develop documents appropriate to its circumstances.

Composition of a QLCC

The QLCC must be composed of at least one member of the audit committee (or another committee consisting solely of independent directors) and two or more directors who are not employed, directly or indirectly, by the company. The committee must adopt written procedures for the confidential receipt and consideration of reports of evidence of material violations. The board of directors must also grant the committee the authority and responsibility to:

- notify the CLO and CEO of a report of evidence of a material violation,
- undertake investigations of such evidence through the CLO or outside attorneys, and notify the audit committee or full board of such investigations,
- recommend by majority vote the appropriate remedial actions, and inform the CLO and CEO of such recommendation, and
- take all other appropriate action, including notification to the SEC if the issuer fails in any material respect to implement the QLCC's recommendations.

The rules do not require that a separate committee be formed if an existing committee (such as the audit committee) meets the requirements for a QLCC. Some companies may designate the governance/nominating committee as the QLCC in cases where such committee includes at least one member of the audit committee. However, since the audit committee is responsible for legal and regulatory compliance under the NYSE's proposed governance standards and is required to receive employee complaints about questionable auditing or

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

accounting matters under Section 301(4) of the Sarbanes-Oxley Act, many companies may elect to designate the audit committee as the QLCC. Since the audit committee is designated as one of the parties that may be notified if either the QLCC undertakes an investigation or an attorney does not receive an appropriate response from an "up-the-ladder" report to the CLO, the audit committee likely will have to review the evidence of a material violation at some point even if it is not designated the QLCC.

Advantages and Disadvantages of a QLCC

The most important advantage of having an established QLCC is that it relieves in-house and outside attorneys of their obligations to assess the adequacy of the issuer's response to a report of evidence of a material violation. In addition, the SEC release adopting the rule states that a QLCC may produce broader benefits, such as encouraging early reporting of possible violations of law so that they can be more effectively stopped. The adopting release also clarifies that the SEC does not intend that service on a QLCC will increase any liability of a board member under state law and expressly finds that it would be inconsistent with the public interest for a court to so conclude (although, as a practical matter, the QLCC members may be more exposed).

On the other hand, establishing a QLCC also has disadvantages. First, use of the QLCC takes the inquiry out of the hands of the CLO. Since any attorney could in theory report evidence of a material violation directly to the QLCC in the first instance, the CLO would not have an opportunity to filter out frivolous reports. The CLO may also be in a better position to assess and address claims than a committee that meets only a few times a year. The company may want the CLO, who may be more familiar with the day to day legal operations of the company, to manage the process.

Second, independent directors serving on the QLCC may be diverted from other board duties, which may be particularly problematic if the audit committee is designated as the QLCC. Even if independent directors conclude that service on the QLCC itself does not increase their liability, they may be reluctant to accept additional obligations that divert time from other duties, such as audit committee service, for which they perceive their risk of liability to be increasing.

Third, the board of directors must grant the QLCC the authority and responsibility to take all appropriate steps, including notification of the SEC, in the event that the company does not implement the QLCC's recommended response to evidence of a material violation. This could be deemed to be an obligation to report out if the QLCC feels that an appropriate response has not been taken.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

"Noisy Withdrawal" considerations

If the SEC adopts either of its proposed "noisy withdrawal" requirements, the balance of risks might shift in favor of establishing a QLCC. Under the original "noisy withdrawal" proposal, which is still under consideration, an in-house attorney who does not receive an appropriate response after fully reporting evidence of a future or current material violation "up-the-ladder" must submit a written disaffirmation to the SEC which disaffirms the opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the SEC or incorporated into such a document. Under the alternative proposal, an in-house attorney would have to notify the company that he or she will cease participating in any matter relating to the suspected violation, and the *issuer* would be required to disclose receipt of such notice to the SEC in a filing under Form 8-K, 20-F or 40-F, as appropriate. Outside counsel would be required to withdraw from representing the issuer under both proposals, citing professional considerations, after which time either the outside counsel (under the original proposal) or the issuer itself (under the alternative) must notify the SEC that counsel has withdrawn, citing "professional considerations," which is meant to serve as a red flag to the SEC.

If a QLCC is established, both in-house attorneys and outside counsel would be permitted to make reports directly to the QLCC. In doing so, they would not have any further obligations to assess the company's response or pursue some form of "noisy withdrawal" or disaffirmation.

III Conclusion

There is no "one size fits all" with respect to the "up-the-ladder" reporting system. Each company will need to devise appropriate procedures based on its own culture, structure and needs. This memorandum has not attempted to provide legal advice or guidance with respect to any particular policy but instead attempts to raise questions which companies may consider in adopting their own procedures. Attorneys should also recognize that the SEC's "up-the-ladder" reporting requirements are in addition to state ethics rules and ABA rules which are also relevant in this area.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

MODEL FORM OF

QUALIFIED LEGAL COMPLIANCE COMMITTEE CHARTER

PURPOSE

The purpose of the Qualified Legal Compliance Committee (the "Committee") of the Board of Directors (the "Board") of [ ] (the "Company") is to: (i) receive, review and take appropriate action with respect to any report made or referred to the Committee by an attorney of evidence of a material violation of applicable U.S. federal or state securities law, material breach of a fiduciary duty under U.S. federal or state law or a similar material violation by the Company or by any officer, director, employee, or agent of the Company, (ii) otherwise fulfill the responsibilities of a qualified legal compliance committee pursuant to Section 307 of the Sarbanes Oxley Act of 2002 and the rules promulgated thereunder and (iii) perform such other duties as may be assigned to it, from time to time, by the Board.

CHARTER

The scope of the Committee's responsibilities and its structure, process and membership requirements are set forth in this charter (the "Charter"), which has been adopted and approved by the Board and may be amended by the Board from time to time in compliance with applicable laws, rules and regulations.

COMPOSITION

[Alternative 1:] The Committee shall consist of at least one member of the Audit Committee of the Board and two members of the Board who are not employed directly or indirectly by the Company.[1]

[Alternative 2:] The Company's Audit Committee shall serve as the QLCC.

The members of the Committee shall be appointed and replaced by the Board.

[1] If the Company is a registered investment company, such persons also must not be "interested persons" as defined in Section 2(a)(19) of the Investment Company Act of 1940.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

PROCEDURES

The Committee shall adopt written procedures for the confidential receipt, retention, and consideration of any oral or written reports received by the Committee. The Committee shall have the authority to establish other rules and operating procedures in order to fulfill its obligations under this Charter and under applicable law, rules and regulations. The Chairman of the Committee shall call a meeting of the Committee wherever circumstances warrant.

AUTHORITY AND RESPONSIBILITIES

1. The Committee shall have the following authority and responsibilities in respect of reports of evidence of a material violation:

a. The Committee shall inform the chief legal officer and chief executive officer of any report of evidence of a material violation.

b. The Committee shall determine whether an investigation is necessary regarding any such report.

c. If the Committee has determined that an investigation is necessary, the Committee shall: (i) notify the Audit Committee or the Board, (ii) initiate an investigation to be conducted either by the Company's chief legal officer or by an outside attorney retained by the Committee and (iii) retain such additional expert personnel as the Committee deems necessary.

d. At the conclusion of an investigation, the Committee shall: (i) recommend, by majority vote, that the Company implement an appropriate response and (ii) inform the chief legal officer, the chief executive officer and the Board of the results of the investigation and the appropriate remedial measures that it recommends to be adopted.

2. The Committee has the authority and responsibility to act, by majority vote, to take all other appropriate action, including the authority to notify the Securities and Exchange Commission in the event that the Company fails in any material respect to implement an appropriate response that the Committee has recommended to the Company.

3. The Committee shall report to the Board on a regular basis regarding the matters that it oversees.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

QUALIFIED LEGAL COMPLIANCE COMMITTEE PROCEDURES

Any attorney or the chief legal officer of [ ] (the "Company") may submit a report (a "Report") of evidence of a material violation of applicable U.S. federal or state securities law, material breach of a fiduciary duty under U.S. federal or state law or a similar material violation by the Company or by any officer, director, employee or agent of the Company to the Qualified Legal Compliance Committee (the "Committee").

In order to facilitate the Committee's confidential receipt, retention, and consideration of Reports, the Committee has established the following procedures:

1. The Committee shall send a written acknowledgement of receipt of each oral or written Report to the sender.

2. The Committee shall notify the Company's chief legal officer and the chief executive officer promptly upon receipt of a Report.

3. The Chair of the Committee shall convene a meeting of the full Committee as often as deemed necessary or desirable and, in any case, promptly upon receipt of a Report.

4. The Committee shall keep minutes of each of its meetings.

5. The Committee shall review each Report and determine whether an investigation is necessary or desirable in connection with the matters addressed in such Report.

6. The Committee may consult with appropriate officers of the Company, who may include the chief legal counsel, or retain outside attorneys or experts in connection with its determination as to whether to commence an investigation in connection with a Report. The Committee may rely on the chief legal counsel or his or her designee to perform a preliminary investigation and advise the Committee as to whether further investigation is required.

7. If the Committee has determined that further investigation is necessary or desirable in connection with a Report, the Committee shall: (i) notify the Audit Committee of the Company's Board of Directors or the full Board of Directors, (ii) initiate an investigation, (iii) determine who shall conduct such investigation (which person may include the chief legal counsel or his or her designee), and (iv) retain such outside attorneys and expert personnel as the Committee deems necessary.

8. The Committee shall have the authority to enter into engagement letters, as appropriate, with outside attorneys and experts retained by it.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

9. At the conclusion of an investigation, the Committee shall: (i) recommend, by majority vote, that the Company implement an appropriate response, if any, and (ii) inform the chief legal officer, the chief executive officer and the Board of Directors of the results of the investigation and the appropriate remedial measures, if any, that it recommends to be adopted.

10. The Committee shall take appropriate action to determine whether the Company has implemented an appropriate response to a Report, as recommended by the Committee, and, if not, shall determine what, if any, additional action should be taken.

11. The Committee shall retain a log of all Reports, tracking their receipt, investigation and resolution and shall periodically report on these matters to the Board of Directors.

12. The Committee shall take appropriate measures so that, to the maximum extent possible, consistent with its obligations, the Company's legal privileges are protected in connection with the Committee's activities.

13. The Committee shall maintain all documents received or reviewed by it in accordance with the Company's document retention policy.

14. The Committee shall maintain confidentiality in its activities to the maximum extent possible consistent with performing a full and fair investigation.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

May 9, 2003 SecMail® No. 03-05-09 *www.ffhsj.com/practice_groups/sec_reg.htm*

The New SEC Enforcement Environment

Just a few years ago, the Securities and Exchange Commission struggled with scant resources while a bull market raged. When the meltdown came, investors, and therefore politicians, were hungry for scapegoats. Congress and the President enacted dramatic legislation, the Sarbanes Oxley Act of 2002 ("SOX"), spawning 18 months of regulatory metamorphosis, half of which lies ahead. Meanwhile, the search for accountability is still underway. What, then, should prac titioners and market participants expect in SEC enforcement cases?

1. More Investigations and Enforcement Actions. Steve Cutler, Director of the SEC's Division of Enforcement, noted in recent speeches that the SEC brought 163 cases involving allegations of improper accounting, inadequate disclosure, or outright financial fraud during fiscal 2002, out of a record 598 cases for that year (http://www.sec.gov/news/speech/spch604.htm); (http://www.sec.gov/news/speech/spch121202smc.htm). As the SEC continues to bulk up its enforcement staff with a sweetened SOX payroll, these records are likely to be surpassed.

2. Increased Criminal and Multi-Jurisdictional Coordination. As Mr. Cutler stated in the first of those speeches, "Now, rather than cajoling criminal authorities into taking securities cases, we're fending off competing phone calls from prosecutors vying to take the lead on any given case." Others with regulatory obligations are also active in securities enforcement activities, as highlighted by the unprecedented 10-firm April 2003 research settlement involving the SEC, NYSE, NASD, NASAA and the states. Practitioners now must plan for cooperating – and sometimes competing – enforcement investigations.

3. Faster, Tougher, More Creative Enforcement. Over a year before SOX, incoming SEC Chairman Harvey Pitt pledged real-time enforcement, and cases have been brought faster ever since. He also prompted creative use of existing authority. In 2002, for example, the SEC used Section 21(a) of the Exchange Act of 1934, which had not changed in over 60 years, in a new way: the agency ordered various companies to submit sworn written statements describing the facts and circumstances of the matter to be investigated. The SEC also revised its view of disgorgement, seeking equity-based compensation – and sometimes even salaries – from corporate executives. The New York State Attorney General also used an old law to do new things: New York lawyers knew of the Martin Act's broad potential scope, but Eliot Spitzer dusted it off and put the Act in the headlines in 2002.

4. The SEC Says, "Show Me the Money!" Even before obtaining greater authority in SOX, the SEC ordered or obtained court orders for approximately $1.3 billion in disgorgement of ill-gotten gains in fiscal 2002 (http://www.sec.gov/pdf/annrep02/ar02full.pdf). SOX has only strengthened the SEC's powers to return money to defrauded investors. "Fair Funds for

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Investors," SOX Section 308, provides that, if disgorgement and penalties are paid in an action alleging securities fraud, the SEC may move or direct the penalties, and even so-called "gifts," to be added to the disgorgement fund, rather than to the U.S. Treasury. This provision gives the SEC a new incentive and opportunity to significantly increase the size of disgorgement pools by assessing penalties – and potentially "inspiring" gifts – in appropriate cases. A significant disgorgement fund also changes the equation for investors, who may bear the pain of owning shares in a company required to pay a substantial penalty, or who may recover more of their lost investment at less personal cost through the fund than through class participation.

5. New, Larger Monetary and Criminal Penalties. SOX created or increased criminal penalties and/or civil monetary penalties for securities fraud, knowingly signing false certifications of public company financial statements, misleading auditors, obstruction of justice and whistleblower retaliation. Suddenly, litigation becomes a more attractive option for defendants who believe proposed allegations or penalties are meritless or unfair. Increased criminal enforcement activities may also prompt individuals to more readily assert their Fifth Amendment rights rather than provide on-the-record testimony. The SEC will need every bit of its new budget to handle the litigation increase sure to result from these ratcheted-up penalties.

6. More, and More Unreliable, Evidence. SOX ramped up corporate governance processes for which documentation will be necessary. It also dramatically increased the evidence required to be preserved. Forensic investigations now include a plethora of paper and electronically-stored data, such as officer certifications, disclosure control procedures and committee minutes, new codes of conduct and emails or other records concerning any of these documents, processes or issues. Just as we saw analysts' emails become the basis for challenges to their published research, we have to expect that executives' emails (and emails sent to or copied to them, whether they responded or not) will become the basis for challenges to their certifications. We now live in a world of accelerated prosecution by inference and tedious defense by rebuttal.

7. Lawyers Face More Scrutiny Than Ever Before. Before 2002, allegations against lawyers typically focused on business judgments rather than legal advice. As a matter of policy, the SEC refrained from sanctioning lawyers for professional misconduct in initial proceedings, trusting state bar authorities to take appropriate action. This changed in November 2002 when the SEC alleged that James Fitzhenry, General Counsel for an Oregon company, misled the company's auditors by attempting to negotiate the removal of contingencies from $4.1 million in sales contracts, signing two management representation letters saying there were no contingencies and then failing to tell auditors about his failed negotiations. Mr. Fitzhenry, in settling SEC charges, consented to a five-year bar from practicing before the SEC, as well as a cease and desist order. *In re James Fitzhenry*, Exchange Act Rel. No. 46870 (Nov. 21, 2002). This policy shift signals the SEC's willingness to review legal work and legal advice in situations where it may have deferred to other regulators before.

Beginning in August 2003, lawyers practicing before the SEC will face additional, congressionally-mandated federal review of their professional conduct as a result of SOX Section 307. Lawyers and clients will need to work together to ensure that these rules do not discourage consultations with counsel throughout the corporation's business activities.

8. The SEC Offers Bigger Carrots and Sticks in Enforcement Investigations. In October 2001, the SEC published its Section 21(a) report of investigation involving the Seaboard Corporation, whose cooperation convinced the SEC it should escape sanction even though its financial statements were fraudulent. To highlight the other end of the cooperation spectrum, the SEC began imposing significant monetary penalties on corporations that did not provide "full cooperation" during investigations. *See*, *e.g*., SEC Press Release re: Xerox, (http://www.sec.gov/news/press/2002-52.txt) ($10 million penalty) (Apr. 11, 2002); *In re Dynegy Inc.*, Exchange Act Rel. No. 34-46537 (Sept. 25, 2002) ($3 million penalty). The carrot and stick approach continues as an underlying theme in every investigation.

9. The Corporate Attorney-Client Privilege is at Risk. Corporations seeking maximum cooperation credit should consider from the outset of an investigation the potential impact and benefits of waiving attorney-client and

Copyright © 2003. Fried, Frank, Harris, Shriver and Jacobson. All rights Reserved.

Securities Regulation, Compliance and Enforcement Group

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

work product protections. While not considering waiver of the attorney-client and work product protections "an absolute requirement," the Department of Justice in its recently revised business prosecution principles called such privilege waivers "critical in enabling the government to evaluate the completeness of a corporation's voluntary disclosure and cooperation." (http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm). The SEC has encouraged companies to share privileged information by agreeing to confidentiality agreements, entering as *amicus* to support the continued assertion of a work product privilege against third parties, and seeking legislation to expressly protect such information as privileged. Combining these incentives with the increased need for lawyers to defend themselves, it is more difficult than ever to rely on the protections of the corporate attorney-client privilege.

10. The SEC Wants Even More Enforcement Authority. The SEC has recently asked Congress for the ability to distribute penalties to injured investors regardless of whether disgorgement was ordered, exclude securities cases from state law property exemptions and contract with outside collection attorneys (http://www.sec.gov/news/studies/sox308creport.pdf). In addition, supporting a recent SEC request, the Senate recently introduced a bill that would grant the SEC administrative authority to impose civil monetary fines on any person who violates Federal securities laws, expanding possible defendants to, for example, corporate officers, lawyers, or publicly traded companies, none of whom are now subject to being fined by the SEC in administrative proceedings. S. 476, the CARE Act of 2003. Although these provisions may not become law, they demonstrate the agency's determination to seize the moment of this scapegoat-inspired environment.

* * * * *

SOX has significantly increased the costs of doing business and conducting investigations. The costs of implementing new governance and compliance measures are becoming apparent to companies now. It appears from the SEC's published economic impact analyses that the agency expects the average cumulative cost to each corporation of the SEC's proposed and adopted regulatory requirements from 2002 and the first quarter of 2003 to be only approximately $60,000-$100,000. Yet, foreign investors and issuers are rethinking whether the U.S. markets provide attractive moneymaking opportunities and small businesses are losing access to investment capital because they cannot afford to go public. We can only hope that the numerous and extensive studies required by SOX will shed light on these increased costs and help the public and Congress measure whether this is the intended result.

SecMail® is published by the Securities Regulation, Compliance and Enforcement Group of, and is a registered trademark and servicemark of Fried, Frank, Harris, Shriver & Jacobson.

SecMail® is provided free of charge to subscribers. If you would like to subscribe to this E-mail service, please send an E-mail message to SecMail@ffhsj.com and include your name, title, organization or company, mail address, telephone and fax numbers, and E-mail address.

To view copies of previous SecMails, please visit our SecMail® archives (http://www.ffhsj.com/secreg/secarch.php3).

To view copies of previous Securities To Our Client Memoranda, please visit our archives (http://www.ffhsj.com/firmpubs.php?topic=Securities+Regulation%2C+Compliance+and+Enforcement).

Copyright © 2003. Fried, Frank, Harris, Shriver and Jacobson. All rights Reserved.

Securities Regulation, Compliance and Enforcement Group

SecMail®

FRIED FRANK HARRIS SHRIVER & JACOBSON

July 30, 2002 **SecMail® No. 02-07-30(2)**

LIVING WITH THE REFORM: THE IMPACT OF THE SARBANES-OXLEY ACT OF 2002

As President Bush signed the Sarbanes-Oxley Act of 2002 into law, it marked the most sweeping revision of the federal securities laws since their New Deal era roots. The statute can be accessed at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf.

The Act is a unique product of a "perfect storm" generated through a series of high profile financial reporting debacles involving prominent companies, an erosion in market confidence and extreme market volatility. The Act is a vast patchwork quilt of reforms that aim at (a) creating an independent regulatory structure for the accounting industry, (b) higher standards for corporate governance, (c) increased independence of securities analysts, (d) improved transparency of financial reporting and (e) a panoply of new civil and criminal remedies for violations of the federal securities laws.

The Act adds to the charged atmosphere in which public company managers and their boards must operate. Given its quick passage, the Act leads to a number of practical considerations in the near term.

1. The Act will place a premium on a good working relationship between public companies and their auditors. A number of reforms clearly are intended to strengthen the hand of auditors in dealing with their clients. The Act directs the SEC to adopt rules making it unlawful to "fraudulently influence, coerce, manipulate or mislead" independent auditors. Section 13 of the Securities Exchange Act is amended to require that financial statements reflect "all material correcting adjustments" identified by independent auditors in accordance with GAAP and SEC rules. Auditors will perform their duties with the added risk of enforcement action by a new oversight board.

The passage of the Act should cause public company managers to revisit and explore ways to improve their working relationship with their independent auditors. Like any other advisory relationship, this one can be made more effective through more advance planning and creating a review process that allows for more informal discussion of accounting treatments well before a reporting deadline. Accounting is not science but the art of applying principles to the results of a unique organization. Since, going forward, the relationship will be subject to a greater level of regulatory micromanagement, this is apt time to ensure that there is an active informal discussion between two sides.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

2. Audit committees will need enhanced support from public company management. Under the Act, the audit committee continues as the pack mule of corporate governance. The statute layers additional burdens on the backs of directors who, by definition, extend part-time service to issuers. For example, the Act requires the Audit Committee's approval, in advance, of non-audit services provided by the issuer's independent auditor. Similarly, the Act requires independent auditors to report to audit committees on, among other things, all alternative treatments of financial information within GAAP that were discussed with management, the ramifications of the use of alternative approaches and the treatment preferred by the independent auditor.

Audit committee members are acutely aware of intense scrutiny and criticism, always with the benefit of perfect hindsight, that falls on the directors of troubled companies. While directors have finite time they can direct to their roles, they will look to management for insight about the judgments and processes that lead to the issuer's financial results. The Act specifically provides that audit committees can retain advisers, including counsel. The multiple roles assigned by the Act to audit committees will increase substantially the time that advisers, internal and external, must devote to the audit committee's processes.

