

City Bar Maps Lawyers' Role In Public Companies – Part I

BY LAZAR EMANUEL

A Task Force of the City Bar appointed by Bettina Plevan, former City Bar President, and chaired by Thomas H. Moreland, partner in Kramer Levin, has submitted a Report of 190 pages on the Lawyer's Role in Corporate Governance.

(see, http://www.nycbar.org/pdf/report/CORPORATE_GOVERNANCE06.pdf).

The Task Force was composed of thirty members, including general counsel to public companies, judges, litigators, transactional lawyers, law professors, general counsel to a major auditing firm, and one non-lawyer who have served on the audit committees of two public companies. The Report's focus was on "public companies, not privately held firms." A public company was defined generally as "a corporation that has a class of stock sufficiently widely held as to require registration under Section 12 of the Securities Exchange Act of 1934...or the filing of reports pursuant to Section 15(d) of that Act."

In an effort to answer the question, "Where were the lawyers?," the Task Force reviewed the roles played by lawyers in the events leading to the scandals involving nine public companies: Enron, WorldCom, Adelphia, Global Crossing, HealthSouth, Livent, Qwest, TV Azteca and Waste Management. The Task Force concluded:

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

(see, pp. 21-30 and Appendix D).

Although this conclusion would suggest that lawyers might serve a useful public purpose as "whistleblowers" or "gatekeepers" of corporate wrongdoing, the Task Force did not recommend that lawyers be assigned to those roles. "To the contrary, we believe that to impose general whistle-blowing or gate keeping duties on lawyers, so contrary to their traditional role as confidential advisors to their clients, would be counter-productive."

The Task Force gave four reasons for rejecting the whistleblower function for lawyers: 1) lawyer-client communications would be stifled; 2) lawyers might be excluded from strategic corporate meetings; 3) the ability of lawyers to give well-informed advice to their corporate clients would be 'degraded'; and 4) lawyers might be constrained from offering effective advice out of concern for their own possible liability.

Instead, the Task Force advised the dual duties of loyalty and preservation of client confidences serve to encourage well-informed legal advice to public companies. By resisting employer pressures and offering unadulterated advice, “lawyers can play their most productive role in avoiding future corporate scandals.”

“The forthright rendition of such advice is every lawyer’s duty. The professional courage necessary to press such advice, sometimes at the risk of losing a client or a job, is indispensable to a lawyer’s ability to play an effective role in corporate governance.” (*see*, pp. 95-96).

Although the Task Force did not recommend so fundamental a change in a lawyer’s responsibilities as to impose a general duty to the investing public, it did remind lawyers that a public company’s duties to the investing public and to its shareholders “must be a matter of active concern for the lawyer in advising the client.” (*See*, pp. 65-67).

Adopting the ABA’s Model Rules

In the year 2003, the ABA amended its Model Rules to define the circumstances in which the lawyer to a corporate client would be expected to act to prevent or mitigate corporate fraud, “particularly in instances where a client has used a lawyer’s services in the wrongdoing.” The ABA amendments, essentially defining a lawyer’s obligation to report “an ongoing impending violation of law likely to cause substantial injury to the client,” are contained in ABA Model Rules 1.13(b), 1.13(c), 1.13(e) and 1.6(b)(2) and (3).

In its general recommendation that New York adopt the format of the ABA Model Rules, the NYSBA Committee on Standards of Attorney Conduct (COSAC), did not endorse the adoption by New York of the ABA’s amendments to MR 1.13(c) and MR 1.6(b)(2) and (3). The amendments permit a lawyer to make limited disclosure of client confidences (as, for example, to regulatory bodies) “to the extent necessary to prevent substantial injury to the corporate client.”

The City Bar Task Force disagreed with COSAC and recommended that the NYSBA House of Delegates reconsider its position and endorses adoption of all the ABA amendments to MR 1.13 and 1.6.

Best Practices

The heart of the Task Force Report was its recommendations for what it called “Best Practices.” These were:

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

The City Bar Task Force divided its recommendations into five general areas: the role of General Counsel; the role of outside counsel; the role of law firms; the lawyer-auditor relationship and financial disclosures; and the role of lawyers who conduct internal investigations.