3. Companies should revisit their compliance procedures, particularly as they relate to financial reporting issues. In-house counsel at public companies should ask themselves a simple question: "If a randomly-selected employee in our company had a concern about the company's revenue recognition practices, who would that employee contact?" If the answer would not be immediately apparent, issuers should revisit the way their compliance procedures are structured and disseminated.

The Act fosters such introspection. The statute requires issuers to disseminate a code of ethics to financial reporting personnel. The Act also imposes on audit committees to establish procedures to address, on a confidential basis, employee complaints regarding questionable accounting practices. And, for good measure, the Act creates a private right of action for "whistleblowers" who face retaliation for raising such issues. While not every employee complaint will be as prescient as Enron's Sherron Watkins, issuers will want to bolster systems that identify and resolve such issues before they are referred to an external source.

4. An issuer's General Counsel should extend an "open door" policy to all counsel acting for the company. The Act requires the SEC to adopt rules mandating that any lawyer acting for the company to report, to the General Counsel or the CEO, any material violation of securities law or fiduciary duty by the company or any of its personnel. If appropriate remedial action is not taken, the Act requires counsel to report the information to the issuer's audit committee or committee of independent directors. It would appear that failure to make the required report could lead to a proceeding under SEC Rule 102(e) aimed at barring the attorney from practicing before the SEC.

From the perspective of corporate counsel, it is hard to imagine a circumstance in which the chief legal officer would not want to be apprised of a potentially material defalcation. While the process of preparing these rules goes through intensive debates, a General Counsel could simply signal to lawyers serving the company that this communication is expected, regardless of the form of the SEC's rules.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

5. **Companies will have to adjust securities trading policies**. The Act amends Section 16(a) of the Exchange Act to effectively require that directors, executive officers and ten percent shareholders disclose transactions involving equity securities on SEC Form 4 before the end of the second business day following the day on which the transaction occurred. This is a significant acceleration of the reporting cycle. For the majority of issuers that assist directors and executive officers in preparing their filings, this will require an adjustment of the company's procedures. Those procedures should also be adjusted to forbid, as the Act does, trading the company's securities while employee benefit plans have restricted transactions for most participants. Since the text of the statute acknowledges that a two-day reporting cycle may be impractical, issuers should position their directors and key officers with systems that reflect a good faith effort to meet the new filing deadline.

6. **CEO/CFO certifications will become a fixture of the reporting process**. The Act requires that each quarterly and annual report be accompanied by a certification from the issuer's principal executive officer and principal financial officer. The certification would affirm that these senior officers have (a) reviewed the report, (b) that it contains no material misstatements, (c) that any significant deficiencies in internal controls have been disclosed to the company's independent auditors and the audit committee. The certification is broader than the certification mandated by the SEC for CEOs and CFOs of 947 domestic issuers due by mid-August.

For all issuers – including the 947 subject to the SEC's June order – the current exercise provides lessons in implementing this requirement. The practical issues include (a) the need to develop a record substantiating the basis on which the certification was made, (b) coordinating to ensure Audit Committee review of the process, (c) and the SEC staff's guidance yesterday that the certifications should be considered material, nonpublic information (and suggesting disclosure on a Form 8-K of the certification before it is available on the SEC's website).

7. **The Act will spur pending SEC and SRO regulatory reforms.** The Act requires rulemaking to address corporate governance reforms that, to a great extent, are addressed in reports compiled by the principal exchanges. The Act also requires SEC rulemaking to foster real-time disclosure of material changes in an issuer's operations or financial results. The Commission proposed, on June 17, 2002, an expansion of events giving rise to a Form 8-K filing requirement. The Act will spawn a bevy of SEC rulemaking and should add fuel to initiatives not directly addressed in the statute. The Act also calls for the preparation of nine separate studies addressing various aspects of the securities markets. These studies, all of which must be completed within a year, also may shape the regulatory agenda.

With only three dissenting votes from over 500 legislators, it is hard to overstate the legislative rush to spur aggressive civil and criminal enforcement of the securities laws. The SEC's budget will increase dramatically as will its panoply of civil remedies. The Act requires review of public company periodic reports on a three-year cycle. Significant new criminal penalties and a Justice Department task force devoted to these issues can only lead to an increased use of criminal inquiries.

With the Act, one cost of being a public company – periodic reporting – will increase and continue to increase over the coming months and years. For public companies that cover a wide spectrum, the immediate and long-term challenge will lie in adjusting their systems, staffing and cultures to the rigors of this environment.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SecMail® No. 01-12-03
December 3, 2001

WHEN IS A CONFIDENTIALITY AGREEMENT A CONFIDENTIALITY AGREEMENT?

The Young President's Organization ("YPO") is a national group of CEO's who are under 50 years old. In March 1999, one member, the CEO of Meridian Data Inc., found himself unable to attend a regional YPO meeting because he was deeply involved in merger discussions with another company. The executive informed the meeting coordinator, and authorized that this information be communicated to the other attendees, emphasizing the confidential nature of the information. One of the attendees, Keith Kim, purchased shares of the target company and, after announcement of the acquisition, sold those shares for a profit of more than $800,000.

Following an SEC investigation, Kim was arrested by the FBI and charged with criminal insider trading on the theory that he had traded on illegally misappropriated information. The SEC posited that Kim's trades violated "the core values of the YPO" that "emphasize a relationship of trust and confidentiality." Specifically, the forum operated under a written confidentiality "commitment" that members would not discuss club information with anyone outside the club.

Judge Breyer, US District Court for the Northern District of California, swiftly dismissed the securities (and related wire) fraud charges, finding that the relationship among club members was not the sort that created a legal duty of confidentiality -- that is, the relationship among the club members was not a "fiduciary or similar relationship of trust and confidence."

In reaching this conclusion, the Judge focused on the what he termed the "primary essential characteristic of the fiduciary relation" -- some measure of superiority, dominance or control -- to determine whether the "club" relationship was sufficiently similar to a fiduciary relationship to support a criminal conviction. After reviewing other misappropriation cases, he observed that fiduciary dominance generally arises out of some combination of (1) disparate knowledge and expertise, (2) a persuasive need to share confidential information, and (3) a legal duty to render competent aid.

In reviewing the facts, he found that (1) the CEOs had similar levels of achievement, experience and expertise, (2) the Meridian CEO provided the information gratuitously (there was no compelling reason to describe the merger discussions when explaining his absence) and (3) the forum members who received the information (unlike doctors or lawyers learning information from clients) had no legal duty to render aid. Because he found no evidence whatsoever of these three factors, he did not decide whether all three

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

factors needed to be present or to what degree any particular factor needed to be present to show fiduciary dominance.

This case is the first reported case to address Rule 10b5-2, adopted by the SEC with little fanfare at the same time as Reg FD. Rule 10b5-2, which became effective after the trades at issue in this case, "provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading." These circumstances include "whenever a person agrees to maintain information in confidence" and whenever there is a "history, pattern, or practice of sharing confidences" such that the recipient reasonably should know that the person communicating the information expects it to remain confidential. Judge Breyer viewed Rule 10b5-2 as creating "new" law, thus supporting his conclusion that the "old" law did not legally prohibit Kim's trades.

The Judge implied, as Kim conceded, that, under Rule 10b5-2, Kim's conduct could have been illegal. But in doing so, Judge Breyer raised the possibility that not every express confidentiality agreement would provide a basis for misappropriation liability. In this regard, the Judge noted that the SEC release did not describe *what type* of express agreement was needed and that, in his view, "any such express agreement must set forth the hallmarks of a fiduciary relationship" as described above. Although he did not directly so state, it is clear that the confidentiality agreement among CEO club members would not have met that test in Judge Breyer's court.

This suggests that in the final analysis -- and, despite what the SEC might contend is the standard set by Rule 10b5-2 -- not every express confidentiality agreement will support a misappropriation charge.

Although the SEC has clearly suffered a setback in its enforcement program (and, has had the scope of a key provision to Rule10b5-2 questioned), we continue to advise that special care be taken when entering into confidentiality agreements, lest subsequent trades be deemed insider trading.

First, broker-dealers, investment advisers, indeed, everyone must understand the implications of expressly agreeing to keep information confidential. Despite the issues raised by Judge Breyer's opinion, the consequences can be much more severe than shunning by your colleagues.

Second, counsel and/or compliance should be involved when entering into a confidentiality agreement to confirm the need for the agreement, review its terms and, if necessary, set up procedures for its implementation. Bear in mind that such agreements are often imbedded in debt and loan agreements, private placement memoranda and other documents not labeled as a "confidentiality agreement."

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Third, do not underestimate the SEC's resolve to bring civil misappropriation cases under Rule 10b5-2, even "edge of the envelope cases" such as this one. Dictum in a criminal case about Rule 10b5-2 will not bind the SEC's enforcement agenda.

Finally, this case reinforces that the "need-to-know" principle must apply at the top, as well as throughout each organization. Judge Breyer was sharply critical of the Meridian CEO who leaked the information. Meridian's CEO was not charged criminally, but that judgment in this case provides scant comfort that the SEC will turn from its resolute pursuit of those who leak material nonpublic information.

In summary, while Judge Breyer's opinion raises the possibility that *some* confidentiality agreements may not be sufficient to support a charge of insider trading, this is not a signal to treat such agreements cavalierly or to relax vigilance when communicating or receiving non-public information that may be material.

See United States v. Kim, Order No. CR 01-0193 CRB (N.D. Cal. Nov. 20, 2001) (order granting defendant's motion to dismiss) at:
http://www.cand.uscourts.gov/cand/tentrule.nsf/4f9d4c4a03b0cf70882567980073b2e4/3f342cc1a5a9a96188256b0a0069b1b3?OpenDocument

David L. Fenimore, *Washington, DC*
Karl A. Groskaufmanis
Matt Morley

Carmen J. Lawrence, *New York, NY*

December 3, 2001
SecMail@ffhsj.com

Copyright 2001 Fried, Frank, Harris, Shriver & Jacobson, All Rights Reserved. SecMail is published by the Securities Regulation, Compliance and Enforcement Group of, and is a registered trademark and servicemark of Fried, Frank, Harris, Shriver & Jacobson.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SecMail® No. 01-09-26
September 26, 2001

FCPA ANTI-BRIBERY CASE SUGGESTS EFFECTIVE STRATEGIES FOR ADDRESSING DISCOVERY OF ILLEGAL CORPORATE ACTIVITY

1. The Baker Hughes case.

On September 11, 2001, the Securities and Exchange Commission (the "SEC") and the Department of Justice (the "DOJ") acted together to address an alleged bribery scheme involving the subsidiary of a U.S. company, an Indonesian tax official, and an Indonesian public accounting firm that allegedly acted as a conduit for the bribe. In an unprecedented display of cooperation, the SEC and DOJ filed a joint civil action against the former Chief Financial Officer and former Controller of Baker Hughes Incorporated *(SEC v. Mattson et al., (http://www.sec.gov/litigation/litreleases/lr17126.htm))*. Based on Baker Hughes' significant cooperation, the SEC instituted settled administrative proceedings against the company itself *(In re: Baker Hughes Incorporated, (http://www.sec.gov/litigation/admin/34-44784.htm))*. The SEC and DOJ also separately filed and simultaneously settled a civil action against the Indonesian accounting firm and a partner of the firm who allegedly facilitated the illicit payment on behalf of the Baker Hughes subsidiary. *SEC v. KPMG Siddharta Siddharta & Harsono et al., (http://www.sec.gov/litigation/litreleases/lr17127.htm)*.

The story, at least as alleged by the SEC and DOJ, is relatively simple. Following an audit, Indonesian tax authorities notified the Baker Hughes subsidiary, PTEC, that it owed $3.2 million. Shortly afterwards, an Indonesian tax official requested a payment in exchange for reducing PTEC's tax assessment.

At first, everything went as it should have. PTEC's tax advisors at its accounting firm rejected the request for a bribe, and PTEC officials instructed that the assessment should be challenged on its merits. In subsequent internal discussions, a senior partner at the accounting firm recognized that such a payment would violate the U.S. Foreign Corrupt Practices Act ("FCPA"), which prohibits payments to foreign officials in connection with obtaining or retaining business.

Then things went terribly wrong. Notwithstanding his recognition of the FCPA issue, the partner allegedly indicated that if Baker Hughes, the U.S. parent, were to indicate that it wanted the accounting firm to make the payment on its behalf, it would do so and that the accounting firm would generate a false invoice that would include money for the payment, in addition to payment for the accounting firm's actual fees.

Discussions of these issues at Baker Hughes brought a clear response from the U.S. general counsel: under no circumstances should any payment be made,

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

whether directly or through the accounting firm. Nevertheless, according to the SEC and DOJ, Baker Hughes' chief financial officer and controller authorized the Indonesian subsidiary to proceed with the plan to make the payment through its accounting firm.

At the end of the day:

- both the accounting firm and its senior partner consented to an entry of permanent injunctions, restraining any violation of the anti-bribery and books and records provisions of the FCPA;

- The SEC filed a civil injunctive action against Baker Hughes' former CFO and former Controller, seeking fines and an injunction against further violations of the anti-bribery and books and records provisions; and

- Baker Hughes consented to an administrative cease-and-desist order for violations of books and records and internal control provisions of the FCPA.

2. Strategies for reacting to the discovery of illegal corporate acts.

These vigorous actions provide a sharp reminder of the dangers inherent in demands by foreign officials for improper payments. More than this, however, the actions also provide a clear strategy for minimizing the impact of a legal violation once discovered by senior corporate management. These lessons extend well beyond the FCPA context.

Baker Hughes' General Counsel faced what must be one of the worst nightmares of every general counsel. After giving clear and correct legal advice to avoid any illicit payment, other corporate personnel proceeded to do exactly what they had been told not to do. At this point, the company's legal risk profile changed dramatically, and the general counsel's focus turned from compliance and prevention to minimizing the corporate consequences of a violation.

In this case, Baker Hughes acted decisively to do all in its power to set the situation right. As a result, the company was able to resolve the matter through settlement of an administrative proceeding with the SEC (without any monetary sanctions), even though regulators could have sought significant monetary penalties and despite other questionable payments made by the company in India and Brazil. This very positive outcome resulted from a number of actions cited by federal officials. Specifically, Baker Hughes:

i. instructed the intermediary (i.e., the local accounting firm) not to make the payment and to return the money;
ii. promptly disclosed the illegal conduct to government authorities;
iii. promptly disclosed the illegal conduct to the company's independent auditors and made sure that the company's books and records were corrected to properly reflect the transaction that had occurred;

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

iv. terminated the local auditor that had agreed to make the payment on behalf of the Indonesian subsidiary;
v. terminated the employees – specifically the chief financial officer and the controller -- involved in the unlawful conduct;
vi. sought to resolve the tax dispute with Indonesian authorities on its merits;
vii. engaged outside counsel to conduct an investigation and report to the audit committee;
viii. implemented enhanced FCPA policies and procedures; and
ix. cooperated fully with the government's investigation.

This is a textbook list of steps that companies can take to minimize the effects of an illegal corporate action that comes to the attention of a company senior management or board of directors. The SEC is inclined, and we believe that it will continue to be inclined, to give credit to companies that "do the right thing" and take decisive steps to clean their own houses once corporate misconduct comes to their attention.

In this case, "full cooperation" with the governmental investigations included a waiver of the attorney-client privilege with respect to all relevant confidential communications with counsel. The public manner in which the SEC cited Baker Hughes' waiver of the attorney-client privilege strongly suggests that the SEC viewed the waiver as a prerequisite to obtaining credit for "full" cooperation in an enforcement investigation. It remains to be seen whether this approach will continue under the leadership of the new Chairman. However, companies should carefully consider this possibility when planning how to investigate potentially unlawful acts, how to convey the results of such investigations, and in determining what corrective action to take because a waiver may result in substantial collateral consequences (such as waiver of privileges with respect to private litigants).

3. Steps to assure FCPA compliance.

The Baker Hughes case also reflects the continuing resolve of U.S. authorities to enforce the provisions of the FCPA, and suggests that companies and professional firms revisit their efforts to assure FCPA compliance. A number of steps, many of which we have previously recommended, merit attention.

a. Review sources of risk. Every company should evaluate - and periodically re-evaluate - its potential sources of FCPA problems. In this regard, it is well known that some areas of the world pose particularly high corruption risks, and particular efforts should be directed at business being done in these countries. Problems often result from business entertainment practices or from local litigation and tax assessment matters. Companies should consider whether their existing compliance programs are sufficient to address their current and anticipated risks.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

b. Re-examine compliance monitoring mechanisms. Even the most carefully drafted policy cannot be effective in preventing violations without procedures to monitor and enforce compliance. This may require some form of periodic auditing, supplemented by annual certifications from relevant personnel that they have adhered to the policy. Most importantly, indications of potential violations should be investigated and resolved, with appropriate remedial and disciplinary action, if necessary. Corporate personnel need to know that senior management will insist upon compliance with company anti-bribery policies.

c. Focus particular attention on the use of foreign agents and consultants. FCPA problems often involve the participation of local agents and consultants. Companies conducting business abroad should ensure that their FCPA policies and procedures and related training sessions include instructions to make inquiries of foreign agents designed to assure that payments to those agents will be not used in a manner contrary to the FCPA's requirements. Furthermore, any contracts with foreign agents should define the scope of services to be performed and include a clear list of proscribed activities, including conduct that violates the FCPA. Simply assuming that foreign agents are in fact familiar with the FCPA's prohibitions and will act accordingly apparently proved, in this case, insufficient to assure compliance or to avoid legal problems.

d. Audit Committees should consider reviewing FCPA procedures with senior management. The Audit Committee can play a critical role in setting the appropriate tone from the top. In this case, Baker Hughes senior management was appropriately credited by the Commission for taking prompt action *after* learning of the misdeeds. However, in an effort to prevent such wrongdoing before it occurs, audit committees of public companies with international operations should be regularly inquiring of senior management about efforts they are making to ensure FCPA compliance. This is particularly true for entities that have operations in countries where bribery of foreign officials is more prevalent.

Matt T. Morley
George B. Parizek
Jonathan P. Scott
Kevin J. Harnisch
Beth H. Colleye

Washington, D.C.

September 26, 2001
SecMail@ffhsj.com

Copyright 2001 Fried, Frank, Harris, Shriver & Jacobson, All Rights Reserved. SecMail is a registered trademark and servicemark of Fried, Frank, Harris, Shriver & Jacobson

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

SecMail® No. 01-10-26
October 26, 2001

SEC GIVES DETAILS ABOUT WHEN COOPERATION WILL COUNT

Once corporate leaders become aware of possible internal wrongdoing, their actions can significantly impact how the federal government will react months and years down the road. On October 23, 2001, the SEC described factors it will consider when evaluating the degree to which a company's actions after discovering possible problems, including its efforts to cooperate with the SEC, will prompt the Commission to exercise prosecutorial discretion. The Report straightforwardly communicates the SEC's desire for corporate America to more aggressively uncover and deal with possible securities law violations, and its intent to credit those efforts when deciding how the SEC should address the underlying conduct.
See http://www.sec.gov/litigation/investreport/34-44969.htm.

The Report. The SEC's Report focuses on a particular, unnamed parent company whose cooperation inspired the SEC not to institute any enforcement action against the company itself. On the same day, however, the SEC commenced and settled an administrative proceeding against the controller of that company's subsidiary, charging that the controller booked improper entries overstating deferred cost assets and understating expenses from 1995 through 2000. The SEC alleges that, by December 1998, she knew that these entries were improper, but instead of raising the issue with her superiors, she deliberately concealed the incorrect entries. The SEC found that the controller's conduct caused misstatements in the company's annual and quarterly reports and caused inaccuracies in the company's books and records. *See* http://www.sec.gov/litigation/admin/34-44970.htm

The SEC noted that, within a week after discovering that there apparently had been misconduct, the company had involved its internal auditors, senior management and the audit committee in a preliminary review. Four days after the full Board was advised and authorized the company to hire outside counsel to conduct a thorough inquiry, the company dismissed the controller and two of her supervisors. A day after that, the company announced, both publicly and to the SEC, that its financial statements would be restated. The company also provided the Staff of the SEC's Enforcement Division with all information it uncovered regarding the underlying violations and did not invoke the attorney-client privilege or work product protection. Finally, the company strengthened its financial reporting processes and hired three new CPAs for the accounting department responsible for preparing the subsidiary's financial statements.

The SEC used the facts of this case as a backdrop for announcing four categories of detailed criteria it will use in future enforcement contexts to evaluate a company's cooperation:

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

1. **Self-policing** – whether the company established, maintained and enforced effective compliance procedures.

2. **Self-reporting** – whether the company promptly, thoroughly and effectively investigated the nature and extent of the misconduct and reported the misconduct to the appropriate regulators, as well as to the public.

3. **Remediation** – whether the company properly disciplined the wrongdoers, strengthened internal controls and procedures to prevent recurrence, and, if appropriate, compensated those adversely affected.

4. **Cooperation** – whether the company provided the SEC with all available information relevant to the underlying misconduct.

The SEC was careful to highlight investor protection as its primary concern, noting that this list may not be strictly applied in every case. Indeed, under some circumstances, no amount of cooperation will convince the SEC not to bring an enforcement action. While reserving complete prosecutorial discretion, the SEC's description of potentially relevant factors offers opportunities for companies to position themselves well, in case SEC scrutiny does occur.

Practice Points. The Report lists many questions the Commission may ask when evaluating whether "credit" should be given in light of a company's cooperation. To position themselves to be able to qualify for this "credit" where appropriate, public companies and regulated entities should consider and, perhaps, re-evaluate the following items:

1. Review the adequacy of your existing compliance regime. The SEC's Report illustrates that having an effective compliance program has never been more important. An effective program creates a vehicle to identify and address potential violations long before they generate government inquiries or lengthy litigation.

Determining the adequacy of a compliance regime, however, is not simply a paper project; it requires a deep evaluation of the effectiveness of compliance efforts. The Department of Justice, citing the federal sentencing guidelines for organizations, has articulated standards by which effectiveness should be measured, and any government authority is likely to use the same yardsticks:

- a written program that establishes procedures reasonably designed to reduce the prospect of improper conduct;
- communication of compliance standards to all relevant personnel;
- training efforts that assure that compliance standards are understood;
- monitoring and auditing efforts to detect violations of the policy;
- mechanisms for reporting potential violations;
- consistent enforcement of the policy; and

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

- an organizational structure that reflects the commitment of senior management and the board of directors to compliance efforts.

2. **Re-evaluate sources of risk and resources.** Consistent with our recent commentary on compliance with the Foreign Corrupt Practices Act, *see* http://www.ffhsj.com/secreg/archives/sc010926.htm, compliance efforts should concentrate on addressing the areas in which a corporate violation of the law is likely to occur. As businesses – and the ways of doing business – continue to evolve, companies need to reassess periodically the nature of legal violations that can arise. This requires the involvement of senior management and legal staff. Similarly, companies should periodically re-evaluate whether adequate resources are committed to its supervision and compliance framework. Resources dedicated to compliance functions should be commensurate with the nature of the particular business and the associated risks.

3. **Have a crisis management plan.** Companies need to know what they will do if and when a problem arises. In its Report, the SEC highlighted that management and the audit committee took rapid and decisive action to address the misconduct that had been discovered. The speed and clarity of this response was key to the SEC's decision to withhold enforcement sanctions. Companies should be prepared to focus quickly and execute a strategy, once this has been determined. In the SEC's view, good corporate citizens will seek to set things right – disciplining misconduct, compensating those harmed, and self-reporting to authorities.

4. **Act with an eye towards "full cooperation" with government authorities.** While it may not be appropriate in every circumstance, every corporation should preserve the option to self-report and cooperate with the authorities, given the potential such a strategy has for avoiding or minimizing sanctions for the misconduct of its personnel. The corporate response to indications of potential misconduct – what is said, what is done, what is written – should be undertaken while cognizant of the possibility that the company may want to bare all before government authorities – waiving privileges and otherwise providing all available information. This corporate response also may come to light under other circumstances. Attention to this possibility from the start may help avoid potential embarrassments if and when a company decides to adopt such a strategy.

5. **The SEC may be willing to limit the "costs" associated with potential waivers of the attorney-client privilege.** It is a stock mantra of SEC attorneys (and other government counsel) that "full cooperation" may mean waiver of applicable privileges. The SEC's Report repeats that point but, in a footnote, notes that the Commission has argued recently, in an amicus brief, that release to SEC staff should be considered a limited waiver that should not waive the privilege with respect to third parties. While such support may not determine the outcome of such waivers, it signals a heightened sensitivity at the SEC to the collateral effects of providing the level of cooperation anticipated by the SEC's Report. There may now be opportunities to limit the adverse effects of that cooperation.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

6. **Some judgment calls will become more important.** The SEC's Report stressed the promptness with which the company acted and reported to the SEC. In the future, there will be pressure to match that level of dispatch. It will fall to counsel to exercise sufficient diligence and judgment to meet a high standard before making a disclosure to the SEC. As always, there will be some – e.g., disgruntled employees trying to bolster wrongful termination claims – who will make unfounded accusations with less than pure motives. Just as it is critical to take corrective action with actual violations, it will fall to counsel to have the fortitude to resist attempts to "self-report" conduct that does not constitute a violation. The costs – institutional and individual – of a bad judgment will be draconian.

7. **Respond consistently and effectively to indications of potential wrongdoing.** In particular, this requires not only sanctioning corporate personnel involved in policy violations, but also subsequent re-evaluations of existing policies to determine whether compliance systems require revision to prevent a recurrence. The Report encourages public companies to invest more in self-regulation, recognizing that companies are in the best position to protect investors by deterring misconduct and by addressing improper activities promptly when they are first discovered. After all, while having effective compliance programs may limit the damage resulting from misconduct, the best use of such programs is to prevent misconduct from occurring in the first place!

Carmen J. Lawrence, *New York, NY*

Karl A. Groskaufmanis, *Washington, DC*
Dixie L. Johnson,
Matt T. Morley,
Paul H. Pashkoff

October 26, 2001
SecMail@friedfrank.com

Copyright 2001 Fried, Frank, Harris, Shriver & Jacobson, All Rights Reserved. SecMail is a registered trademark and servicemark of Fried, Frank, Harris, Shriver & Jacobson

SecMail is provided free of charge to subscribers. If you would like to subscribe to this E-mail service, please send an E-mail message to SecMail@friedfrank.com and include your name, title, organization or company, mail address, telephone and fax numbers, and E-mail address.

To view copies of previous SecMails, please visit our SecMail archives at http://www.ffhsj.com/secreg/archives.htm.

To view copies of previous Securities To Our Client Memoranda, please visit our archives at http://www.ffhsj.com/secreg/cmemos.htm

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

THE OPENING MOVES OF THE SEC INVESTIGATION

ACCA'S 2003 ANNUAL MEETING

October 9, 2003

JOHN K. VILLA
WILLIAMS & CONNOLLY LLP
WASHINGTON, D.C.

Significant contributions to this article were made by Williams & Connolly lawyers Bradley J. Bondi, Edward J. Bennett and Brian Neach

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

The Opening Moves of the SEC Investigation

John K. Villa
Williams & Connolly LLP*

Introduction

Responding to a Securities and Exchange Commission ("SEC") investigation is among the most difficult problems that a public company will confront. On the one hand, the SEC is an adversary that can impose sanctions and initiate actions that can have a crippling effect on the company. Viewed in isolation, this would suggest a "scorched earth" defense. On the other hand, the SEC is the current regulator for the company, and, particularly with the new powers being provided by Sarbanes-Oxley,[1] can put immense ongoing pressure on a company that is unduly belligerent. This would counsel a cooperative approach. Balancing these two competing principles is an immensely difficult problem.

To make the problems more difficult, the SEC investigation often focuses on the conduct of senior management of the company – the same executives who would ordinarily direct the company's response to a governmental investigation. These individuals are, at a minimum, distracted, and may be conflicted by the prospect of individual liability, thus making them ineffective to oversee the company's response.

Finally, the substantial likelihood of civil securities and shareholder derivative litigation and the increasing, yet still small, prospect of a federal criminal investigation make every decision exceptionally complex. The well-advised company must consider not only how every decision impacts the SEC investigation but also how it may affect each of these other fronts.

This analysis is intended to discuss the opening moves of the investigation, identify the first list of questions that inside counsel should ask in the early stages of the investigation, and provide some insights on how to answer these questions.

I. Who Should Be Your Lawyer?

The selection of outside counsel is one of the first and most significant decisions facing a company that finds itself the subject of an SEC investigation. An informed decision considers the experience and capabilities of counsel to handle effectively the current investigation, the potential for conflicts of interest or disqualification that may result from counsel's prior work for the company, the

---

[1] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

company's ability to obtain reimbursement from its insurance carriers for the fees and expenses paid to counsel, and counsel's ability to deal with potential follow-on or even parallel civil litigation and grand jury investigations. An informed decision must therefore undertake to answer the following questions.

a. Does your lawyer possess the correct qualifications for the assignment?

The company should consider two primary factors in determining whether counsel have the qualifications to handle the SEC investigation: experience with the SEC and skills in the broad array of legal issues that will arise. Experience (hopefully positive) with the SEC is essential because the SEC's Enforcement Division ("Enforcement") can adopt one of several approaches to investigations depending in part on the extent to which they are prepared to rely, in the first instance, on the representations and investigations of the corporation's outside counsel. If the SEC has faith in outside counsel, it may – depending upon other circumstances – defer conducting its own formal investigation and allow counsel to conduct an internal investigation and report the results to Enforcement. Many companies prefer the internal investigation because it may be less disruptive than having the SEC conduct a formal investigation. In addition, the result may prove better for the Company as the SEC typically considers favorably the company's cooperation in deciding on the final disposition.[2]

Historically, the SEC is more willing to accept the results of the company's own internal investigation if Enforcement has a high regard for the outside counsel and feels that it can rely upon the law firm to conduct the investigation competently and objectively. Former SEC lawyers, who are now in private practice, are often viewed positively by the SEC. In addition, there are a number of law firms that practice regularly before the SEC that have developed a positive reputation. In short, if the company desires to retain the option of active cooperation – which carries its own risks (as discussed in part IV *infra*) – the professional standing of its counsel is significant.

A second important quality for outside counsel is facility and knowledge in the broad array of issues that will be presented in an investigation of a public company. The matter inevitably will require counsel to be sharp on issues of attorney-client privilege, work-product, white-collar criminal law, substantive securities law, and fiduciary duties of directors and officers. The particular case

---

[2] In its Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, Accounting & Auditing Enforcement Release No. 1470, [2001-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,985, at G3195 (Oct. 23, 2001), the SEC addresses favorable treatment for corporations that cooperate and assist in investigations.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

may also require counsel to be familiar with accounting issues, foreign corrupt practices, software licensing practices, off-balance sheet transactions or other unique areas. The legal issues, unfortunately, rain down on the company and there is often little time to reflect and research them with the care that typical civil litigation permits. Therefore, the law firm should be knowledgeable before the assignment. More importantly, when the company sits down with its outside counsel to develop a strategic approach to the problem – the cooperate or fight, waive or assert, settle or litigate decisions – counsel should have in mind the entire endgame of the case and how each decision will affect not only the SEC investigation but the derivative litigation, the securities fraud litigation, the employment suits from discharged employees, even the criminal investigation. Having a working knowledge of all of those issues at the time that strategic decisions are made can avoid serious problems later. On-the-job training is not the order of the day.

b. Does your lawyer have a conflict of interest or face disqualification?

SEC investigations can create issues of conflict of interest or even possible disqualifications for corporate counsel. Conflicts are especially problematic when a shareholder brings a derivative action against directors or officers of the company and may require a disruptive disqualification of the attorney at a crucial point in the case, or worse, could negatively affect the outcome of the litigation.[3] Inside counsel will need to recognize these potential conflicts from the outset to avoid an expensive and time-consuming transition to a non-conflicted attorney.

The possibility of waiver of the attorney-client privilege imposes significant limitations on the selection of outside counsel to handle an SEC investigation. Under the doctrine of implied waiver, a client who expressly invokes advice of counsel as an element of its defense may well be deemed to have waived the attorney-client privilege.[4] The doctrine of implied waiver has been extended even more broadly by some courts to apply where the client's position, in practical effect, is reliant upon the lawyer's advice even if the client expressly disavows

---

[3] *See Stepak v. Addison*, 20 F.3d 398, 404-07 (11th Cir. 1994) (concluding that use of a conflicted law firm for an internal investigation may establish that a board's refusal of a shareholder demand is wrongful).

[4] *See, e.g., Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1163 (9th Cir. 1992) (holding that a party puts advice in issue and waives the attorney-client privilege where it claims that its tax position was reasonable because the defense was based on the advice of counsel); *United States v. Mierzwicki*, 500 F. Supp. 1331, 1335 (D. Md. 1980) (holding that a defendant waives the attorney-client privilege when he asserts as a defense to a prosecution for tax evasion that the tax returns were amended as a result of counsel's advice).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

reliance on counsel. The danger of waiver poses an especially significant problem where the company frequently relies upon in-house and outside counsel to advise closely upon major matters for the company.[5] The ability of the company to protect its lawyers' past advice from disclosure in future litigation is constantly at risk. A company should, therefore, weigh carefully the potential disqualification issues when selecting counsel.

c. Can the lawyer who conducted the internal investigation also defend the company?

In certain circumstances, the company may decide to waive its privilege voluntarily with respect to certain advice to persuade the SEC to limit further action. If the matter involves the Department of Justice ("DOJ"), a company may feel even more coerced to waive its privilege. The DOJ recently has revised its guidelines for determining whether to bring charges against business entities. The new guidelines may condition favorable treatment of the company upon waiver of the attorney-client privilege.[6] The decision to waive voluntarily the privilege of the company involves legal issues that cannot be covered fully in this article. Suffice it to say, as explained *infra*, the decision should not be undertaken prematurely.

The company must, however, consider whether the same law firm that delivers its "report" to the SEC can defend the company if the report is not accepted and the investigation continues. The law firm may be in an awkward position because its credibility, at least on this assignment, has been tarnished.

---

[5] Indeed, the passage of the Sarbanes-Oxley Act was influenced, in part, by the widespread involvement of lawyers in modern corporate transactions. Explaining his support for Sarbanes-Oxley, Senator Michael Enzi (R-Wyo) stated, "[O]ne of the thoughts that occurred to me was that probably in almost every transaction there was a lawyer who drew up the documents involved in that procedure." 148 Cong. Rec. S6554 (daily ed. July 10, 2002) (statement of Sen. Enzi). Similarly, Senator Corzine (D-NJ), a former Goldman Sachs executive, stated, "In fact, in our corporate world today – and I can verify this by my own experiences – executives and accountants work day to day with lawyers." 148 Cong. Rec. S6556 (daily ed. July 10, 2002) (statement of Sen. Corzine).

[6] Memorandum from Larry D. Thompson, Deputy Attorney General to Heads of Dep't Components, United States Attorneys, *Principles of Federal Prosecution of Business Organizations*, § VI (Jan. 20, 2003) (stating that one factor to be considered in charging a corporation for wrongdoing is the corporation's willingness to cooperate, which includes the corporation's willingness to waive its attorney-client privilege and work-product protection), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

d. Is your lawyer approved by the insurance carrier so that you will be entitled to reimbursement for the fees paid?

When presented with the choice of whether the company would bear the fees and expenses of its securities defense or have those expenses paid by an insurance carrier, most right-thinking companies will choose to have the carrier pay. To accomplish this, however, the company must review carefully the terms of its directors' and officers' liability insurance policy to determine whether it has coverage for securities investigations, and whether there are provisions that restrict the company's ability to select counsel. Even if the company does not have coverage for SEC investigations (and many do not), it may be important to review the company's directors' and officers' policy due to the substantial likelihood that the SEC's investigation will be followed by civil securities litigation – for which there is very likely to be coverage. Thus, if the company intends to use the same lawyer for the SEC investigation and the securities litigation, some advance planning is necessary.

The carrier that undoubtedly has the largest share of the market for directors' and officers' liability insurance – National Union – maintains "panel counsel" for many types of cases and the insureds have agreed in the insurance contract to utilize panel counsel for the defense of certain types of claims including securities claims. If the company wants to be reimbursed for its legal fees, then it must select from the list or seek approval for a non-panel counsel law firm – for which approval is rarely given. Other carriers allow the company to select counsel subject to the approval of the insurer – which cannot be unreasonably withheld. A clear understanding of the terms of the insurance policy is, therefore, essential.

II. How Should the Company Preserve Documents?

Document preservation, and its converse, obstruction of justice, have become hot buttons in SEC investigations and follow-on DOJ investigations. Initially given impetus by the prosecution of Arthur Andersen LLP, this topic became the subject of several provisions of Sarbanes-Oxley and has come into even more prominence by the prosecutions of Frank Quattrone, former investment banker with Credit Suisse First Boston ("CSFB") and Martha Stewart. The government has learned that in complex transactions, it is often easier to prove an obstruction of justice than to prove an intent to commit substantive securities fraud. Private litigants also are pursuing, with increasing fervor, claims of spoliation from the alleged failure to retain documents.

It is therefore imperative that counsel is aware of the company's preservation obligations and prepared to act as soon as the SEC appears, and perhaps earlier if the company first learns of the problem before an SEC

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

investigation. The company's obligations to preserve information even prior to the onset of an investigation are the subject of new provisions of Sarbanes-Oxley.

Recent changes in federal law have lowered the government's burden in proving an obstruction case against a company whose documents are destroyed. Pre-existing federal law allowed prosecution of companies and individuals that either directly destroyed documents that were subject to an existing request or who "corruptly persuade[d]" others to destroy documents with intent to impair the document's availability in an official proceeding, in violation of 18 U.S.C. §§ 1505 and 1512(b)(2). The penalties for violating sections 1505 and 1512(b)(2) are up to 5 and 10 years in prison, respectively.

Sarbanes-Oxley added to the existing law two new, more sweeping provisions, 18 U.S.C. §§ 1512(c) and 1519.[7] Under section 1512(c), an individual or company that "corruptly" destroys or attempts to destroy a document with intent to impair the document's use in an official proceeding may be fined or imprisoned for up to twenty years. In addition to the harsher sentence it allows, this provision differs from section 1505 in that it does not require the presence of an existing request for the destroyed document, and it differs from section 1512(b)(2) in that it prohibits direct destruction as opposed to destruction procured through "corrupt persuasion."

Section 1519 is even more perilous for companies and individuals who fail properly to preserve documents. This section prohibits companies and individuals from "knowingly" destroying documents "in relation to or contemplation of" "any matter [or case] within the jurisdiction of any department or agency of the United States . . . ." At least three significant changes in the law are embedded in the short text of section 1519. First, instead of the "corruptly" *mens rea* requirements of sections 1505 and 1512 (which has been read as requiring a "bad purpose"), section 1519 prohibits only "knowing" destruction – a much lower standard of culpability. Second, section 1519 appears to require only that the documents destroyed relate to "any matter" within the jurisdiction of the federal government – a lower threshold than section 1505's requirement of a "pending proceeding." Third, the new law prohibits destruction of documents "with the intent to . . . obstruct . . . or in relation to or contemplation of" any potential federal matter. The full reach of "in relation to or contemplation of" has yet to be tested, but it certainly expands the law beyond its prior bounds.[8] Section 1519 carries a penalty of up to twenty years imprisonment.[9]

---

[7] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 802 & 1102, 116 Stat. 800-01, 808 (2002).

[8] The meaning of section 1519's provisions has not been litigated, but the "any matter" language is similar to language in 18 U.S.C. § 1001, which courts have

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

In light of the heightened government focus on document preservation, it is imperative that inside counsel is prepared to act before the SEC calls and that counsel adroitly executes the company's plan. Adequate preparation and execution of a document preservation strategy will assist in avoiding a botched document preservation that quickly turns a limited, defensible SEC investigation into a "bet the company" criminal defense.

a. What are the Immediate Steps to Take?

Inside counsel should ask at least four questions upon learning that an investigation has been instituted or is reasonably likely to begin.

1. **Have you ensured that the company has immediately stopped all routine document destruction activities, including the shredding of physical documents and the overwriting, modification, or deletion of electronic data?**
2. **Have you sent a carefully-phrased e-mail to all appropriate employees asking them to preserve documents?**
3. **Have you collected and securely stored back-up computer tapes and key computer hard drives?**
4. **Have you sent a carefully-phrased e-mail to employees warning them about the perils of destroying or encouraging others to destroy or modify documents?**
5. **Have you physically confirmed that all appropriate employees have complied with these requests?**

After addressing the first set of questions, counsel should discuss the following questions with the attorneys handling the investigation.

---

interpreted as being extremely broad. *See, e.g.*, *United States v. Rodgers*, 466 U.S. 475, 480 (1984).

[9] In addition, section 805 of the Sarbanes-Oxley Act directed the United States Sentencing Commission to review the relevant sentencing guidelines to ensure that they appropriately reflected the intent and purpose of the Act. Of course, as has traditionally been the case, companies convicted under these provisions are subject to fines and other sanctions (such as debarment from government contracts).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

b. *Should experts be retained to participate in the electronic document retention and collection?*

The answer to this question depends largely on the size of the company and the breadth of the investigation. The explosion in use of electronic data, especially e-mail, has provided immeasurable benefits to businesses, but it has brought with it logistical nightmares when a broadly-written document request arrives from the SEC. Although advance preparation will help, suffice it to say that it is nearly impossible to recognize all the problems that go with collecting and producing electronic data.

To address this need, there is now an industry of experts who focus primarily on finding, retrieving, analyzing and categorizing documents. Using these experts can avoid major problems that most companies might not even recognize. Their familiarity with most systems is astonishing and they can take the burden off the shoulders of an Information Technology ("IT") Department that is told it may need to recover literally millions of documents. Perhaps of equal importance, these experts provide a company with considerable protection if they are asked to devise and implement a data recovery program and do so – even if the program has flaws. If the screw-up occurs, a company that can demonstrate good-faith reliance on expert advice will be in a far better position than a company that relies on its own personnel.

The bad news is that the quality and cost of electronic data experts varies hugely. Most major litigation firms now have extensive experience with electronic data experts, can help select the best experts, and can often negotiate down the price of services by a large percentage from the first bid. This is where experience counts and can save big bucks.

c. How should the company go about collecting and preserving documents?

Once the initial steps have been taken to avoid inadvertent or ill-advised document destruction, as discussed *supra*, the real work begins. That is the job of identifying responsive documents (if there is a subpoena or request for documents) or collecting relevant documents (if the company is launching its own investigation). After receiving a subpoena for documents, the company should consider that other documents – not yet subpoenaed – may ultimately be deemed relevant to the investigation and must be preserved.

The development of a document retention and collection process is extremely fact-specific and unique to the investigation and the company involved. In other words, no one protocol will work for every company. Several points, however, generally should be followed when collecting and preserving documents.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

First, the plan for collecting and preserving documents should be developed by an interdisciplinary team that includes, at a minimum, inside counsel, outside counsel, the electronic data expert, company employees from the IT Department (or the equivalent group with knowledge of the company's computer systems), and employees from the company's document management and retention systems. Only with these constituencies represented can the company feel assured that it has identified all of the places in which responsive documents may be found, and developed a plan to find them. The fact that all of these constituencies must be present at the creation of the plan, however, does not mean that they must monitor it throughout.

Second, the plan must involve extensive documentation regarding the extent and manner of the search and its results. If the plan ultimately fails to collect or preserve some documents (as is nearly always the case with a large company), the documentation regarding the efforts made by the company will provide substantial protection against charges of obstruction or deliberate document destruction. Documentation regarding the responses from employees also is essential because flaws in document collections often do not turn up until years after the actual collection occurred. Personnel may have changed or memories dimmed or both. Careful recordkeeping that will survive changes in personnel and the passage of time is essential.

Third, a responsible and senior employee or junior officer should be placed in charge of the effort and given the time and resources to accomplish the job. Trying to add the document collection efforts to the responsibilities of an already busy officer or employee seldom works as they view the document collection responsibilities as subordinate to their "real job." Low-level employees are not ideal candidates for this position as they seldom command the respect within the organization to accomplish the necessary goals.