I. The role of General Counsel. Sound and intelligent utilization of General Counsel is central to an effective system of corporate governance. Counsel's role as a senior member of management is sometimes difficult to reconcile with her responsibility to secure management's compliance with the law and the company's own ethical standards. The City Bar Task Force offered the following suggestions for strengthening Counsel's "ability to discharge her compliance requirements":

- Require the Company's Board of Directors to review and approve Counsel's tenure and compensation, to define Counsel's role and to confirm any decision to discharge her.
- Define Counsel's duties to include alerting the Board and other decision-makers within the company to potential significant law violations and damage to the company.
- Install processes and procedures to emphasize the importance of Counsel's function in promoting compliance with the law and the company's ethical standards.
- Provide resources and authority to Counsel necessary to performance of her role.
- Ensure that Counsel is seen as a "senior, influential and respected officer" of the company and as a member of senior management and that she is recognized as having strong qualities of "independence, judgment and discretion."
- Provide to Counsel reporting requirements, access to management and the Board, and compensation consistent with her senior status in the company.
- Inform all employees which lawyer in the company's legal department is assigned to hear their concerns.
- Establish employee hotlines and assure that company lawyers participate in the resolution of messages to the hotline.
- Train junior lawyers in the steps necessary to involve senior and experienced lawyers – including General Counsel – to discuss and "elevate" issues when needed.
- Ensure that Counsel has direct access to senior management and the Board and that problems are elevated to the appropriate level.
- Require that General Counsel report to company officers of the highest rank, "typically the CEO," and that she have direct access to executives and/or directors and to the company ombudsman on matters relating to compliance, governance and ethics.
- Enable Counsel to meet regularly with independent members of the Board.
- Require Counsel to attend all meetings of the Board, of the Audit Committee and of the legal compliance committee.
- Provide General Counsel with authority to require "dotted line" reporting from internal lawyers assigned to company subsidiaries and with a "significant voice in their hiring, firing and compensation."
- Assure that Counsel's independence is not undermined by arbitrary controls over Counsel's compensation and provide Counsel with a substantial role in determining the compensation of other internal lawyers.
- Give Counsel ultimate authority in the selection of principal outside counsel and in defining their roles. Outside firms should understand Counsel's role and expectations, including that outside counsel will "report up" any apparent wrongdoing by corporate employees or agents.
- Require Counsel to meet regularly with any outside firm providing "substantial ongoing work" for the company.

II. The role of outside counsel. The Task Forces cited two changes which have occurred over the last few decades in the relationship between a corporation and its outside counsel: 1) outside counsel are now more focused on specific transactions and on “projects that require special expertise;” and 2) the evolution within the legal profession of a “more competitive, bottom line orientation, with client relationships often in play and critical to the compensation of partners.” These changes have resulted in reduced knowledge by outside counsel of the context in which his services will be used, as well as increased pressure on the outside lawyer to yield to “questionable client conduct rather than place the client relationship at risk by pressing unwelcome advice.”

The Task Force noted that these changes make it important that the profession “adhere to professional standards that support the rendition of forthright advice and the rejection of clearly improper client conduct. (See, Report pp. 112-18).”

Specifically, the Task Force advised:

- To reduce the risk that the services of outside counsel will be put to some improper purpose, counsel should make appropriate inquiries when “circumstances suggest some reason for concern.”
- Outside counsel should talk with General Counsel and management to learn the context and purpose for which his services will be used.
- If outside counsel becomes “seriously concerned about the legality of the company’s actual or intended conduct,” he should make reasonable inquiry of the company, whether or not his concern rises to the level of requiring a report under the SEC’s lawyer conduct rules or “comparable state ethical rules.”
- If outside counsel’s concern about the company’s conduct is not dispelled, “counsel should seriously consider withdrawing from the representation.”
- “In the rare situation” when a company’s Board of Directors refuses to consider or take action “in response to counsel’s report of a threatened or ongoing clear and material violation of law,” outside counsel should seriously consider reporting the violation to the appropriate regulatory or government authorities (as permitted by the SEC’s lawyer conduct rules, the ABA Model Rules and the ethics rules of most states.)
- If outside counsel has a substantial reason to “doubt the independence of the company’s directors,” the case for “reporting out” is especially compelling.
- When a law firm is asked by a company to succeed other outside counsel “in connection with corporate advice or a transaction,” under circumstances which suggest that the departing counsel’s withdrawal or discharge “may have involved an issue in the company’s conduct,” successor counsel should ask permission to discuss the reasons for prior counsel’s departure.
- The company’s refusal to permit successor counsel to talk with outgoing counsel “should usually disincite successor counsel from accepting the engagement.”