III. What Are the Company's Immediate Disclosure Obligations?

The SEC Rules Relating to Investigations state, "unless otherwise ordered by the Commission, all formal investigative proceedings shall be non-public."[10] Nonetheless, in certain situations companies are required to disclose material information. In addition, a company subjected to an investigation may need to disclose the fact of the investigation in its public disclosures. Item 103 of Regulation S-K requires a registered company to describe any "material pending legal proceedings, other than ordinary routine litigation incidental to the

[10] 17 C.F.R. § 203.5 (2003).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

business."[11] Item 103 further requires a company to "[i]nclude similar information as to any such proceedings known to be contemplated by governmental authorities."[12] Given these requirements, inside counsel should discuss the following questions with its securities disclosure counsel.

a. What kind of SEC investigation has been initiated?

Whether the company should disclose the investigation may depend upon the nature of the investigation and is a prime issue to discuss with securities disclosure counsel. Neither the text to Item 103 nor its instructions clarify the point at which a company knows that legal proceedings are contemplated. However, there is some support for the notion that the very fact that the SEC is investigating a company may be enough to establish that litigation is "contemplated," thereby requiring the company to disclose the investigation itself.[13] Inside counsel should discuss the details of the investigation and attempt to determine the likelihood that litigation may arise from it. Many companies disclose "formal" investigations as they usually signify a significant prospect of SEC action against the company. The initiation by the SEC of informal investigations, on the other hand, may not necessarily require immediate disclosure. Sometimes the SEC inquiry may only reflect the staff's interest in a highly-publicized transaction or event. The SEC lawyer may not have a specific violation in mind when the call is made.

b. Does the company know enough about the nature and gravity of the investigation to make an accurate disclosure?

When an investigation is in its beginning stages, the company simply may not have adequate knowledge of the facts and circumstances that led to the SEC's interest. The question then arises as to whether the company can make a full and accurate disclosure of the nature of the investigation. An SEC investigation, however, often results in the company conducting its own independent investigation. If the company itself discovers material facts through an internal investigation, it likely will be obligated to disclose its findings in public filings and/or proxy statements.[14] The company's obligation arises from the anti-fraud provisions of the federal securities laws, SEC regulations, and the various

---

[11] Reg. S-K, Item 103, 17 C.F.R. § 229.103 (2003).

[12] *Id.*

[13] *See United States v. Yeaman*, 987 F. Supp. 373, 382-83 & n.10 (E.D. Pa. 1997) (holding that Item 103 required that the company disclose a two-year SEC investigation into an officer and the company).

[14] *See SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

rules of the exchanges where the company's stock may be traded. Whether the company should disclose the potential investigation and just how much the company should disclose are matters best referred to the company's regular securities disclosure counsel.

c. *Is there a transaction, securities offering or public report on the horizon that would require disclosure?*

Inside counsel will need to assess whether there are any upcoming filing requirements, such as periodic reports on Form 10K or 10Q, that will bring with them a duty to disclose a number of things, including the requirements of Item 103 discussed *supra*. The federal securities laws, however, require disclosure in a number of instances and because of a number of triggering events. For example, a company that is considering a public offering or a shelf registration will be required to disclose material information beyond that which is required in periodic reports under the Exchange Act.[15] Similar disclosure obligations may arise when the company purchases or sells its own stock on the market.[16]

d. *Will upcoming "certifications" required by Sarbanes-Oxley force disclosure?*

Although it is beyond the scope of this article to discuss in detail the certifications by the CEO and CFO that are required by Sarbanes-Oxley, counsel must be aware that such certifications can have the practical effect of forcing disclosure of a pending SEC investigation. For example, if the investigation involves current operations, accounting practices or policies, current financial statements, or the efficacy of internal controls, the CFO may be unwilling to certify that the company's financial statements comply with the requirements of section 13(a) or 15(d) of the Exchange Act or that they fairly present, in all material respects, the financial condition or results of the issuer. As discussed *supra*, the pendency of an SEC investigation places huge pressures on a public company and creates a minefield through which a company must maneuver.

---

[15] *See Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996) ("Indeed, in the context of a public offering, there is a strong affirmative duty of disclosure."); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (stating that the Securities Act "was designed to provide investors with full disclosure of material information concerning public offerings").

[16] *See* McCormick *v. Fund Am. Cos., Inc.*, 26 F.3d 869, 876 (9th Cir. 1994) ("[T]he corporate issuer in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them.").

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

e. Is it prudent not to disclose the investigation in the current climate?

In today's world, there are a large and growing number of events that can prompt disclosure of SEC investigations. And, if the gravity of the matter is misjudged, and disclosure is delayed, only to result in a major SEC action against the company, the company will pay dearly. These factors result in an inevitable tilt toward disclosure of formal investigations.

IV. What Are the Common Pitfalls To Avoid in the Early Steps of the Investigation?

A company facing an SEC investigation may be tempted to make immediate pledges or commitments that sound and feel comforting – temporarily –but can prove disastrous, or at least extremely painful, in the long run. Hesitate and think twice before embarking on the road of active cooperation because many companies have found that once trod it is extremely difficult to turn back. Unfortunately, the common wisdom from many law firms is that immediate and unconditional promises of cooperation are desirous but that is a decision that the company should seriously consider deferring until it receives advice based upon a review and analysis of the facts. While this may present some frosty and uncomfortable early meetings with regulators, it can avoid much more painful problems later.

a. Should the company commit to a course of action before it understands the problem?

If the company commits to active cooperation, the SEC will expect the company's <u>full</u> cooperation. While counsel may rightly conclude that full cooperation is in the company's best interest, that determination seldom can be made before understanding the real scope of the problem. The government might become impatient when time extensions are requested, but it is important not to kowtow on this point. Counsel's relationship with the government might be strained initially, but that critical relationship could be permanently destroyed if counsel prematurely pledges cooperation only to have to pull back when facts are discovered indicating that cooperation on the SEC's terms would not serve the company's interests.

b. Should the company commit to producing documents on a specific timetable before it has a firm grasp as to the extent of the documents requested?

Do not accede to the SEC's initial document request without first determining what can actually be collected, reviewed, processed, and produced, how long it will take, and how much it will cost. The SEC's initial request might be phrased in simple terms such as "produce all documents related to transaction X".

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Assuming that transaction X is a material transaction to the company, that request could require the production of millions of pages of e-mail, electronic documents, and hard copies. However, it is likely that only a small percentage of this voluminous amount of documents would be of interest to the SEC. After taking time to learn about transaction X, counsel likely will be in a position to offer a much smaller, more relevant subset of what would be technically responsive to the SEC's initial request, and provide those documents in a reasonable time period.

Unfortunately, volume and overbreadth are not the only problems counsel will face in responding to the government's requests. Do not underestimate the amount of time it will take to harvest electronic documents (including e-mail), convert them into a format in which they can be reviewed for both privilege and responsiveness, and produce the responsive, non-privileged ones. These time-consuming and arduous tasks are compounded by the necessary effort to determine and conduct privilege review for every permutation of attorneys' (in-house and outside) e-mail addresses. Consultation with experts in electronic data can be invaluable during this process.

c. Should the company offer to conduct an internal investigation and promise to waive privilege and produce the report to the SEC?

The two issues of whether to proclaim publicly an "internal investigation" and whether to waive the attorney-client privilege for the report of the investigation are inextricably linked. The principal reason to conduct such an investigation is precisely to encourage the SEC to defer its own investigation, and, thus, the SEC will expect that the report, or at least the substantive results, will be turned over to it.[17] This, in turn, presents two issues. First, is it wise to agree to provide the government with the results of the internal investigation without having any sense of what will be uncovered? Second, even if there is no doubt that cooperation with the SEC is desirable, what are the chances that the report of the investigation will fall into the hands of plaintiffs in securities cases or third parties litigating with the SEC?

1. Should the company agree to perform its own internal investigation?

There are several levels at which a company can "cooperate" with the SEC. It can cooperate in the most rudimentary sense by accepting service of subpoenas, providing documents without the necessity of subpoena enforcement proceedings, producing witnesses on a reasonable basis, and responding to simple,

[17] Of course, the board of directors of the company might insist on an independent investigation after it learns that the company is being investigated by the SEC.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

factual questions. In most instances, companies provide at least this level of cooperation. The issue that a company must consider carefully is whether to go beyond this, undertake an internal investigation and then agree to turn the fruit of the investigation over to the SEC before knowing what the investigation will uncover?

Deciding whether to conduct an internal investigation – the results of which will be turned over to the SEC – is a major step, and there are circumstances in which the company may not find it in its best interest to follow that path. It is clear, for example, that most companies have many more resources to devote to an investigation than the SEC has. The company's lawyers will probably turn up many leads and eventually problems that even the most astute SEC investigators will not find. Thus, by agreeing to turn over its work product to the SEC, the company has in effect deployed its own resources to develop information that could be used to impose sanctions against itself. The more complex the problem, the greater the impact of the company's agreement to investigate itself. Put another way, the well-financed internal investigation is likely to develop more evidence against the company than any government agency is likely to achieve.

A second consideration is that by using the company's own resources to develop evidence against itself, the company has in effect deprived itself of one of the most potent weapons it has – the threat to advance a spirited defense if the SEC's terms are not acceptable. If the company already has turned over all of the damning evidence to the SEC, superior litigation capabilities may count for little in the endgame of negotiation. Most companies, of course, would shrink from litigation with the SEC, but the fact is that a company must be prepared to fight to get the best possible outcome.

One could argue that companies should consider making promises of complete cooperation only if they are reasonably confident that the investigation will show no serious problem (and the SEC may simply drop the matter when it fully understands it) or a very limited problem (that the SEC would have uncovered anyway) and the company would not fight in any event. If the company does not fall into one of these categories, there is a question whether, especially in the early stages of the investigation, it is wise to pledge to turn over the work product of an internal investigation.

2. Can the company protect the "report" it provides the SEC?

The decision whether to share the report of an internal investigation with a regulatory agency is among the most vexing problems that a company will encounter. Refusing to cooperate invites the regulatory agency, such as the SEC, to pursue aggressively its own investigation and may reduce the agency's willingness

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

to reach an amicable resolution of the investigation.[18] Providing the report of the investigation to the regulatory agency poses its own significant risks that the report will lose its attorney-client privilege and/or work-product protection in litigation, will be disclosed to adversaries (most likely in class action litigation), and then used against the corporation.

As a general rule, disclosing a report from an internal investigation to a governmental agency waives the attorney-client privilege with respect to that report regardless of whether the governmental agency agreed to maintain the confidentiality of the investigation. Most of the circuits which have considered the issue have rejected the so-called "limited-waiver rule" or "selective-waiver doctrine,"[19] which provides that a company may voluntarily disclose information to a government agency under certain circumstances without waiving the attorney-client privilege.[20] Considering that a company may find itself litigating in many different jurisdictions, a company should not expect to maintain the attorney-client

---

[18] *See In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1369 (D.C. Cir. 1984) (observing that voluntary disclosures are made to the government in order to receive the *quid pro quo* of more lenient punishment); *Neal v. Honeywell, Inc.*, No. 93 C 1143, 1995 WL 591461, at *6 (N.D. Ill. Oct. 4, 1995) (observing that, by participating in a voluntary disclosure program with a government agency, a company receives the possibility "of more lenient treatment than it could reasonably have expected to receive in the absence of [its] cooperation" with the government).

[19] The Eighth Circuit was the first court to recognize the selective waiver doctrine. *See Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977) (en banc).

[20] *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002) (holding that company waived the attorney-client privilege, despite a confidentiality agreement with the DOJ, by disclosing privileged documents to the DOJ), *cert. dismissed*, No. 02-888, 2003 U.S. Lexis 5311 (Aug. 5, 2003); *Genentech, Inc. v. United States Int'l Trade Comm'n*, 122 F.3d 1409, 1417 (Fed. Cir. 1997) (holding that it "has never recognized such a limited waiver [of the attorney-client privilege]"); *United States v. Mass. Inst. of Tech.*, 129 F.3d 681 (1st Cir. 1997) (holding that voluntary disclosure of privileged materials to the government constitutes a waiver of the attorney-client privilege to all other adversaries); *Westinghouse Elec. Corp. v. Republic of Philippines*, 951 F.2d 1414 (3d Cir. 1991) (rejecting the selective waiver doctrine); *In re Martin Marietta Corp.*, 856 F.2d 619, 623 (4th Cir. 1988) (rejecting the selective waiver doctrine); *Bowne of New York City, Inc. v. AmBase Corp.*, 150 F.R.D. 465, 480 (S.D.N.Y. 1993) (holding that "even if the disclosing party requires, as a condition of disclosure, that the recipient maintain the materials in confidence, this agreement does not prevent the disclosure from constituting a waiver of the privilege; it merely obligates the recipient to comply with the terms of any confidentiality agreement").

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

privilege for an internal investigation report if that report is provided to a governmental agency.

Disclosing the results from an internal investigation also may waive the work-product protection of that report. The work-product doctrine protects from disclosure documents or other tangible items prepared by a company or by its attorneys in anticipation of litigation.[21] The voluntary disclosure of otherwise protected information to a third party does not waive the protection of the doctrine, unless the disclosure enables an adversary or a potential adversary to gain access to the information.[22] In determining whether a particular disclosure constitutes a waiver, courts consider, among other things, whether a common interest exists between the company and the third party and whether the disclosure was made pursuant to a confidentiality agreement.[23] This rule has been recognized as applying to voluntary disclosures made to any third party, including government investigators.[24]

Recognizing the importance of voluntarily receiving internal investigations from a Company, the SEC has filed amicus briefs in support of the principle that the production of information by a company to the SEC pursuant to a confidentiality agreement does not waive the work-product protection. The SEC has explained that it executes confidentiality agreements "only when it has reason to believe that obtaining the work product will significantly improve the quality and timeliness of its investigations," and "only with persons that have demonstrated that they have reason to produce reliable work product and are likely to do so."[25] The SEC appears to have persuaded the Georgia Court of Appeals in *McKesson HBOC, Inc. v. Adler*, to, at least, be open to the prospect of work-product protection notwithstanding the production of an internal investigation report to the SEC due

---

[21] *Hickman v. Taylor*, 329 U.S. 495, 510-11 (1947); Fed. R. Civ. P. 26(b)(3).

[22] *In re Grand Jury Subpoena*, 220 F.3d 406, 408 (5th Cir. 2000); *Westinghouse Elec. Corp.*, 951 F.2d at 1428.

[23] *See, e.g.*, *United States v. Am. Tel. & Tel. Co.*, 642 F.2d 1285, 1299-1300 (D.C. Cir. 1980); *see generally*, John K. Villa, CORPORATE COUNSEL GUIDELINES § 2.12 (ACCA and West 2002).

[24] *See In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2d Cir. 1993); *In re Sealed Case*, 676 F.2d 793, 817 (D.C. Cir. 1982).

[25] Brief of the United States Securities and Exchange Commission, Amicus Curiae, at 2, submitted in *McKesson HBOC, Inc. v. Adler*, 562 S.E.2d 809 (Ga. Ct. App. 2002).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

to the presence of a confidentiality agreement.[26] The appeals court held that the trial court had erred in failing to address defendant's claim of work-product protection and to make the requisite findings of fact on this issue.[27] Recognizing that work-product protection "is not necessarily waived by disclosure to a third party,"[28] the appeals court found that there was some evidence supporting defendant's contention that the company and the SEC were not adversaries, but instead, "share[d] a common interest in developing legal theories and analyzing information,"[29] and that the company had obtained a written confidentiality agreement from the SEC.[30]

In a recent decision stemming from the same SEC investigation described in *McKesson*, however, the United States District Court for the Northern District of California in *United States v. Bergonzi*, rejected the Government's insistence on work-product protection.[31] Contrary to the ruling in *McKesson*, the court in *Bergonzi* found that the SEC and the disclosing party did not have a common interest to prevent waiver because "the Company and the Government did not have a true common goal as it could not have been the Company's goal to impose liability onto itself, a consideration always maintained by the Government."[32] Because the confidentiality agreement contemplated future prosecution of the Company[33] and permitted the Government to disclose the report "to the extent that the [SEC] determines that disclosure is otherwise required by

[26] *See* 562 S.E.2d 809 (Ga. Ct. App. 2002).

[27] *See id.* at 813-14.

[28] *Id.* at 813.

[29] *Id.* at 813 (quotation omitted).

[30] *Id.* at 813.

[31] *See United States v. Bergonzi*, 214 F.R.D. 563 (N.D. Cal. 2003).

[32] *Id.* at 572. For this reason, the court also rejected the contention that the report was protected by the Company's attorney-client privilege.

[33] *Bergonzi*, 214 F.R.D. at 571.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

federal law,"[34] the court held that neither the Company nor the SEC had successfully met its burden of establishing that the SEC was not an adversary.[35]

There are several lessons learned from *McKesson* and *Bergonzi*. First, counsel should never promise to produce an internal investigation report before learning the facts, investigating the possible allegations, and considering the ramifications of disclosure. Too often, counsel prematurely waives the company's attorney-client privilege and work-product protection by agreeing to disclose the results of an investigation before knowing the facts. Second, before counsel for a company even considers conducting an internal investigation, it should thoughtfully analyze whether the company intends or hopes to use the investigation to secure favorable regulatory treatment or provide the results to the regulators. Third, if the company does anticipate using the report for such purposes, then counsel must take care in selecting investigators to make sure that the agency views them as able to provide timely and reliable work product. The investigators should be independent and should not be affiliated with litigation counsel or the corporation. Finally, counsel should attempt to secure a confidentiality agreement governing the production of any report before sharing it with the SEC. The agreement should set forth the common interest of the SEC and the company and indicate that the SEC will not disclose the report to a third party under any circumstance. If possible, the agreement also should include language explaining that the SEC is not an adversary of the company and that the SEC will file an amicus brief supporting the work-product assertions if the company makes it.

V. How Does the Company Assure that Its Current Public Disclosures Reflect All Facts Known to Counsel Without Waiving the Privileges and Work-Product Protection?

Section 13 of the Exchange Act, as amended, requires public companies to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the [company]."[36] This obligation applies throughout an SEC investigation, and can

---

[34] *Id.* at 567 (quotation omitted). Based on that language, the court rejected the contention that the report was protected by the Company's attorney-client privilege.

[35] *See id.* at 573; *see also In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002) (holding that company waived its work-product protection over documents generated in an internal investigation by providing them to the DOJ pursuant to a confidentiality agreement); *Permian Corp. v. United States*, 665 F.2d 1214, 1220 (D.C. Cir. 1981) (rejecting the selective waiver doctrine and holding that company waived its work-product by disclosing documents to the SEC despite a confidentiality agreement).

[36] 15 U.S.C. § 78m(b)(2)(A) (2000).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

cause friction between the company's books and records obligations and the role of counsel engaged in defending the company. Simply put, the real problem is that defense and/or investigative counsel may uncover information that materially affects the company's current securities filings or financial statements, and thus must be reported. There is a parallel problem under section 303 of Sarbanes-Oxley, which makes it unlawful for any officer, director, or person "acting under the direction thereof," to take "any action to fraudulently influence, coerce, manipulate, or mislead" a company's auditor.[37] How can defense and/or investigative counsel take steps that bring this information to the attention of those individuals who prepare the public disclosures without also waiving the attorney-client privileges? To address this inevitable tension, inside counsel should discuss these issues with their regular securities disclosure attorney. And this is a topic on which your counsel will earn their fees because there are no good answers!

There are potential solutions that enable the company to discover and correct errors in its books without waiving its privileges. One obvious approach is to simply copy the CFO on all correspondence with and documents produced to or received from the government and/or third parties. In most cases, however, this approach is unduly burdensome (think of the hapless CFO drowning in documents). It also is too imprecise to be a viable solution and may jeopardize the work-product protection that might otherwise shield counsel's inquiries to third parties.

Another approach is to commission a CFO review that shadows the work of defense and/or investigative counsel but which also conducts independent information gathering and analysis. Under this approach, the CFO receives from counsel very general information regarding deals that should be reexamined or individuals who should be interviewed. The CFO then conducts a separate inquiry and adjusts the books and records accordingly. This approach, properly segregated from the work of counsel, should theoretically protect the privilege. Its efficacy in protecting the privilege has not been tested in court, and there is no guarantee that the CFO, working with only general guidance from counsel, will hit on the right issues and achieve the intended result.

VI. How does the Company deal with the alleged "whistleblower"?

This is a minefield best navigated by experts. Prior to the advent of Sarbanes-Oxley, companies often faced civil suits by employees claiming that they were victims of retaliation for exposing wrongdoing.[38] Sarbanes-Oxley greatly

---

[37] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 778 (2002) (to be codified at 15 U.S.C. § 7242).

[38] 42 U.S.C. § 2000e-3 (2000). According to EEOC statistics, claims of retaliation by employers constituted 27% of all charges filed with the EEOC in 2002, compared to

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

expands the potential for civil liability of a company and its officers for retaliating against a whistleblower.[39] Section 806 of Sarbanes-Oxley provides that no company, its officers, or agents "may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment" because that employee engaged in a protected activity.[40] The range of protected activities encompasses "provid[ing] information, caus[ing] information to be provided, or otherwise assist[ing] in an investigation" concerning conduct that the employee "reasonably believes" to be a violation of the federal mail fraud statute,[41] the federal wire fraud statute,[42] the federal bank fraud statute,[43] the new securities fraud law,[44] and "any provision of Federal law relating to fraud against shareholders," including the securities fraud statutes and related SEC rules and regulations.[45] The investigation into the possible fraud could be conducted by a federal regulatory or law enforcement agency, a member or committee of Congress, a person with supervisory authority over that employee, or a person conducting an investigation on behalf of the company, such an outside counsel.[46]

In addition to the expansive civil liability, Sarbanes-Oxley creates a new criminal offense for retaliating against whistleblowers by amending section 1513 of the federal criminal code. The new provision criminalizes "knowingly, with the intent to retaliate, tak[ing] any action harmful to any person, including interference with the lawful employment or livelihood of any person," who provides information relating to the "commission or possible commission of any Federal

---

15.3% in 1992. *See* EEOC Charge Statistics, *available at* http://www.eeoc.gov/stats/charges.html

[39] Sarbanes-Oxley created only two private causes of action: one providing for the recovery of profits from insider trading, 15 U.S.C. § 7244, and another providing protection for whistleblowers, 18 U.S.C. § 1514A.

[40] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 802, 116 Stat. 800-01 (2002) (to be codified at 18 U.S.C. § 1514A).

[41] 18 U.S.C. § 1341 (2000).

[42] 18 U.S.C. § 1343 (2000).

[43] 18 U.S.C. § 1344 (2000).

[44] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 807(a), 116 Stat. 804 (2002) (to be codified at 18 U.S.C. § 1348).

[45] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 802, 116 Stat. 800-01 (2002) (to be codified at 18 U.S.C. § 1514A).

[46] *Id.*

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

offense."[47] Unlike its civil counterpart, the criminal whistleblower provision only protects the giving of information to a law enforcement officer.[48] If the whistleblower suffers retaliation for providing information in response to an internal corporation investigation, the retaliator would not be subject to criminal liability.

Whistleblower problems are among the most difficult issues that a company will face because they place immense pressure on the current defense team to handle the problems correctly or expose themselves to civil or even criminal liability. These problems are made worse by the broad wording of these statutes, the lack of precedent and experience under these provisions, and the fact that disgruntled employees can easily abuse the whistleblower role to achieve personal employment benefits. Navigating through the shoals of the new whistleblower statutes requires counsel who specialize in this area and, preferably, have handled whistleblower problems before. The recent vintage of the new statutes, however, limits the extent of experience that any lawyer could have. Here are some issues to ponder.

a. *Is the whistleblower known?*

If the company knows that it has a whistleblower, then a number of questions need immediate attention. A company must protect the whistleblower from retaliation by loyal, but misguided, corporate employees. If the whistleblower is unknown – which will occur more frequently with Sarbanes-Oxley's mandate for anonymous reporting procedures – outside counsel should be sensitive to the identity of the whistleblower during its internal investigation but avoid any appearance of a witch hunt. The whistleblower may be asked to serve as a Trojan horse by delivering confidential company information to the federal agency. In the case of in-house counsel acting as the whistleblower, the whistleblower may be asked to violate his ethical duties as a lawyer by divulging attorney-client confidences. While the temptation may be great, terminating or demoting the employee may expose the company to both civil and criminal liability even where the whistleblower has violated an ethical duty. Regardless of whether the whistleblower remains unknown, counsel should ensure that employees know and follow the law protecting employees from retaliation. All potentially adverse employment decisions should be well documented and scrutinized by counsel.

---

[47] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1107(a), 116 Stat. 810 (2002) (to be codified at 18 U.S.C. § 1513 (e)).

[48] *Id.*

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

b. ***Does the whistleblower allege that he/she currently is being asked to engage in unethical conduct?***

If the whistleblower is known, the company must determine whether the whistleblower alleges he/she is being asked to engage in unethical conduct in his/her current position. This may require transferring the employee, but can that be done consistent with the prohibitions in Sarbanes-Oxley against "interference with lawful employment"?[49] Better get advice of counsel!

If the whistleblower is an attorney who provided information to a superior under the professional reporting requirements of section 307 of Sarbanes-Oxley, the company may need to prove to the whistleblower that adequate steps have been taken to investigate the alleged fraud.[50] If the whistleblower already has reported alleged fraud to a governmental agency, however, the company should erect immediately a screen to block the whistleblower from receiving secrets relating to the defense strategy or any other additional information that could be useful to the government.

c. ***May the employee be transferred to a commensurate position?***

In light of the two broad whistleblower provisions, it goes without saying that a company should not take any action that could be perceived as retaliation. Given that there has yet to be any Sarbanes-Oxley whistleblower litigation, there are simply no standards for measuring proper treatment of the reporting employee. Any demotion of the whistleblower could subject the company to civil liability.[51] For example, is it retaliatory to move an employee from an office with a view to a windowless workspace?[52] A court likely would apply analogous reasoning from Title VII cases to determine whether the commensurate position constitutes a demotion. As with Title VII actions, the question of whether an employee has suffered a demotion normally will depend on the facts of each individual case.[53] It may be impossible, however, to transfer some employees. How can a company transfer a lawyer who reports alleged wrongdoing if the company

---

[49] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1107(a), 116 Stat. 810 (2002) (to be codified at 18 U.S.C. § 1513 (e)).

[50] 17 C.F.R. § 205 (2003).

[51] 18 U.S.C. § 1514A.

[52] *See Nicholson v. Ga. Dep't of Human Res.*, 918 F.2d 145, 147 (11th Cir. 1990) (recognizing a similar claim in the gender-discrimination context).

[53] *See, e.g., Bass v. Bd. of County Comm'rs*, 256 F.3d 1095, 1117 (11th Cir. 2001).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

has few in-house lawyers? These are difficult issues that must be addressed by counsel.

The more difficult area may be minimizing a company's criminal exposure. If a company knowingly takes "any action harmful" to the whistleblower, "including interference with the lawful employment or livelihood" of the whistleblower, then the company could face criminal liability.[54] The phrase "any action harmful" and the term "interference" are broad and could encompass activity short of demoting the whistleblower. Conduct that might pass muster under the civil provision may subject a company to criminal liability. To protect the company, counsel may wish to consider the appointment of an ombudsman or mediator to determine whether the new position is commensurate with the employee's existing one. Counsel also may want to obtain an agreement from the employee's lawyer that the transfer is not harmful to the employee. Only time will tell how the new whistleblower statutes are applied.

Conclusion

The opening gambits of the company's response to an SEC investigation are among the most important decisions inside counsel will be required to make. Those decisions, if wrong, can ultimately cause the company immense problems throughout the investigation. There is no assurance, however, that if those decisions are made "correctly" that the game will have a happy ending for the company. The key to a successful outcome is to focus always on the endgame.

[54] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1107(a), 116 Stat. 810 (2002) (to be codified at 18 U.S.C. § 1513).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

ETHICS & PRIVILEGE

Final Report of the American Bar Association's Task Force on Corporate Responsibility: A Look at the Proposed Amendments to the Model Rules

By John K. Villa
Author of *Corporate Counsel Guidelines*, published by ACCA and West

John K. Villa is a partner with Williams & Connolly LLP in Washington, DC. He specializes in corporate litigation (civil and criminal) involving financial services, directors', officers', and lawyers' liabilities, and related issues. He is an adjunct professor at Georgetown Law School and a regular lecturer for ACCA. He is also the author of *Corporate Counsel Guidelines*, published by ACCA and West. He is available at JVilla@wc.com.

On April 29, 2003, the ABA Task Force on Corporate Responsibility (sometimes referred to as the "Cheek Commission" because of its chairman, James Cheek) issued an 89-page final report recommending among other things significant amendments to two ethical rules that are important for corporate lawyers: Model Rule 1.6 involving confidentiality and Model Rule 1.13 specifying the special loyalties and duties of corporate lawyers.[1] This unusual report is the culmination of a year-long, highly public process in which the American Bar Association undertook to reexamine the rules governing corporate counsel in light of the tumultuous effects of major corporate failures. That process included a controversial preliminary report that recommended major changes in the obligations of corporate lawyers, particularly in the area of required disclosure of client confidences. The amendments urged by the final report are more modest but would, if adopted by the ABA's Board of Governors and by the states, significantly affect the standards in many jurisdictions. Although the task force report is not binding on the ABA, it is an important statement of position by a distinguished group of securities lawyers and can be expected to have a significant role in shaping the ABA's Model Rules.[2]

DISCLOSURE OF CONFIDENTIAL INFORMATION: MODEL RULE 1.6

Background

The current version of Model Rule 1.6(b) permits but does not require the disclosure of confidential information without the client's consent in several instances, and it does not differentiate between individual and "entity" clients:

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
(1) to prevent reasonably certain death or substantial bodily harm;
(2) to secure legal advice about the lawyer's compliance with these Rules;
(3) 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
(4) to comply with other law or court order.[3]

Most jurisdictions, however, have adopted a version of this rule that also permits (but does not require) disclosure of client information in order to prevent the perpetration of a fraud that constitutes a crime.[4] In addition, several jurisdictions have adopted still another exception in their confidentiality rules that permits (but again does not require) disclosure in order to mitigate substantial injury or loss caused by the client's commission of a crime or fraud while using counsel's services; a tiny minority of states require disclosure in these circumstances.[5] In § 67 of the *Restatement (Third) of the Law Governing Lawyers,*[6] the American Law

Reprinted with permission of the author(s) and the American Corporate Counsel Association as originally appeared:
John K. Villa, "Final Report of the American Bar Association's Task Force on Corporate Responsibility: A Look at the Proposed Amendments to the Model Rules," *ACCA Docket* 21, no. 7 (July/August 2003): 116–121. Copyright © 2003 John K. Villa and the American Corporate Counsel Association. All rights reserved.
For more information or to join ACCA, call 202.293.4103, ext. 360, or visit www.acca.com.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Institute has endorsed permitting disclosure beyond the standard in the current Model Rules. The preliminary report of the task force had recommended mandatory disclosure for certain client conduct—a change that some commentators (including the author) considered heresy and that would have exceeded the rules of virtually all jurisdictions.[7]

At its core, the confidentiality rule is a balancing between sometimes competing policy interests: one interest is in encouraging clients to be candid with their lawyers by assuring broad confidentiality, and the countervailing interest is that lawyers cannot knowingly permit their services to further client fraud or illegality. And as the theory goes, if it takes disclosure of client confidences to prevent the client from abusing the lawyer's services, so be it. The question is where to draw the line.

The Final Proposal

The task force concluded that the current version of Model Rule 1.6 "is significantly out of step with the policy balance reflected in the rules of professional conduct in most of the states,"[8] and because "this inconsistency has become increasingly dissonant in the past year, as public opinion has demanded that lawyers play a greater role in promoting corporate responsibility,"[9] the task force recommends that the rule be amended to conform to existing law and policy.[10] Its proposed amended Rule 1.6(b) would therefore provide as follows:

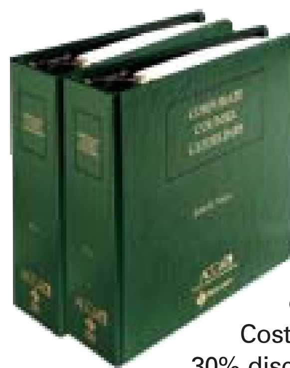
(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
   (1) [unchanged];
   (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests 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; . . .[11]

The proposed amendment to Model Rule 1.6 is the same as that proposed by the Ethics 2000 Commission,[12] but rejected by the House of Delegates in August 2001.[13] The notion that lawyers can, at their own discretion and without client consent, disclose client confidences to rectify what they believe is a past client fraud will once again prove controversial for the ABA. Indeed, corporate lawyers have been criticized[14] and disbarred[15] for similar conduct. Perhaps, the recent cries for greater accountability will increase the chances for approval of the task force's proposed amendment to Model Rule 1.6.[16]

According to the task force, similar balancing considerations come into play when determining the scope of counsel's duty of confidentiality with respect to organizational clients.[17] Although organizational constituents may legitimately expect that counsel will not disclose confidential information to others outside the organization,[18] the task force asserts that there may be situations in which such disclosure is necessary in order for counsel to act "'as is reasonably necessary in the best interest of the organization'" to protect the organization against substantial injury.[19] For this reason, the task force proposes a new confidentiality-waiving provision in Rule

Do Not Miss John K. Villa's

Corporate Counsel Guidelines
published by ACCA and West



In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions. Cost: $220, and ACCA members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

1.13 that permits corporate counsel to report outside the corporation under these circumstances.[20] New subsection 1.13(c) would provide as follows:

(c) Except as provided in Paragraph (d), if

(1) despite the lawyer's efforts in accordance with Paragraph (b), the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate fashion action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.[21]

The task force, however, recognizes that this proposed new subsection threatens to trump the general restrictions on disclosing client confidences under Rule 1.6(a). Accordingly, it cautions that the provision is applicable only in cases in which counsel has "a heightened level of certainty as to the violation of law," not just the violation of a legal duty.[22] One important exception is that this proposed provision would not authorize the disclosure of information obtained by counsel specifically hired by the organization to investigate alleged wrongdoing within the organization or retained to represent the organization in the defense of a claim alleging a violation of law.[23] To underscore these latter limitations on subsection (c)'s applicability, the task force recommends the adoption of a new subsection (d) providing to this effect.[24]

"UP-THE-LADDER" REPORTING: MODEL RULE 1.13

Background

The duty of counsel with respect to the internal communications of an organizational client is set forth in Model Rule 1.13. Subsection (b) of this rule, which defines the circumstances triggering counsel's duty to act with respect to wrongful conduct on the part of an officer or an employee, currently provides as follows:

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization 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 which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

(1) asking for reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.[25]

The Final Report

According to the task force, the rule correctly directs counsel to take appropriate action without clearly defining the appropriate action and generally instructs counsel to "proceed as is reasonably necessary in the best interest of the organization."[26] Because the rule suggests measures that counsel may pursue, but does not mandate any of these measures, the task force finds that the current listing of these measures "confuse[s] rather than clarif[ies] the mandatory nature of the lawyer's obligations" and, therefore, recommends their deletion from the rule.[27] In addition, the task force recommends revising subsection (b) in two particulars: (1) by refining the definition of the circumstances triggering counsel's duty to act and (2) by clarifying when counsel must communicate with higher authority within the organization.[28]

As presently written, subsection (b) requires action on the part of counsel when he or she "knows" that a person associated with the organization is engaging in or intends to engage in wrongful conduct that is likely to result in substantial injury to the organization. By using the term "knows," the

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

current Model Rules denote a subjective knowledge of the illegal nature of the conduct.[29] In its final report, the task force recommends changing that aspect of subsection (b) to provide as follows:

> (b) If a lawyer for an organization knows facts from which a reasonable lawyer, under the circumstances, would conclude that an officer, employee or other person associated with the organization 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 which 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.[30]

The task force describes the duty to act under the proposed amendment as still initially subjective in nature, arising "only on the basis of facts known to the lawyer."[31] The threshold for required action by the lawyer, however, would be based on an objective test: "whether a reasonable lawyer who knows such facts would, in similar circumstances, conclude that the conduct" in question "constitutes a violation of law or duty to the organization that is likely to result in substantial injury to the organization."[32] The task force recognizes that lawyers are under no duty of investigation of information provided by the client, but then states that "the lawyer may not simply accept such information at face value if to do so would be unreasonable in the circumstances."[33]

If the lawyer suspects that illegality is afoot, what choice is there except to investigate? Yet investigation is not required. This standard will sow confusion. The task force has backed into the very problem that Model Rule 1.13 has avoided by focusing on actual knowledge of corporate wrongdoing.

With respect to reporting wrongful conduct to higher authority within the organization, the current rule identifies reporting up the corporate ladder as one of several potential courses of action that counsel may pursue when armed with knowledge of wrongful conduct. The task force recommends, however, that "reporting up" be made a mandatory requirement, unless counsel reasonably believes that it is not necessary to make such a report. As explained in the final report, the proposed change is not like the "rigid" reporting requirements of the Sarbanes-Oxley Act rules issued by the SEC,[34] because it permits counsel to exercise professional judgment to determine what constitutes the appropriate way to proceed in the best interest of the organization.[35]

As amended, therefore, Model Rule 1.13(b) would provide, in its entirety, as follows:

> (b) If a lawyer for an organization knows facts from which a reasonable lawyer, under the circumstances, would conclude that an officer, employee or other person associated with the organization 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 which 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, the highest authority that can act on behalf of the organization as determined by applicable law.[36]

THE RECOMMENDATIONS PROPOSED BY THE TASK FORCE REPRESENT SIGNIFICANT MODIFICATIONS TO THE MODEL RULES ON ISSUES THAT WILL HAVE A SUBSTANTIAL EFFECT ON CORPORATE LAWYERS.

What happens when counsel's attempts are unsuccessful to prevent or avoid wrongful conduct that poses serious adverse consequences for the organization, resulting in counsel's withdrawal[37] or discharge? Does that event end counsel's duty to report? In other words, must counsel disclose that they have been discharged or have withdrawn? Under current subsection (b), counsel has the option, "if warranted by the seriousness of the matter," to report the conduct to the highest authority within the organization.[38] There is no provision, however, that addresses reporting the fact of withdrawal or discharge to the organization's highest authority. In the view of the task force, reporting this fact falls within counsel's obligation to act in the best interest of the organization.[39] Accordingly, the task force recommends the addition of a new subsection that obligates counsel to assure that the

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

highest authority is made aware of counsel's withdrawal or discharge and the circumstances underlying it.[40]

CONCLUSION

The recommendations proposed by the task force represent significant modifications to the Model Rules on issues that will have a substantial effect on corporate lawyers. This result was probably inevitable given the outcry over the most recent brace of corporate collapses. Whether this report will in fact result in a change in the rules must await the vote of the ABA's House of Delegates, which will presumably take place at the ABA's 2003 Annual Meeting in San Francisco August 7–12. It is a good bet that the rules will be modified and that new challenges will be heaped upon those lucky enough to escape the SEC's up-the-ladder reporting requirements from the Sarbanes-Oxley Act.

NOTES

1. The report also addressed several recommended corporate governance reforms, including requiring the general counsel to meet with the directors outside the presence of management.
2. Report of the ABA Task Force on Corporate Responsibility, dated Mar. 31, 2003, and issued Apr. 29, 2003, at www.acca.com/public/policy/corpresp/aba.pdf (hereinafter referred to as the "Final Report").
3. *ABA Model Rules of Professional Responsibility*, Rule 1.6(b).
4. According to the Final Report, 41 states have such a confidentiality rule, and in four of those states, disclosure is mandatory. *See* Final Report, at 50, note 89.
5. *Id.* (noting that 18 states have such a provision and that in three of these states disclosure is required under these circumstances).
6. Section 67 provides, in part, that a lawyer may use or disclose confidential client information when the lawyer reasonably believes that its use or disclosure is necessary to prevent the client's commission of a crime or fraud threatening substantial financial loss in a matter for which the client is using the lawyer's services. In cases in which the fraud or crime has already occurred, § 67 further authorizes the disclosure of such information to prevent, rectify, or mitigate the loss. *Restatement (Third) of the Law Governing Lawyers* § 67 (2000).
7. *See* Preliminary Report of the ABA Task Force on Corporate Responsibility, July 16, 2002, at 34; *see also* Final Report at 49–50, note 89 (containing a breakdown of those states having a permissive disclosure rule and those having a mandatory disclosure rule for purposes of preventing a client's perpetration of a crime or fraud or of rectifying substantial loss from a client's crime or fraud in which the client used the lawyer's services). ACCA commentary on these proposals can be found in Recent Proposals for Changes in Corporate Governance, Public Auditing, and the Role of Corporate Counsel: An Update as of July 26, 2002, by John K. Villa et al., at www.acca.com/public/reference/enron/acca_update.pdf.
8. *Id.*
9. *Id.* at 52.
10. *Id.* Another important impetus for amending the confidentiality rules, particularly as applied to the organizational client, is to preclude "further regulatory intrusion into the critical domain of the attorney-client relationship." *Id.* at 51. In this regard, the task force notes the SEC's deferral of a proposed regulation under the Sarbanes-Oxley Act that would require a lawyer to report a corporate client's wrongdoing to the SEC, *see* 68 Fed. Reg. 6296, 6324 (Feb. 6, 2003), and quotes the former SEC chairman's comment on the deferral to the effect that both the legal community and the SEC need to work on finding a solution to the issue raised by the deferred proposal. Final Report at 51, note 90.
11. *Id.* at 52.
12. In its Preliminary Report, the task force had proposed an amendment that would require counsel to disclose confidential client information. The task force modified its proposal, based, in part, on the reasoning underlying the ABA's opposition to the SEC's proposed "noisy withdrawal" regulation that would require counsel to withdraw from representation and to notify the SEC of the withdrawal. *See id.* at 53, note 94.
13. *See Conference Report*, 17 ABA/BNA LAWS. MAN. ON PROF. CONDUCT 492 (Aug. 15, 2001).
14. *See* Douglas v. DynMcDermott Petroleum Operations Co., 144 F.3d 364, 375–376 (5th Cir. 1998) (holding that in-house counsel's disclosure of confidential information to the government about alleged discrimination within the corporation violated Rule 1.6 and that "unique position of special trust" held by an in-house counsel).
15. *See* The North Carolina State Bar v. Robert L. Petersen, Attorney, Disciplinary Hearing Commission, No. 10 DHC 21 (Wake County, NC, Sept. 18, 2002).
16. *See ABA Corporate Responsibility Task Force Suggests Changes to Attorney Ethics Rules*, 71 U.S. LAW WEEK 2694, 2695 (May 6, 2003) (according to task force chairman James Cheeks, "'there obviously have been significant events that have impacted American investors . . . [which] perhaps make people a little more mindful and sensitive about the role lawyers can and should play in providing a system of accountability'").
17. Final Report at 56.
18. *Id.* As noted by the task force, Model Rule 1.6 does not preclude counsel from disclosing information imparted by one member of the organization to another member of the organization, such as "by sharing with a corporation's general counsel or its board of directors facts learned from a corporate officer." *Id.*
19. *Id.* at 56–57.
20. Under existing Rule 1.13, counsel is cautioned that any measures undertaken after learning of wrongful conduct within the organization must "be designed to minimize . . . the risk of revealing information relating to the representation to persons outside the organization." Instead of retaining this provision in the text of the rule, the task force recommends incorporating it in the commentary. *See id.* at 57, note 98.
21. *Id.* at 57. The *Restatement* also recognizes that limited circumstances may arise in which it clearly appears that limited disclosure outside the organization "to prevent or limit harm would be in the interests of the organizational client[.]" *Restatement (Third) of the Law Governing Lawyers* § 96, cmt. f (further noting that it takes no position on what cir-

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

cumstances would warrant such a disclosure). *See* Final Report at 57–58 (generally concurring with the *Restatement* view).

22. Final Report at 58.
23. *Id*. at 59.
24. Proposed subsection (d) would provide as follows:

    Paragraph (c) shall not apply with respect to information relating to a lawyer's engagement by an organization to investigate an alleged violation of law or to defend the organization or an officer, employee or other person associated with the organization against a claim arising out of an alleged violation of law.