III. The role of law firms. The Task Force advanced several suggestions directed specifically at law firms that advise public companies. Its Report noted that the ethical responsibilities of these firms have received increased attention and that the “reporting up” rules adopted by the SEC “appear to have stimulated a heightened focus on the firms’ responsibilities to provide ethical guidance to their attorneys.”

Again, the Report offers the following specific suggestions for law firms, including examples in several Appendices to the Report:

- All firms with “significant public company representations” should adopt written procedures defining and implementing the “up-the-ladder” reporting requirements of the SEC and applicable ethics rules.
- The firm’s procedures should include: 1) a mechanism for reporting violations; 2) clear assurance that no retaliatory action will be taken against lawyers – “especially junior lawyers” – who report up a perceived problem; 3) lawyer education and training sessions; and 4) the designation of senior lawyers or committees to facilitate compliance.
- For the guidance of its attorneys, every firm should draft and adopt a statement of best practices in advising public companies. This will enhance the firm’s culture and have a significant impact on how ethics rules are interpreted and enforced by the firm’s lawyers.
- Designate a partner or other senior lawyer or a committee of senior lawyers, or outside counsel, to act as ethics adviser to its lawyers, to consult with its lawyers, and to “advance the firm’s promotion of high ethical standards.”
- Apply the lawyer-client privilege “to protect consultation between the firm’s lawyers and the firm’s ethics counsel (in- house or specially retained outside counsel) on issues of professional conduct, “including issues pertaining to clients.”

This protection will facilitate compliance with applicable rules and statutes, and enable the firm to enforce the ethical standards internally, thereby strengthening the lawyer’s role in corporate governance,

The Task Force recommended that the courts construe issues of lawyer-client privilege in contacts between a firm’s lawyer and the firm’s ethics adviser “in light of this strong public interest” [i.e., strengthening the lawyer’s role in corporate governance”].

IV. Lawyers conducting internal investigations. Inside counsel and designated outside law firms are asked increasingly to conduct internal investigations into the conduct and practices of public companies. Investigations can be initiated by the company itself or by the SEC, another regulatory agency, or the company’s auditors. Many of the recent investigations have been perceived by the public as inadequate and failing in their purpose. Although “the ethical parameters of such investigative assignments have not been clearly delineated,” the Task Fork recommended a number of “important basic ground rules.”

- Before undertaking an investigation, counsel should consider and discuss with the company and its officers, directors and employees, all prior and current relationships between counsel and the company.
- Counsel should determine whether any relationship with the company will undermine “the fact or appearance of counsel’s independence,” and adversely affect how the investigation is perceived by regulators and others.
- Counsel should confirm: 1) the identity of the person to whom he should report in connection with the investigation; 2) whether counsel’s relationship with that person will undermine the fact or appearance of counsel’s independence; 3) the scope of the investigation and of any limits on the investigation; 4) “to whom and the manner in which” the results of the investigation will be disclosed.

- Because General Counsel and other in-house counsel may be involved in many investigations, the Board should consider whether some investigations (e.g., one involving the CEO) should be conducted by independent external counsel.
- When a potential conflict exists between General Counsel or other in-house counsel and “a peer...or other officer with whom counsel conducts significant business,” the investigation should be handled by outside counsel or by in-house counsel who is not conflicted.

In connection with an investigation, counsel should:

- Be alert to, and elevate within the company, restrictions or limits on the investigation “motivated by factors contrary to law or the company’s interest,” such as an attempt to cover up apparent wrongdoing.
- Require authorization to communicate the scope of the investigation to regulators, as well as limits on the investigation and to whom counsel is reporting.
- “Continually assess whether the company has a reporting obligation to regulators,” or to the markets or others, and “to discuss with the company the pros and cons of voluntary self-reporting.”
- Exercise independent judgment whether improper conduct has occurred and recognize pressures leading to an “under charge” (too lenient) or an “over charge” (too broad).
- Consider the fiduciary duties of the company’s directors and officers “to safeguard the best interests of the company.”
- Offer advice consistent with the company’s interests, “as opposed to any differing interests of individual officers and directors, or counsel’s own interest in his or her reputation or career.”

[Part II of this article – the Task Force’s recommendation on the lawyer-auditor relationship and financial disclosures – will be published in the February issue.]