    See id. at 60 and at Appendix A.
25. *ABA Model Rules of Professional Responsibility*, Rule 1.13(b) (2002).
26. Final Report at 41.
27. *Id*.
28. *Id*. at 42.
29. *See ABA Model Rules of Professional Conduct*, Rule 1.0(f) (defining "knows" as denoting actual knowledge of the fact in question).
30. *Id*. at Appendix A, p. 82–83 (emphasis in original).
31. *Id*. The task force rejected the position taken in its preliminary report that recommended imposing a "reasonably should know" standard as the initial triggering point for action. As noted in the criticism to the preliminary proposal, such a standard could impose on counsel an affirmative duty to investigate that could not be evaluated until "after the fact with the benefit of hindsight." *Id*., note 76.
32. *Id*. at 43.
33. *Id*.
34. *See* 68 Fed. Reg. 6296, 6321–6322 (Feb. 6, 2003).
35. Final Report at 44, note 78.
36. *See id*. at Appendix A.
37. Current subsection (c) permits counsel to withdraw from the representation if the organization's highest authority insists upon, or refuses to act, on unlawful conduct that is likely to cause substantial injury to the organization. The task force recommends that this provision be removed from the text of the rule and incorporated into the commentary. *Id.* at 46, note 82.
38. *ABA Model Rules of Professional Responsibility*, Rule 1.13(b)(3).
39. Final Report at 46.
40. Subsection (e) would provide as follows:

    A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to Paragraphs (b) or (c), or who withdraws in circumstances that require or permit the lawyer to take action under either of those Paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

    See id. and Appendix A.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

ETHICS & PRIVILEGE

Corporate Attorney-client Privilege: Alive and Well in Alabama

Your corporation is litigating in state court regarding the propriety of royalty payments to the state under oil leases. The state compels production of a memorandum from an in-house lawyer to a corporate executive regarding possible interpretation of the leases in question. The memorandum is used extensively during trial as evidence of the allegedly fraudulent intent of the corporation. The jury returns a verdict against the corporation for $87.7 million in compensatory damages and $3.42 billion in punitive damages. Can ACCA help?

By John K. Villa

Author of *Corporate Counsel Guidelines*, published by ACCA and West Group

John K. Villa is a partner with Williams & Connolly LLP in Washington, DC. He specializes in corporate litigation (civil and criminal) involving financial services, directors', officers', and lawyers' liabilities, and related issues. He is an adjunct professor at Georgetown Law School and a regular lecturer for ACCA/GCCA. He is also the author of *Corporate Counsel Guidelines,* published by ACCA and West Group. He is available at JVilla@wc.com.

Corporation[1] faced in Alabama arising out of its dispute with Alabama regarding the royalty payments from the Mobile Bay oil leases. After having lost a jury verdict for approximately $3.5 billion, including $3.42 billion in punitive damages, Exxon appealed to the Alabama Supreme Court challenging the verdict and, particularly, the introduction of the privileged letter. In support of Exxon's position, ACCA filed an amicus brief, which was reportedly a significant factor in the oral argument on the corporate attorney-client privilege.[2] The result was a December 20, 2002, decision of the Alabama Supreme Court reversing and remanding, ***per curiam***, the lower court decision and verdict.[3]

The case presented a classic scenario for testing the corporate attorney-client privilege albeit with billions of dollars at stake. In the course of a bitterly fought jury trial between Exxon and the Alabama Department of Conservation and Natural Resources over the appropriate royalty payments under the lease, the Department of Natural Resources secured from Exxon and introduced into evidence a letter alleged to be privileged. The letter was from Charles Broome, an in-house lawyer in Exxon's legal department, to R. J. Kartzke, the project manager and Broome's principal client on a day-to-day basis (the "Broome letter"). The Broome letter responded to a request by an Exxon accounting supervisor for a legal opinion from Exxon's legal department "regarding what are the requirements under the mineral lease." Mr. Broome, a member of the Louisiana bar, held the position of "Counsel, Southeastern Production Division" and was accustomed to interpreting leases as part of his duties.

Mr. Broome engaged in those tasks that a careful lawyer would be expected to perform, including reading the lease, collecting and reading pertinent cases, and reviewing secondary legal research sources. He also took into account the position of other parties on how the lease should be interpreted. Finally, he prepared a letter evaluating the legal merits of (1) the position taken by the state, (2) the position taken by another party, (3) a third position that he believed harmonized the two, and (4) a more extreme interpretation that he advised had little chance of being upheld. Having provided the legal analysis, Mr. Broome did not participate in

John K. Villa, "Corporate Attorney-client Privilege: Alive and Well in Alabama," *ACCA Docket* 21, no. 3 (March 2003): 94–96.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Reprinted with permission of John K. Villa and the American Corporate Counsel Association as it originally appeared: John K. Villa, "Corporate Attorney-client Privilege: Alive and Well in Alabama," *ACCA Docket* 21, no. 3 (March 2003): 94–96. Copyright © 2003 John K. Villa and the American Corporate Counsel Association/Global Corporate Counsel Association. All rights reserved. For more information or to join ACCA, call 202.293.4103, ext. 360, or visit www.acca.com.

management's subsequent discussion of the royalty payments or in the management decision. In short, this case was a seemingly perfect one for the invocation of the corporate attorney-client privilege. When the document was offered, Exxon objected on the ground of the attorney-client privilege, but the trial court overruled the objection. The ground for the ruling was subject to dispute, but the Alabama Supreme Court interpreted it as a finding that the document was not intended to be confidential because of both its substance and the recipients of copies. The trial court rejected the state's claim that the crime-fraud exception applied.[4]

THE BROOME LETTER WAS INTRODUCED INTO EVIDENCE, USED IN OPENING STATEMENT, REFERRED TO AS "INFAMOUS" THROUGHOUT THE TRIAL, USED IN THE CROSS-EXAMINATION OF SEVERAL EXXON WITNESSES, AND REFERRED TO IN CLOSING STATEMENTS.

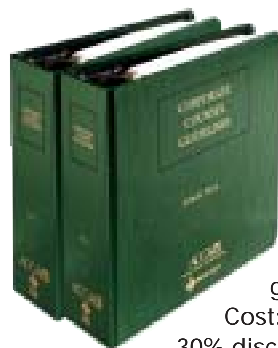
The Broome letter was introduced into evidence, used in opening statement, referred to as "infamous" throughout the trial, used in the cross-examination of several Exxon witnesses, and referred to in closing statements. "No other document played such a central role in the state's fraud case, and through the statements of its attorneys at trial the State essentially admits that the admission of the letter prejudiced Exxon." The result was a jury verdict against Exxon for $87.7 million in compensatory damages and $3.42 billion in punitive damages.[5]

Exxon appealed, and ACCA submitted an amicus brief in support of Exxon's position. On appeal, ACCA's amicus brief focused on the importance, scope, and application of the corporate attorney-client privilege. In the brief, after a review of the history and development of the corporate attorney-client privilege generally and in Alabama, ACCA made four points: (1) the public purpose served by the privilege is to encourage communications between clients and attorneys and thereby promote the broader interests of observance of the law, and it applies with particular force to modern corporations which, cumulatively, have a huge effect on society; (2) corporate counsel is especially effective and important as an advice-giver because he or she is more knowledgeable and accessible to corporate officers, and to give a narrow reading of the privilege to them is particularly harmful to the broader social goals advanced by the privilege; (3) the corporate attorney-client privilege is intended to promote confidential communications, and it cannot do so if its application is uncertain or haphazard; and (4) the denial of the privilege to in-house counsel deprives corporate clients of their attorney of choice. The ACCA brief then applied the Alabama law of privilege to the facts presented in the trial court.

Reversed and remanded was the decision on appeal. The vindication for in-house lawyers was that the Alabama Supreme Court accepted, without direct comment, that the attorney-client privilege applied with full force to communications between the corporation and its inside counsel. Absorbing most

Do Not Miss John K. Villa's

Corporate Counsel Guidelines
published by ACCA and West



In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions. Cost: $220, and ACCA members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

Copyright © 2003 John K. Villa and the American Corporate Counsel Association/Global Corporate Counsel Association. All rights reserved.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

ETHICS & PRIVILEGE

of the court's analysis was the issue of whether the Broome letter was intended to be confidential. The applicable standard was provided by Rule 502 of the Alabama Rules of Evidence and specifically Rule 502(a) (5), which defines when a communication is deemed "confidential." The criteria for confidentiality is gleaned from the Advisory Committee Notes on Rule 502, which states the rule that "the communication may be made only between representatives of the client who are within the 'control group' ***or whose duties are closely related to the matter about which the communication is made***" (emphasis in original). The court examined carefully the record evidence regarding the people copied on the letter to determine whether there was a showing that it had been sent to any "client representative" that did not "need to know" the information. Crucial to this analysis was Mr. Broome's testimony regarding the position and duties of each of the persons copied on the letter that he could identify. Thus, the Broome letter was deemed confidential.

IN THE LAST ANALYSIS, EXXON'S CORPORATE ATTORNEY-CLIENT PRIVILEGE HAD BEEN UPHELD DESPITE A SEARCHING "NEED-TO-KNOW" ANALYSIS THAT COULD PROVE FATAL TO THE PRIVILEGE IN MANY SUPPOSEDLY CONFIDENTIAL COMMUNICATIONS THAT OCCUR EVERY DAY IN CORPORATE AMERICA.

The Alabama Supreme Court also rejected several claims that the confidentiality had been waived by alleged disclosure, by the crime-fraud exception, and by disclosure of other material (referred to as the "Condray documents") that was similar in content to the Broome letter. One of the most impressive aspects of the Exxon decision was its insightful handling of the argument that the admissibility of the Condray documents somehow reduced the significance of the Broome letter or constituted a waiver of the substance of the letter:

> Moreover, while some of the information found in the Broome letter can also be found in the Condray documents, the admission of the Broome letter provided more than information alone to the jury. This point goes directly to whether the admission of the letter prejudiced Exxon. The admission of the Broome letter permitted the State to argue, as it did several times before the jury, that Exxon's own lawyer believed that its interpretation of the lease agreement concerning royalty payments 'has little chance of being upheld.'"

The state's remaining allegations were rejected by the Alabama Supreme Court over spirited dissents.

In the last analysis, Exxon's corporate attorney-client privilege had been upheld despite a searching "need-to-know" analysis that could prove fatal to the privilege in many supposedly confidential communications that occur every day in corporate America.

Several lessons can be gleaned from one corporation's close call in Alabama:

- Distribution of privileged documents should be limited to those individuals who truly need to know as part of their duties. Even such innocent "normalities" as stamping documents with a distribution stamp may become unintentionally critical evidence that you should avoid.
- Lawyers must take care to document the nature of the request for advice and the fact that the advice given is legal and not business advice.
- Inside lawyers must maintain membership in a state bar.
- To the extent possible, separating analyses between the pure legal analysis and the mixed business analysis will help preserve the confidentiality of the true legal work.

NOTES

1. Although the name of the company is now ExxonMobil, the case started before the merger, so we refer to the company as Exxon throughout this article for simplicity's sake.
2. The amicus brief was drafted by the author of this article and F. Lane Heard, of Williams & Connolly LLP, and reviewed, edited, and approved by a number of ACCA officers and members, including the following: Frederick J. Krebs, president and chief operating officer of ACCA; Susan Hackett, senior vice president and general counsel of ACCA; Sally S. Reid, corporate counsel to Southern Progress Corporation (Birmingham) and then president of ACCA's Alabama Chapter, who served as counsel of record for ACCA's brief; Michael Roster, executive vice president and general counsel of Golden West Financial Corporation and past chair of ACCA's board of directors; John H. McGuckin Jr., executive vice president, general counsel, and secretary of Union Bank of California, N.A., and vice chair of ACCA's board of directors; and William B. Lytton, executive vice president and general counsel of Tyco International and immediate past chair of ACCA's board of directors. The amicus brief is available on ACCA Online[SM] at www.acca.com/advocacy/exxonamicus/.
3. Exxon Corp. v. Department of Conservation and Natural Resources, 2002 WL 31845900, _ So. 2d. _ (Ala. 2002).
4. Under the crime-fraud exception to the attorney-client privilege, there is no privilege for otherwise privileged communications if they are in furtherance of a crime or fraud even if the attorney is not aware of the crime or fraud. United States v. Bauer, 132 F.3d 504, 509 (9th Cir. 1997). ***See*** J. VILLA, CORPORATE COUNSEL GUIDELINES, at § 1.26.
5. 2002 WL 31845900 at *9.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

ETHICS & PRIVILEGE

Reprinted with permission of John K. Villa and the American Corporate Counsel Association as it originally appeared: John K. Villa, "A First Look at the Final Sarbanes-Oxley Regulations Governing Corporate Counsel," *ACCA Docket* 21, no. 4 (April 2003): 90–99. Copyright © 2003 John K. Villa and the American Corporate Counsel Association. All rights reserved. For more information or to join ACCA, call 202.293.4103, ext. 360, or visit www.acca.com.

A First Look at the Final Sarbanes-Oxley Regulations Governing Corporate Counsel

By John K. Villa
Author of *Corporate Counsel Guidelines*, published by ACCA and West

John K. Villa is a partner with Williams & Connolly LLP in Washington, DC. He specializes in corporate litigation (civil and criminal) involving financial services, directors', officers', and lawyers' liabilities, and related issues. He is an adjunct professor at Georgetown Law School and a regular lecturer for ACCA. He is also the author of *Corporate Counsel Guidelines*, published by ACCA and West. He is available at JVilla@wc.com.

On January 29, 2003, the U.S. Securities and Exchange Commission ("SEC") issued its final rule implementing § 307 of the Sarbanes-Oxley Act of 2002. The rule derives from the ABA's Model Rule 1.13, "The Organization as Client," which introduced the principle that a corporate lawyer may be required to go "up the corporate ladder" if the lawyer knows of serious misconduct by corporate officials.

No doubt, these rules will have a profound effect on attorneys who represent companies regulated by the SEC. The effect, however, will not be nearly as significant or as troublesome as it would have been if the SEC had promulgated the rule that it had initially proposed. In this environment, we should be grateful for even small gifts.

STATUTORY BACKGROUND AND THE PROPOSED REGULATIONS

On July 30, 2002, President Bush signed into law the legislation that is widely known as the Sarbanes-Oxley Act. Although the principal focuses of the Sarbanes-Oxley Act are increased disclosure by public companies, new oversight of the accounting profession, and reforms in corporate governance, one section of the Sarbanes-Oxley Act is directed at the securities bar. Section 307 of the Sarbanes-Oxley Act, codified at 15 U.S.C. § 7245, directed the SEC to issue regulations

> setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[1]

The SEC was directed to issue such final rules within 180 days of the effective date of the Sarbanes-Oxley Act or no later than January 29, 2003.

Like a number of other federal regulatory agencies, the SEC has long maintained rules governing the conduct of professionals appearing before it.[2] Professionals who were disciplined under the SEC rules and thus suspended or disbarred from practicing before the SEC could find their careers severely limited, if their practice consisted of counseling public companies on compliance with the federal securities laws. Known colloquially as "2(e)," these rules prohibited but did not define "improper professional conduct." Although the SEC has used its 2(e) authority with some frequency against accountants,[3] the SEC has, for the past 20 years, been more restrained in using § 2(e) against lawyers, primarily because lawyers are regulated by state ethics authorities. When the SEC has moved against lawyers, it has primarily been to discipline attorneys who had already been found by another tribunal

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

to have violated a criminal or ethical provision or to give guidance to the securities bar. The two most famous examples of this direction-giving are the SEC's decisions in *In re Carter and Johnson*,[4] involving the obligations of outside counsel when a client declined to take counsels' advice on issues of disclosure, and *In re John H. Gutfreund et al.*,[5] which arose out of the Salomon treasury bond trading scandal and examined the conduct of an inside general counsel presented with evidence of corporate misconduct.[6]

THE PROPOSED RULES ISSUED NOVEMBER 21, 2002

On November 21, 2002, the SEC issued proposed rules that would implement § 307 of the Sarbanes-Oxley Act.[7] The proposed rules addressed the two core principles in § 307: (1) requiring that counsel report evidence of material violations of securities laws or breach of fiduciary duty to the chief legal officer ("CLO") or chief executive officer ("CEO") of the company and (2) requiring, if the officers did not "appropriately respond," that counsel take the matter to the board of directors or a committee of the board "comprised solely of directors not employed directly or indirectly by the issuer." The proposed rules expressly went beyond what § 307 required by proposing an expansive definition to the concept of practicing before the SEC (a definition that even reached foreign attorneys who do not practice in the United States) and by requiring that lawyers who do not receive an appropriate response to their report from the company notify the SEC. These provisions and a number of others resulted in an outpouring of comments from the bar, including foreign lawyers. From the SEC's citations in the comments in the final rule, it appears that the comments in general were divided: practitioners and groups representing their interests pointed out problems and flaws in the proposed rules, while academics urged the SEC to promulgate even harsher regulations. State ethics regulators objected to the expansion of federal regulation over the ethical conduct of the bar, viewing regulation of the practice of law as their province.

THE FINAL RULES

In the final rules, the SEC responded to some of the comments by practitioners, state ethics regulators, and foreign lawyers. The provisions necessary to implement the mandate of § 307 of the Sarbanes-Oxley Act survived, but the SEC deferred or eliminated some of the most controversial provisions that ventured beyond the Sarbanes-Oxley Act. The effective date of the new regulations has been deferred until 180 days after publication in the *Federal Register*.

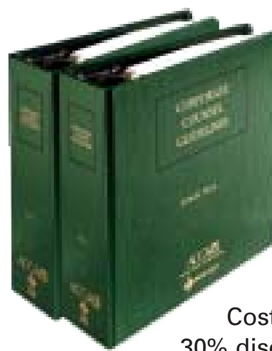
Summary of the Final Rules

Summarizing the proposed rules has become a cottage industry for major law firms. Because the basic structure of the final rules does not depart significantly from that of the proposed rules, this article will review them only briefly and will compare the rules to the principles of the ABA's Model Rules, identify the major changes from the proposed rules, and highlight troublesome issues.

Reduced to their essentials, the new rules require lawyers who appear and practice before the SEC to report material violations of securities laws and breaches of fiduciary duties to the CLO or CEO of the issuer, to evaluate the response of the CLO or CEO, and, if that response is not, in the reporting lawyer's view, appropriate, to bring the matter to the board of directors of the issuer (or a designated committee of

Do Not Miss John K. Villa's

Corporate Counsel Guidelines
published by ACCA and West



In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions. Cost: $220, and ACCA members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

Copyright © 2003 John K. Villa and the American Corporate Counsel Association. All rights reserved.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

outside directors). The rules also give companies the option of establishing a committee of outside directors, known as a "Qualified Legal Compliance Committee" ("QLCC"), to which such reports could be made—that is, in lieu of being made to the CLO or CEO. If the lawyer makes his report to the QLCC, the lawyer need not determine the appropriateness of the response and is relieved of taking further action.

Applicability of the New Rules

The final rules apply to attorneys "appearing and practicing before the Commission" "in the representation of an issuer." Section 205.2(a) defines "appearing and practicing before the Commission" broadly as any of the following:

- "Transacting any business with the Commission, including communications in any form."
- "Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena."
- "Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to . . . the Commission."
- "Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to . . . the Commission."

Under these final rules, "appearing and practicing before the Commission" does not include an attorney who is providing only nonlegal services or who is a "non-appearing foreign attorney," as that new term is defined.

Thus, in addition to the more obvious forms of practicing before the SEC, an attorney is "appearing and practicing before the Commission" if the attorney provides securities law advice relating to a document that the attorney has notice will be filed with the SEC, including participating in the drafting of the document, or if the attorney advises a company as to whether particular information is or is not required to be filed with the SEC.

Perhaps the most fundamental question raised by this definition is whether a lawyer who is appearing and practicing before the SEC in connection with an issuer is subject to the mandates of this rule for *all* of the lawyer's activities for that client. In other words, if a lawyer is clearly subject to the Sarbanes-Oxley Act rules for one matter for a client, must the lawyer follow the new SEC regulations in all other matters for the client if the other matters do not constitute "appearing and practicing before the Commission"? Illustratively, must a lawyer who gives advice on, for example, a proxy statement (and would therefore be subject to the rules for the proxy), be required to follow the § 205 rules for breach of fiduciary duty that was discovered in the defense of a wholly separate (not covered) civil litigation? Neither regulations nor commentary addresses this issue. Although we would hope that the answer is "no," the result is not free from doubt. This key issue is one on which SEC guidance is essential, particularly because the SEC regulations purport to preempt state ethics rules, which might well reach a different result.

Additional questions arise regarding the application of the term "appearing and practicing before the Commission." First, if the issuer has retained counsel to investigate a charge of "material violation" and also to defend an investigation or proceeding by the SEC or a third party for possible violation of the federal or state securities laws or breach of fiduciary duty, is counsel obliged to initiate internal Sarbanes-Oxley reporting procedures as to the specific matters already in litigation? As the commentary recounts,

> several commenters were concerned over a possible chilling effect on an attorney's representation of an issuer in a Commission investigation or administrative proceeding if the attorney were subject to reporting and disclosure requirements. Some noted that an issuer's disagreement in good faith with the Commission over a matter in litigation should not raise a reporting obligation under the rules.[8]

The final rules explicitly apply to defending SEC investigations and proceedings and decline to provide a blanket exemption for the internal investigations to determine whether such violations occurred or for the defense of SEC proceedings.[9] The investigator-litigator's salvation, if any, is in § 205.3(b)(6):

> An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:
> . . . .
> (ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors [or a QLCC].

As the commentary highlights, the "colorable defense" exception applies only in cases in which "the response is undertaken with the consent of the issuer's board of directors [or the

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

QLCC]."[10] This condition, according to the commentary, is to "protect against the possibility that a chief legal officer would avoid further reporting 'up-the-ladder' by merely retaining a new attorney to investigate so as to assert a colorable, but perhaps weak, defense."[11]

Another major issue is whether the obligations embodied in the regulations extend beyond traditional securities lawyers to those who respond to auditors' "letters or prepare work product in the ordinary course unrelated to securities matters that may be used for that purpose and lawyers preparing documents that may eventually be filed as exhibits . . . ."[12] The ABA had protested that the definition in the proposed regulations could unfairly be read to reach such lawyers.

IN ASSESSING HOW BROADLY TO READ THESE PROVISIONS, HOWEVER, ONE MUST REMEMBER THAT AGENCIES ARE LOATHE TO CONSTRUE NARROWLY THEIR OWN JURISDICTION.

The SEC's response was helpful on several of the examples raised by the ABA, but, again, was not as explicit as it could have been. The SEC modified the definition appearing in § 205.2(a)(1)(iii) to reach those attorneys who provide advice on securities laws or SEC regulations "regarding any document that the attorney *has notice* will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing or participating in the preparing of, any such document . . . ."[13] The SEC's explanation "clarifies" that the rule is not intended to reach "an attorney's preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission as an exhibit or in connection with a filing . . . ."[14] How does this apply to, for example, counsel negotiating executive employment agreements or other contracts, which are often exhibits to securities filings? One would presume that such counsel would not be "appearing and practicing before the Commission" because they are not "providing advice in respect of the United States securities laws or the Commission's rules"—the first element of the definition—even if the lawyer/drafter knew that the document would be attached to an SEC filing. Likewise, a lawyer who responds to an inquiry from the client regarding the client's independent auditor presumably would be beyond the reach of the rule: although the lawyer may (but probably does not) have notice that the response may be incorporated into the auditor's opinion on the financial statements, the response is not "providing advice" on any securities law or SEC rule. A final question not directly addressed by the SEC's commentary is whether the definition reached a lawyer who negotiates or drafts a transaction that, because of its materiality, would reasonably be expected to be discussed in the issuer's securities filings or affect the issuer's reported financial statement. Is the lawyer within the scope of this rule because of the transactional work? Once again, the presumptive answer is "no," because the lawyer is not providing securities advice relating to the transaction.

In assessing how broadly to read these provisions, however, one must remember that agencies are loathe to construe narrowly their own jurisdiction. If experience here inside the beltway is any guide, a prudent lawyer would await more explicit guidance from the SEC before concluding that the SEC would not attempt to reach a lawyer in the gray areas identified above.

For the rule to apply, a lawyer who is "appearing and practicing before the Commission" must *also* be providing services "in the representation of an issuer." That term is defined in § 205.2(g) as "providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer." The definition of "issuer" reaches beyond the issuing company itself and includes "any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer."[15] The commentary states the SEC's intention is that this provision reach "an attorney employed or retained by a non-public subsidiary of a public parent issuer" if the attorney is acting "on behalf of, at the behest, or for the benefit of" the parent.[16]

Issuer's Counsel's Reporting Obligations

Assuming that the lawyer falls within the reach of the regulations, the lawyer's obligation is governed by § 205.3(b)(1), which provides in part that,

> "[i]f an attorney . . . becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer . . . or to both the issuer's chief legal officer and its chief executive officer . . . forthwith . . . ."

Unpacking this sentence crystallizes several key issues. One of the most important issues is that subsection 3(b)(1) is not limited to information learned during the course of the attor-

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

From this point on . . .
Explore information related to this topic.

ONLINE:

- ACCA's comment letter to the SEC, available on ACCA Online[SM] at www.acca.com/advocacy/307comments.pdf.
- ACCA's committees, such as the Corporate and Securities Law Committee, which have listservs to join and other benefits. If you have questions about these or other ACCA committees, contact the chairs (listed in each issue of the *ACCA Docket*), or contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or windley@acca.com, or visit ACCA Online[SM] at www.acca.com/networks/ecommerce.php.
- ACCA's Corporate Responsibility page, available on ACCA Online[SM] at www.acca.com/legres/corpresponsibility/index.php.
- ACCA's executive summary of the rule and its provisions, available on ACCA Online[SM] at www.acca.com/legres/corpresponsibility/307/summary.pdf.
- ACCA's five practical suggestions to consider as you and your law department look at how the SEC rule and the new proposed reporting out alternative may affect your client representation, available on ACCA Online[SM] at www.acca.com/legres/corpresponsibility/307/steps.pdf.
- SEC Final Rule: Implementation of Standards of Professional Conduct for Attorneys, at www.sec.gov/rules/final/33-8185.htm.
- SEC proposed rule on noisy withdrawals, at www.sec.gov/rules/proposed/33-8186.htm.

ON PAPER:

- JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES (ACCA and West 1999, with annual updates).

If you like the resources listed here, visit ACCA's Virtual Library[SM] on ACCA Online[SM] at www.acca.com/resources/vl.php. Our library is stocked with information provided by ACCA members and others. If you have questions or need assistance in accessing this information, please contact Legal Resources Manager Karen Palmer at 202.293.4103, ext. 342, or palmer@acca.com. If you have resources, including redacted documents, that you are willing to share, email electronic documents to Managing Attorney Jim Merklinger at merklinger@acca.com.

ney's representation. The SEC rule thereby differs from ABA Model Rule 1.13, which was its acknowledged model. Model Rule 1.13 can require an in-house lawyer to take action, including going "up the corporate ladder," if the lawyer learns certain facts, but it applies only to information "related to the [lawyer's] representation."

The second element of the operative language is that it applies if the lawyer "becomes aware of *evidence* of a material violation."[17] By way of comparison, Model Rule 1.13 requires action only in cases in which a lawyer

> *knows* that an officer [or] employee . . . is engaged in action, intends to act or refuses to act in a matter . . . that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization and is likely to result in substantial injury to the organization . . . .[18]

A lawyer governed by Model Rule 1.13 is not required to take any action unless the lawyer has reached a high level of certainty ("knows") that a violation has occurred. The corresponding standard in § 205.3(b)(1) requires action if the lawyer becomes aware of *evidence* of a material violation. The rule itself does not specify any required quantum, proportion, or persuasive effect of the evidence. The definition in the rules provides that "evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[19] The SEC's commentary explains that it has specifically rejected as "too high" the standard from the ethical rules that requires that the lawyer "know" that the conduct is a violation of law or legal duty to the corporation.[20] Instead, the SEC adopts a "reasonably likely" standard, which the SEC describes as "more than a mere possibility but it need *not* be 'more likely than not.'"[21] This loose standard is sure to present nightmares for counsel as they wrestle with its application to various factual scenarios.

Although the regulation contemplates an objective standard, the SEC's commentary seems to incorporate

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

contradictory objective and subjective elements. The commentary states that an attorney's decision of whether to initiate Sarbanes-Oxley reporting procedures will be measured by the "circumstances," which "may include, among others, the attorney's professional skills, background and experience, the time constraints in which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the attorney may consult."[22] The references to the attorney's "professional skills" and "background and experience" strongly suggest a subjective standard that will vary from one lawyer to another. On the other hand, the introductory comments in the rule itself—whether "it would be unreasonable . . . for a prudent and competent attorney not to conclude"—clearly denotes an objective standard.[23]

The other major issue embedded in 205.2(e) is the meaning of the term "material violation." That term is defined as "a material violation of an applicable United States federal or state securities law, a material breach of a fiduciary duty arising under United State federal or state law, or a similar violation of any United States federal or state law." Whether this definition incorporates the definition of "material" that has been developed in securities case law or some other definition of material is not entirely clear.

Including "material breach of fiduciary duty" within the definition of a "material violation" is certain to cause problems, but those problems cannot be laid at the SEC's feet. Section 307 of the Sarbanes-Oxley Act expressly required that the rules reach "evidence of a material violation of securities law or *breach of fiduciary duty or similar violation*," so the SEC was required to extend the rule to breaches of fiduciary duty. Requiring lawyers to sit in judgment of corporate management and decide whether there is "evidence" that a corporate manager breached his or her fiduciary duty to the corporation is, candidly, an invitation for confusion and trouble. Lawyers are poorly equipped to evaluate whether, for example, a corporate manager has breached a duty of care—which inherently involves balancing risk and return. Presumably for that reason, the commentary to ABA Model Rules 1.13 (the original "up-the-corporate-ladder" rule) provides that, "[w]hen constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing substantial risk, are not as such in the lawyer's province."[24] Lawyers interpreting the Sarbanes-Oxley Act will wish that a similar principle governed their obligation.

It is reasonable to expect that the low threshold or quantum of evidence required by the new regulations, coupled with the vagaries of fiduciary duties, will bedevil issuers' counsel in many instances that were probably not contemplated or intended by the sage lawmakers who enacted § 307 of the Sarbanes-Oxley Act.

Assuming that an issuer's counsel concludes that a report is required under § 205.3(b)(1), the report must be made either to the CLO (or CLO and CEO) or, if the issuer had established a QLCC, to it.[25] If the report is made to the QLCC, the reporting lawyer's obligation ends. On the other hand, if the report is made to the CLO or CLO and CEO, then the corporate executive receiving the report must make inquiry into the matter and must take appropriate action. That action must be reported back to the counsel who first raised the issue.[26]

Unless the reporting counsel "reasonably believes that the [CLO or CEO] has provided an appropriate response within a reasonable time, the attorney shall report the evidence . . . to" the audit committee or other equivalent committee or to the full board of directors.[27] This last provision is exceptionally ticklish and reverses the roles of in-house and outside counsel. As such, it has been the focus of considerable comment since it was first proposed, but it has not materially changed in the final regulations. The significant deletion from the proposed rules, noted below, is that counsel is no longer required or permitted to go beyond the issuer's board of directors to the SEC to make a "noisy withdrawal."

Major Deletions from the Proposed Rules

Several significant trial balloons contained in the proposed rules have thus far deflated. Although these provisions have been eliminated from this final rule, it is likely that the SEC will revisit these issues in the near future. These deleted provisions relate to matters that are not expressly mandated by the statutory directive in § 307 of the Sarbanes-Oxley Act.

Foremost among the deleted provisions is language that would have obligated outside counsel to engage in a "noisy withdrawal"—withdrawing from the representation of an issuer if the issuer failed to take what counsel believed to be an appropriate response to evidence of a material violation *and notifying the SEC of that withdrawal*. In light of the strongly negative response to this proposal, the SEC did not adopt that proposal and is "extending the comment period on the 'noisy withdrawal' and related provisions of the proposed rule and is issuing a separate release soliciting comments on this issue."[28] The separate release proposes an alternative procedure: if the attorney withdraws from the representation of

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

the issuer for failing to receive an adequate response, the SEC is proposing that "the issuer would be required to disclose its counsel's withdrawal as a material event." This change is obviously to blunt the criticism that the "noisy withdrawal" requirements in the proposed regulations would conflict with ethics rules in a number of jurisdictions. By cleverly shifting the burden of disclosure from counsel to the issuer client, the SEC hopes that this conflict may be relieved. The procedure appears analogous to the familiar requirements that an issuer report as a material event the resignation of its auditor.

A second major change is the withdrawal or elimination of the recordkeeping requirement formerly in § 205.3(b)(2) of the proposed rule. Under that proposal, lawyers were required to prepare and maintain documentation of their reports of material violations to the issuer and of the issuer's response. The SEC acknowledged that the comments received were "almost unanimously in opposition" to this proposal and that many comments asserted that it "could be an impediment to open and candid discussions."[29] Some comments correctly observed that "the documentation requirement might increase the issuer's vulnerability in litigation" and would be "a treasure trove of selectively damning evidence."[30]

A third significant modification from the proposed regulations is the tighter limitations on the circumstances in which an issuer's lawyer may provide information to the SEC. The final regulation, § 205.3(d)(2), has been modified to more closely parallel the more liberal disclosure principles adopted by the ethics rules of a number of states. Specifically, an issuer's lawyer *may* but is not required to disclose, without the issuer's consent, confidential information *to the SEC* to the extent that the attorney reasonably believes that it is necessary to "prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest of the issuer or investors," to prevent the issuer from committing perjury, suborning perjury, or making false statements in any SEC investigation or proceeding, and to rectify the consequences of a material violation by an issuer that caused substantial injury to the financial interest of the insured or investors "in furtherance of which the attorney's services were used." A similar provision in the proposed regulations permitted disclosure but authorized disclosure for any "illegal acts" rather than "material violations" that caused substantial financial loss to the issuer or investors. This proposed provision was controversial not so much for the standards espoused, which are similar to those adopted by a number of states, but because the SEC would be preempting contrary state ethics rules that would prohibit disclosure in other jurisdictions. That problem remains.

The proposed rules' extension of jurisdiction to foreign attorneys prompted extensive controversy and ultimately resulted in another significant change. The SEC's proposed rules would have included many foreign attorneys within the definition of attorneys "appearing and practicing before the Commission." In response to comments and to meetings with groups representing foreign attorneys, the SEC relented and adopted § 205.2(j), which defines "Non-appearing foreign attorneys." To be a "non-appearing foreign attorney," (1) a lawyer must be admitted to practice outside of the United States and must not hold himself out as practicing or giving advice on federal or state securities laws (except as permitted in this rule), and (2) his appearance and practice before the SEC must be (a) incidental to and in the course of practice in a foreign country or (b) only in consultation with a licensed American lawyer. As the commentary observes, the "effect of this definition will be to exclude many, but not all, foreign attorneys from the rule's coverage."[31]

CONCLUSION

The foregoing review touches a number of the major issues arising out of the new rules, but it is far from comprehensive. Although many attorneys will be unhappy with the SEC's new rules under § 307, it is only fair to recognize that the basic elements of the rules were dictated by the Sarbanes-Oxley Act and that the SEC did respond sensibly to the overwhelmingly negative response from the practicing bar. The SEC promulgated rules that are substantially narrower and less burdensome on the attorney-client relationship than the rules that it had initially proposed. Now, it is for the bar to press for elimination of the ambiguities and learn to live with the rule.

NOTES

1. 15 U.S.C. § 7245.
2. *See* 17 C.F.R. § 201.102(e)(1)(2002).
3. *See, e.g.*, Checkosky v. SEC, 139 F.3d 221 (D.C. Cir. 1998) (ordering SEC proceedings against accountants to be dismissed and stating that "the Commission's statements come close to a self-proclaimed license to charge and prove improper professional conduct whenever it pleases, constrained only by its own discretion" and that "the Commission's opinion yields no clear and coherent standard for violations of Rule 2(e)(1)(ii)").
4. SEC Rel. No. 34-17591 [1981 Transfer Binder] Fed. Sec. L. Rep. ¶82,847 (Feb. 28, 1981).
5. SEC Rel. No. 34-31554, Fed. Sec. L. Rep. (CCH) ¶85,067 (Dec. 3, 1992), 52 SEC 2849.
6. An excellent summary of the use of § 2(e) in proceedings involving lawyers is in Lorne and Calcott, *Administrative Actions against Lawyers before the SEC*, 50 BUS. L. 1293 (1995).

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

7. The proposed rules were published in the *Federal Register* on Dec. 2, 2002. 67 Fed. Reg. 71669 (Dec. 2, 2002).
8. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6299–6300 (Feb. 6, 2003) (footnotes omitted).
9. *See* § 205(b)(5) ("An attorney retained or directed by an issuer to investigate evidence of a material violation reported under [this section] shall be deemed to be appearing before the Commission . . . .").
10. 68 Fed. Reg. at 6301.
11. *Id*. The commentary also discusses the meaning of "colorable defense":

    The term "colorable defense" does not encompass all defenses, but rather is intended to incorporate standards governing the positions that an attorney appropriately may take before the tribunal before whom he or she is practicing. For example, in Commission administrative proceedings, existing Rule of Practice 153(b)(1)(ii), 17 CFR 201.153(b)(1)(ii), provides that by signing a filing with the Commission, the attorney certifies that "to the best of his or her knowledge, information, and belief, formed after reasonable inquiry, the filing is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." An issuer's right to counsel is thus not impaired where the attorney is restricted to presenting colorable defenses, including by requiring the Commission staff to bear the burden of proving its case. Of course, as some commenters noted, an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.
12. *Id*. at 6297–98.
13. (Emphasis supplied).
14. 68 Fed. Reg. at 6298.
15. Section 205.2(h).
16. 68 Fed. Reg. at 6303 n. 58.
17. (Emphasis supplied).
18. (Emphasis supplied).
19. Section 205.2(e).
20. 68 Fed. Reg. at 6302.
21. *Id*. (footnote omitted) (emphasis supplied).
22. *Id*.
23. The commentary states that "[t]his revised definition of 'evidence or a material violation' clarifies aspects of the objective standard that the Commission sought to achieve in the definition originally proposed." *Id*. at 6301 (footnote omitted).
24. Model Rule 1.13, cmt 3.
25. Defined generally by § 205.2(k) to be a committee consisting entirely of directors who are not employed directly or indirectly by the issuer.
26. *See* § 205.3(b)(2).
27. Section 205.3(b)(3).
28. 68 Fed. Reg. at 6297.
29. *Id.* at 6306.
30. *Id*. at 6307.
31. *Id*. at 6303.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Reprinted with permission of John K. Villa and the American Corporate Counsel Association as it originally appeared: John K. Villa, "Supervisory Attorney Liability under § 307 of Sarbanes-Oxley: Another Sand Trap for the Unwary," *ACCA Docket* 21, no. 5 (May 2003): 112–116. Copyright © 2003 John K. Villa and the American Corporate Counsel Association. All rights reserved. For more information or to join ACCA, call 202.293.4103, ext. 360, or visit www.acca.com.

Supervisory Attorney Liability under § 307 of Sarbanes-Oxley: Another Sand Trap for the Unwary

You are just beginning to absorb your own responsibilities under the SEC's new up-the-corporate-ladder rules implementing § 307 of the Sarbanes-Oxley Act when your colleagues remind you that, as general counsel, you have potential liability for those whom you supervise. Great Scott. Will it never end? Who is a supervisory counsel, and what is supervisory counsel's liability under the new regulations anyway? As it turns out, the answer, for once, is that it could be worse—thanks to those who pointed out to the SEC the degree to which the proposed rules deviated from the ABA's model rules. But there are still risks.

By John K. Villa
Author of *Corporate Counsel Guidelines*, published by ACCA and West

John K. Villa is a partner with Williams & Connolly LLP in Washington, DC. He specializes in corporate litigation (civil and criminal) involving financial services, directors', officers', and lawyers' liabilities, and related issues. He is an adjunct professor at Georgetown Law School and a regular lecturer for ACCA. He is also the author of *Corporate Counsel Guidelines*, published by ACCA and West. He is available at JVilla@wc.com.

As every corporate lawyer now knows, the U.S. Securities and Exchange Commission ("SEC") has followed the mandate of § 307 of the Sarbanes-Oxley Act[1] and promulgated an initial set of rules of professional conduct for attorneys who appear and practice before it on behalf of an issuer.[2] Given the confusion over responsibilities imposed by these rules, an important question that has been largely ignored is to ascertain which attorneys within a general counsel's office or a law firm may be held responsible for ensuring compliance with these rules. And to what extent do these rules depart from the standards under the *Model Rules of Professional Conduct* in imposing liability on supervisory attorneys for the unethical conduct of their subordinates? *(Got you there: I bet many of you did not even know that a supervisory attorney could be held responsible for the unethical conduct of subordinates!)*

Let's begin with Model Rule 5.1 to ensure that we all remember the ethical requirements imposed on supervisory lawyers:

Responsibilities of Partners, Managers, and Supervisory Lawyers

(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or
(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

One can view the mandates of Model Rule 5.1 as threefold, proceeding from the most general to the most specific. Model Rule 5.1(a) imposes on lawyers with managerial authority the obligation to make reasonable efforts to ensure that the firm has in effect procedures giving reasonable assurance of compliance with ethical rules. "Firm," for these purposes would include the legal department of a corporation.[3] Model Rule 5.1(b) imposes obligations on a lawyer who has "direct supervisory authority over another lawyer [to] make reasonable efforts to ensure that the other lawyer" conforms to the ethical rules. Finally, Model Rule 5.1(c) describes the circumstances in which a lawyer will have sufficient knowledge of or involvement in the unethical conduct of another (either by ratifying the conduct or by failing to take remedial steps) to be held ethically responsible for the misconduct of another lawyer. Subsections (a) and (b), thus, provide that it is unprofessional conduct not to properly supervise. Subsection (c) makes a lawyer individually liable for more than inadequate supervision: the supervisory lawyer is individually liable for another lawyer's misconduct. Liability under Model Rule 5.1(c) is thus much more severe than (a) or (b) because the supervisor is liable for the acts of the subordinate.

With that background, let us turn to the SEC rule. The responsibility of supervisory attorneys with respect to the up-the-ladder reporting requirements of the SEC's new rules of professional conduct is set forth in § 205.4, the final version of which provides as follows:

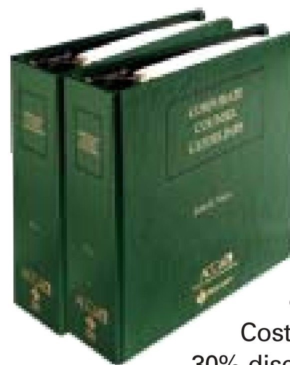
§ 205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing[4] before the Commission in the representation of an issuer is a supervisory attorney. **An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.**
(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a),[5] that he or she supervises or directs conforms to this part. **To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.**
(c) A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.
(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.[6]

In tracking the evolution of the final rules, we will see that the comments of the ABA and others clearly reshaped the rule to make it similar albeit not identi-

Do Not Miss John K. Villa's

Corporate Counsel Guidelines
published by ACCA and West



In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions. Cost: $220, and ACCA members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

Copyright © 2003 John K. Villa and the American Corporate Counsel Association. All rights reserved.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

cal to the Model Rules. The proposed rules defined "supervisory attorney" in § 205.4(a) to include any attorney "supervising, directing, or having supervisory authority over another attorney."[7] In its comments to the proposed rule, the ABA criticized this definition: the ABA observed that it exceeded the obligations imposed on supervisory attorneys under Rule 5.1 of the *Model Rules of Professional Responsibility* "by including any attorney with supervisory authority over another attorney," such as partners or senior associates, even if such authority is unrelated to the particular matter involving the SEC.[8] The ABA contrasted the SEC proposal with Model Rule 5.1, which provides that a "lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct."[9]

The ABA also criticized § 205.4(b) of the proposed rule, which provided that a supervisory attorney was responsible for ensuring compliance with the new rules and "with the statutes and other rules administered by the Commission," as well as the provision that a supervisory attorney will be deemed to be appearing and practicing before the SEC to the extent that a subordinate attorney appears and practices before the SEC.[10] By expanding a supervisory attorney's obligation to ensure compliance with all federal securities laws and by treating a subordinate attorney's appearance and practice before the SEC as that of the supervisory attorney, "without regard to whether the supervision relates to the matter involving appearing and practicing before the Commission or whether the supervisory attorney is even aware the subordinate attorney is so practicing," the ABA argued that the proposed rule placed "extraordinary burdens" on attorneys that "go well beyond the obligations imposed by Rule 5.1(c).[11] Under the Model Rule, the ABA pointed out, a supervisory attorney is responsible for a violation of an ethical rule by another attorney only "if he orders or knowingly ratifies the conduct or knows of the conduct and fails to take reasonable remedial action."[12]

In response to these objections,[13] the final SEC rules modified 205.4(a) to provide "that only a senior attorney who actually directs or supervises the actions of a subordinate attorney appearing and practicing before the Commission" will be considered a supervisory attorney subject to the rule.[14] According to the SEC, in cases in which the supervision or direction of a subordinate attorney concerns matters unrelated to the latter's appearing and practicing before the SEC, the senior attorney will not be considered a supervisory attorney under the rule.[15] With respect to § 205.4(b), the SEC eliminated the proposed requirement that a supervisory attorney ensure a subordinate attorney's compliance with the federal securities laws—only compliance with the new up-the-ladder rules must be ensured.

Do the modifications in the final rule defang § 205.4? Hardly.

Although it now resembles Model Rule 5.1,[16] § 205.4(b) still equates a subordinate attorney's appearance and practice before the SEC with that of the supervisory attorney. This provision means that every corporate chief legal officer or any other attorney who supervises another attorney practicing before the Commission is subject to the SEC rules and sanctions. Can a supervisory attorney be disciplined for failure to report up-the-ladder by the subordinate if the issue was not known to the supervisor? It would not seem that § 205.4(c) and (d) appear to impose duties on the supervisor if the supervisor is informed of the necessity to report by the subordinate. Can a supervisor be subject to SEC discipline under § 205 for failure to "make reasonable efforts to ensure that a subordinate attorney . . . conforms to [these rules]"? Very likely—although it may be that the supervisory lawyer would not be held individually liable for the misconduct of the subordinate attorney if the only sin were failure to supervise. That distinction, as we have observed, is the one drawn between Model Rules 5.1(a) and (b) on the one hand and 5.1(c) on the other. What is the extent of the duty on chief legal officers? In other words, what constitutes "reasonable efforts" under § 205.4(b)? Model Rule 5.1(b)—from which the "reasonable efforts" standard was derived—and the SEC commentary provide some direction. Here are some suggestions derived from the commentary to the Model Rules and the SEC's comments:[17]

- The general counsel should mandate the imposition of clear, mandatory, and specific procedures designed by lawyers schooled in the principles of § 205. ACCA may be able to assist in this regard. See generally ACCA's corporate responsibility page on ACCA Online℠ at www.acca.com/legres/corpresponsibility/index.php.
- The office should have periodic meetings to explain and review the SEC rules and to impress on subordinate attorneys the obligation to observe them. Records that such meetings were held should be maintained.
- The office should have a knowledgeable advisor available to consult on the obligations under Rule 205 and should strongly encourage subordinate attorneys to consult orally with that advisor with any questions.[18]

ACCA's second round of comments to the SEC address the issue raised in this column and are available on ACCA Online℠ at www.acca.com/advocacy/307comments2.pdf.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

NOTES

1. Pub. L. No. 107-204, 116 Stat. 745, 784 (2002).
2. Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6320 (2003) (to be codified at 17 C.F.R. pt. 205). Briefly stated, these rules require an attorney that appears and practices before the SEC on behalf of a company to report up the ladder within the company whenever the attorney becomes aware of evidence of a material violation of the securities laws or a breach of fiduciary duty. The SEC had also proposed a rule that would require the attorney to withdraw from representation and notify the SEC if the attorney reasonably believed that the organization's directors either had made no response or had made an inappropriate response to the attorney's up-the-ladder report. *See* Proposed Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71705–71706 (proposed Dec. 2, 2002). Because of numerous comments received in response to this proposal, known as the "noisy withdrawal" provision, however, the SEC has extended the comment period on this proposed rule and has also proposed an alternative approach. *See* Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324 (proposed Feb. 6, 2003).
3. *See* the definition of "firm" in Model Rule 1.0.
4. The phrase "appearing and practicing before the Commission" has its own definition, which can be summarized as the provision of legal services to an in issuer that includes any of the following: the transacting of any business with the SEC; representing the issuer in SEC administrative proceedings or in connection with any SEC investigation, inquiry, information request, or subpoena; providing advice concerning the securities law or the SEC's regulations with respect to any document to be filed in any manner with the SEC; or advising as to whether certain information is required to be filed in any manner with the SEC. Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6320 (to be codified at 17 C.F.R. § 205.2(a)).
5. Section 205.5(a) defines a subordinate attorney as any "attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)." Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6323 (to be codified at 17 C.F.R § 205.4).
6. Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6323 (to be codified at 17 C.F.R § 205.4). (Emphasis supplied.)
7. Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71706.
8. Comments of the American Bar Association, dated Dec. 18, 2002, at 23 (emphasis in original) (available at www.abanet.org/poladv/letters/other/comment_letter.pdf).
9. *ABA Model Rules of Professional Conduct*, Rule 5.1(b) (2003). (Emphasis supplied.) Subsection (a) of the rule imposes upon partners, as well as other lawyers with comparable management authority in the firm, the obligation "to make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Under subsection (c), partners, managerial lawyers, and supervisory attorneys will be held responsible for ethical violations committed by other attorneys if they knew of the conduct at a time when its consequences could have been avoided or mitigated but failed to take reasonable remedial action.
10. Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71706.
11. Comments of the American Bar Association, *supra* note 8, at 23.
12. *Id. See supra* note 6.
13. Similar objections were raised by several commenters. *See* Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6313.
14. *See supra* note 2.
15. "Conversely, an attorney who typically does not exercise authority over a subordinate attorney but who does direct the subordinate attorney in the specific matter involving the subordinate's appearance and practice before the Commission is a supervisory attorney under the final rule." *See supra* note 2.
16. Section 205.4(a)'s classification of an issuer's chief legal officer as a supervisory attorney subject to the requirements of the rule is also analogous to Model Rule 5.1(a)'s imposition of compliance obligations on law firm partners and/or managers. Under Model Rule 5.1(a), however, the obligation imposed on partners and managerial lawyers is directed to the firm as a whole, requiring them to "make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Unlike the SEC rule, moreover, under which an issuer's chief legal officer "cannot avoid responsibility . . . by claiming a lack of knowledge of, or supervision over, the actions of subordinate attorneys," Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71695, responsibility for specific misconduct by an attorney cannot be imposed on a partner or managerial attorney unless the partner or managerial lawyer had had knowledge of the misconduct and had either ratified it or failed to take reasonable remedial action when able to do so. *ABA Model Rules of Professional Conduct*, Rule 5.1(c).
17. *ABA Model Rules of Professional Conduct*, Rule 5.1, cmt. 6. According to the SEC, § 205.4(b) requires the supervisory attorney to take "affirmative steps" to ensure compliance with the rules, but "leaves to the professional judgment of the supervisory attorney how best to accomplish this goal." The SEC, however, "would expect that these steps would include the creation of procedures for subordinate attorneys to report evidence of material misconduct they learn about and, perhaps, periodic meetings for the purpose of discussing how to address such matters." Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71695. As to how the courts have variously construed the term "reasonable efforts" under Model Rule 5.1, *see Supervisory and Subordinate Lawyers*, LAW. MAN. ON PROF. CONDUCT 91:101 (ABA/BNA).
18. *See* Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, n. 17.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

WAIVING THE ATTORNEY-CLIENT PRIVILEGE BY PLACING ADVICE OF COUNSEL IN ISSUE

You have been the very picture of prudence. You run every important decision by your primo outside counsel so that, if anything goes wrong, you have a chip shot "advice of counsel" defense. Well, something has gone wrong. Your tax shelter goes awry. Your securities filings are attacked. Your internal investigation is challenged. Your interpretation of a contract is held in bad faith. Your lawyers send in the A-team litigators for your defense. So far, so good. But wait! The plaintiff has subpoenaed your trial lawyers' firm? What's this business about implied waiver?

By John K. Villa
Author of *Corporate Counsel Guidelines*, published by ACCA and West

John K. Villa is a partner with Williams & Connolly LLP in Washington, DC. He specializes in corporate litigation (civil and criminal) involving financial services, directors', officers', and lawyers' liabilities, and related issues. He is an adjunct professor at Georgetown Law School and a regular lecturer for ACCA. He is also the author of *Corporate Counsel Guidelines*, published by ACCA and West. He is available at JVilla@wc.com.

Most lawyers know or should know that expressly invoking advice of counsel as an element of their client's defense will be deemed at least a partial waiver of the attorney-client privilege.[1] The jurisprudential principle on which this rule is based, however, has been applied more broadly and inconsistently to situations in which the client has merely asserted an innocent state of mind. For example, the implied waiver theory has been applied in cases in which the client's position in practical effect relies upon the lawyer's advice even if the client expressly disavows reliance on counsel. Well-counseled corporations who run major matters by their lawyers and expect to rely upon the lawyers' advice must therefore consider the effect that this reliance may have on their ultimate ability to protect their lawyers' advice from prying eyes in the event of litigation over the propriety of the underlying corporate decision and the limitations that it may impose on their selection of trial counsel.

Any informed treatment of the general topic of waiver of privilege in the corporate context must also identify several other related risks that we will raise here but leave to another day for a more extensive analysis: the *Garner* doctrine, which can permit a shareholder in a derivative action, upon a showing of "good cause," to discover communications between a corporation's management and its counsel (both inside and outside); the new Department of Justice ("DOJ") guideline that may condition favorable treatment of the corporate client upon waiver of the attorney-client privilege;[2] and the prohibition in Model Rule 3.7 of a lawyer appearing as an advocate in a case in which the lawyer is likely to be a necessary witness.

Reprinted with permission of the author(s) and the American Corporate Counsel Association as originally appeared:
John K. Villa, "Waiving the Attorney-Client Privilege by Placing Advice of Counsel in Issue," *ACCA Docket* 21, no. 8 (September 2003): 102–106.
Copyright © 2003 John K. Villa and the American Corporate Counsel Association. All rights reserved.
For more information or to join ACCA, call 202.293.4103, ext. 360, or visit www.acca.com.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

Back to our basic point, the implied waiver of privilege that can result from a litigation position, this principle can be boiled down to a pithy slogan: the attorney-client privilege is not to be used as both a sword and a shield.[3] That is, a party cannot use the privilege to prejudice an opponent's case or to disclose selected communications for a self-serving purpose.[4] Accordingly, whenever a party asserts reliance on the advice of counsel as the basis for action or inaction in a particular matter or to rely upon the lawyer's interpretation of a legal standard of conduct, that party is deemed to have placed the attorney-client relationship "in" or "at" issue, thereby implicitly waiving the protections of the privilege[5] as to all communications pertaining to that matter.[6] Recognition of an implied waiver under these circumstances is grounded on principles of "forensic fairness."[7] By placing the advice of counsel in issue, "fairness requires examination of [the] protected communications."[8]

Not just any act or assertion, however, is sufficient to constitute a waiver of the privilege. Rather, establishing an implied waiver requires a showing that the party seeking the protections of the privilege has affirmatively injected an issue into the case that places the legal advice at issue.[9] Thus, the mere commencement[10] or defense of a lawsuit generally does not constitute a waiver of the privilege.[11] Simply denying an allegation in a complaint likewise does not waive the privilege.[12] On the other hand, when a party asserts an affirmative defense that relies on the advice of counsel, the general rule is that the party has sufficiently placed the advice at issue so as to waive the attorney-client privilege.[13] The Third Circuit explains:

> Advice is not in issue merely because it is relevant, and does not necessarily become in issue merely because the attorney's advice might affect the client's state of mind in a relevant manner. The advice of counsel is placed in issue where the client asserts a claim or defense and attempts to prove that claim or defense by disclosing or describing an attorney-client communication.[14]

If you are certain to litigate in the Third Circuit (and perhaps before the panel that decided this case), this distinction is helpful: waiver is not implied simply because the lawyer's advice is relevant to the inquiry; the client must attempt to use the lawyer's advice as evidence. Many courts, however, have drawn the line differently to include waiver in cases in which the client's state of mind becomes an issue in the case. According to the Second Circuit, for example, an investor's testimony that he thought his actions were legal would waive the privilege because it "would have put his knowledge of the law and the basis for his understanding of what the law required in issue[,]" and thereby make "conversations with counsel regarding the legality of his schemes . . . directly relevant in determining the extent of his knowledge and, as a result, his intent."[15] Similar assertions of good faith[16] or the reasonableness of a party's actions[17] have also been held to inject an issue into the case so as to constitute a waiver of the attorney-client privilege, even if reliance on the advice of counsel is expressly disclaimed.[18]

Although these decisions may be seen to test the limits of the implied waiver theory, the problem for litigants is that the application of the rule is a patchwork and the standards are applied inconsistently. So even if a corporation could be assured that it is in a jurisdiction where the implied waiver

Do Not Miss John K. Villa's

Corporate Counsel Guidelines
published by ACCA and West

In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions. Cost: $220, and ACCA members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

theory is strictly construed, the modern corporation can find itself litigating in nearly any state. In keeping with one of what should be a basic precept of defensive counseling, in-house counsel should accept this lack of predictability and take into consideration the least favorable legal standard in deciding on the corporation's best course of action.

Does this precept mean not seeking legal advice for a securities disclosure or a tax-driven structure? Of course not. But in-house counsel should consider the effect that seeking such advice will have on the corporation's privilege and, therefore, from whom to seek the advice and how much must be disclosed. Too often, corporations are put in the unhappy position of having their principal counsel out of their defense because of a necessary and unanticipated reliance on that lawyer. As broad as the implied waiver doctrine has been interpreted by some courts, fairness is still the standard generally applied by the courts in determining the question of waiver. In the absence of a showing of manifest need[19] or prejudice,[20] therefore, the privilege remains intact.

GARNER DOCTRINE

Aside from the foregoing implied waiver theory, another omnipresent risk to the corporate attorney-client privilege is the exception spawned by the Fifth Circuit in *Garner v. Wolfinbarger*.[21] *Garner* arose out of a shareholder derivative suit charging management with fraud. The shareholders sought discovery of protected communications between corporate management and in-house counsel.[22] To keep the shareholders, as owners of the corporation, informed of matters affecting the corporation, the Fifth Circuit carved out an exception to the corporate attorney-client privilege, known now as the *Garner* doctrine. That rule requires a balancing of competing interests, such as comparing the harm from disclosure of privileged communications, with the benefit to be realized from "the correct disposal of litigation."[23] *Garner* identified a number of factors that should be taken into consideration by the court[24] and has become the rule in most jurisdictions.[25]

DOJ GUIDELINES

DOJ has recently revised its guidelines in determining whether to bring charges against business entities, and the new guidelines now may coerce waiver of attorney-client privileges.[26] According to the deputy attorney general, the primary focus of the revised guidelines is an "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation [since] [t]oo often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation."[27] Because two of the perceived impediments to governmental investigations into corporate wrongdoing are the attorney-client privilege and work product protection, the guidelines provide that the corporation's willingness to waive these protections constitutes a factor to consider in assessing the corporation's cooperation and, ultimately, the decision to prosecute.[28] Although waiver is not considered by the Department as "an absolute requirement," the guidelines strongly encourage prosecutors to "consider the willingness of a corporation to waive such protection when necessary to provide timely and complete information[.]"[29] Although the guidelines characterize the waiver as limited in scope, covering only "the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue,"[30] few in the defense bar see it as so benign.

WITNESS-ADVOCATE AND MODEL RULE 3.7

Although the witness-advocate prohibitions have been relaxed in recent years, Model Rule 3.7 still generally prohibits a lawyer from acting as an advocate at a trial in which the lawyer is likely to be a necessary witness. There are exceptions, including the degree to which the issue on which the lawyer testifies is truly contested, the degree of hardship on the client, and, possibly, whether there will be a testimonial or other conflict between the lawyer and the client. Some testimonial problems can be solved by introducing another lawyer to try the case. Others, however, involve such profound conflicts that the entire firm may face disqualification under Model Rules 1.7 and 1.10.

WHAT IS IN-HOUSE COUNSEL TO DO?

- Remember that seeking advice from a lawyer who is trial-counsel-of-choice on an important issue may at some later date place the corporation in the unhappy position of having its trial lawyer disqualified (or constantly fending off disqualification) or foregoing important advice of counsel defense.
- With the increasing number of exceptions to the attorney-client privilege for corporations under scrutiny, in-house counsel must weigh whether any advice sought on high-risk conduct or transactions will remain confidential if the problem blows up. Prudence may dictate making an assumption that no attorney-client privileges will survive.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).

- The broadening reach of the "at" or "in" issue exception to the attorney-client privilege must be carefully considered in shaping litigation strategy to avoid inadvertently waiving privileges.

NOTES

1. *See, e.g.*, Chevron Corp. v. Pennzoil Co., 974 F.2d 1156, 1163 (9th Cir. 1992) (party puts advice in issue and waives attorney-client privilege where it claims that its tax position was reasonable because it was based on the advice of counsel); United States v. Mierzwicki, 500 F. Supp. 1331, 1335 (D. Md. 1980) (in a prosecution for tax evasion, the defendant waives privilege when he asserts as a defense that returns were amended because of counsel's advice).
2. *See* U.S. Department of Justice, Office of the Deputy Attorney General, *Principles of Federal Prosecution of Business Organizations*, § VI (Jan. 20, 2003) (stating that one factor to be considered in charging a corporation for wrongdoing is the corporation's willingness to cooperate, which includes the corporation's willingness to waive the corporate attorney-client and work product protections), available at www.usdoj.gov/dag/cftf/corporate_guidelines.pdf.
3. *See* Cox v. Adm'r U.S. Steel & Carnegie, 17 F.3d 1386, 1419 (11th Cir.), *modified on reh.*, 30 F.3d 1347 (11th Cir. 1994, *cert. denied*, 513 U.S. 1110 (1995); *United States v. Bilzerian*, 926 F.2d 1285, 1292 (2d Cir. 1991); *Dion v. Nationwide Mut. Ins. Co.*, 185 F.R.D. 288, 295 (D. Mont. 1998). As stated by one district court, "[A] privilege is meant to be used defensively as a shield against divulging privileged information, rather than offensively as a sword." American Medical Systems, Inc. v. Union Fire Ins. Co. of Pittsburgh, Inc., 1999 WL 970341 at *2 (E.D. La. 1999), *aff'd*, 1999 WL 1138484 (E.D. La. 1999).
4. Bilzerian, 926 F.2d at 1292.
5. *See* JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES § 1.25 (ACCA and West Group 2002 and annual updates).
6. Rhone-PoulencRorer, Inc. v. Home Indemnity Co., 32 F.3d 851, 863 (3d Cir. 1997) (placing counsel's advice in issue "opens to examination facts relating to that advice").
7. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 80, comment (b) (2000).
8. Bilzerian, 926 F.2d at 1292; *see also* Conkling v. Turner, 883 F.2d 431, 435 (5th Cir. 1989) (in such a situation, "fairness demands treating the [assertion] as a waiver of the privilege;" quoting United States v. Mierzwicki, 500 F. Supp. 1331, 1335 (D. Md. 1980)).
9. Cox v. Adm'r U.S. Steel & Carnegie, 17 F.3d at 1419. Under the RESTATEMENT view, "[t]he attorney-client privilege is waived for any relevant communication if the client asserts as to a material issue in a proceeding that: (a) the client acted upon the advice of a lawyer or that the advice was otherwise relevant to the legal significance of the client's conduct[.]"RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, *supra* note 7, § 80(1)(a).
10. IndustrialClearinghouse, Inc. v. Browning Manufacturing Div. of Emerson Elec. Co., 953 F.2d 1004, 1007 (5th Cir. 1992).
11. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, *supra* note 7, § 80(1)(a), Reporter's Note, comment (b).
12. Cox v. Adm'r U.S. Steel & Carnegie, 17 F.3d at 1419; Lorenz v. Valley Forge Ins. Co., 815 F.2d 1095, 1098 (7th Cir. 1987).
13. *See* Rhone-PoulencRorer, 32 F.3d at 863; Chevron Corp. v. Pennzoil Co., 974 F.2d at 1163.
14. Rhone-PoulencRorer, 32 F.3d at 863. *See, e.g.*, Chevron Corp, 974 F.2d at 1163 (legal advice asserted as basis for contention that tax statement was valid waived attorney-client privilege); Harding v. Dana Transport, Inc., 914 F. Supp. 1084, 1093 (D. N.J. 1996) (finding waiver where the defendant attempted to use an internal investigation as a defense in a discrimination action).
15. Bilzerian, 926 F.2d at 1292.
16. *See* Cox v. Adm'r U.S. Steel & Carnegie, 17 F.3d at 1419 (assertions as to the defendant's good faith are "inextricably intertwined" with his state of mind and require waiver of the privilege in order to determine the basis of his belief).
17. *See* State Farm Mut. Ins. Co. v. Lee, 199 Ariz. 52, 13 P.3d 1169, 1177 (2000) (an affirmative assertion by party that he acted reasonably and in good faith because he had evaluated and interpreted the policy and applicable law necessarily included the information received from counsel so as to waive the attorney-client privilege).
18. *Id.* (holding that an "affirmative disavowal of express reliance on the privileged communications is not enough to prevent a finding of waiver").
19. *See* VILLA, *supra* note 5.
20. *See* COX v. Adm'r U.S. Steel & Carnegie, 17 F.3d at 1417-1418 (no waiver where party attacking the privilege has not been prejudiced).
21. 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974, 91 S. Ct. 1191, 28 L.Ed.2d 323 (1971).
22. *Id.* at 1103.
23. *Id.* at 1100.
24. These factors include the following: the number of shareholders and their percentage of stock ownership; the bona fides of the shareholders and the nature and colorability of their claim; legitimacy of their need for the information and its availability from other sources; existence of allegations of criminal or illegal behavior; the time frame of the communications—that is, whether they involve past or future actions—the relationship of the communications to the litigation at hand; evidence that the discovery is merely a fishing expedition; and the risk that discovery would divulge trade secrets. *Id.* at 1104. *See also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, *supra* note 7, § 85 (2000).
25. *See* In re Occidental Petroleum Corp., 217 F.3d 293 (5th Cir. 2000) (action under ERISA by employees of former subsidiary of defendant corporation); *see generally* VILLA, *supra* note 5, § 1.27.
26. U.S. Dept. of Justice, Office of the Deputy Attorney General, *Principles of Federal Prosecution of Business Organizations, supra* note 2, at 1 (noting that the revision is an attempt "to enhance [its] efforts against corporate fraud").
27. *Id.*
28. *Id.* at 7, § VI.
29. *Id.*
30. *Id.* at note 3.

This material is protected by copyright. Copyright © 2003 various authors and the Association of Corporate Counsel (ACC).