Chair's Forum: Wearing More Hats Than a Hydra Has Heads-In-house Practitioners in Today's Corporate Environment...Anticipating the Challenges and Meeting the Demands in Today's Corporate Practice

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Faculty Biographies

Timothy J. Coleman

Timothy J. Coleman is senior counsel to deputy attorney general James B. Comey at the U.S. Department of Justice. He advises the deputy attorney general on white-collar crime issues, including corporate and securities fraud, financial institution fraud, and health care fraud, as well as sentencing, bankruptcy, and civil litigation. Mr. Coleman works closely with the President's Corporate Fraud Task Force, an interagency group chaired by the deputy attorney general. The Task Force oversees significant financial crime investigations conducted by federal prosecutors and regulatory agencies throughout the United States.

Prior to joining the deputy attorney general's staff, Mr. Coleman was counsel to assistant attorney general Christopher A. Wray in the criminal division of the Department of Justice. Previously, Mr. Coleman served as assistant U.S. attorney in the southern district of New York. He has handled a wide range of white-collar and other criminal cases, and was the lead prosecutor in the investigation of Adelphia Communications Corporation, which resulted in the conviction of the company's CEO, CFO, and other senior executives. Before entering government service, he was a civil litigator with Cravath, Swaine & Moore in New York.

Mr. Coleman is a graduate of Northern Kentucky University and Georgetown Law School.

Brackett B. Denniston, III

Brackett B. Denniston III is vice president and general counsel for General Electric Company in Fairfield, Connecticut. Mr. Denniston also serves as chair of the company's policy compliance review board, the governing compliance board of the company. He is a member of the board of directors of GE Capital Corporation and of GE's corporate executive council.

Mr. Denniston previously served as GE's vice president and senior counsel for litigation and legal policy. Before joining GE, he was chief legal counsel to Governor William F. Weld of Massachusetts. He was also a partner, and earlier an associate, at Goodwin, Procter in Boston, where he specialized in complex civil litigation, securities matters, and white collar crime cases throughout the United States. From 1982 to 1986, 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 in 1973-74.

He is a trustee of Kenyon College and of the Boston Bar Foundation.

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.*

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Deborah K. Fulton
Senior Vice President, General Counsel & Secretary
Midway Games Inc.

Robert J. Grey, Jr.

Robert J. Grey Jr., a partner in the Richmond, Virginia, office of Hunton & Williams, is president of the American Bar Association. Mr. Grey's law practice is focused on administrative matters before state and federal agencies, mediation and dispute resolution, and legislative representation of clients.

Mr. Grey came to Hunton & Williams from the law firm LeClair Ryan, where he was a partner. Prior to that he had cofounded the firm of Grey & Wesley, and then joined Mays & Valentine. He also received several gubernatorial appointments, including chair of the Virginia Alcoholic Beverage Control Board, and vice chair of the Virginia Public Building Authority, and member of the Virginia Polytechnic Institute and State University board of visitors.

Mr. Grey has long been active in the ABA, as chair of the policy-making House of Delegates in 1998-2000, the association's second-highest office, and as a member of the Board of Governors. Mr. Grey's service as House of Delegates chair made him the first person of color to serve in a top ABA office. He is the second consecutive person of color to serve as president, the association's highest office. Throughout his ABA career, Mr. Grey has been active in strategic planning and increasing diversity in the profession. In addition to his volunteer leadership within the ABA, Mr. Grey has chaired the Greater Richmond Chamber of Commerce, the Greater Richmond Partnership, and Youth Matters, and was president of the Richmond Crusade for Voters. Mr. Grey has various other honors, including: the UNCF/The College Fund's Flame Bearer Award, Dominion Power's "Strong Men and Women in the Community" award, the "Distinguished Leadership Award" from the National Association for Community Leadership, the "Alumni Star" from VCU School of Business, and the Gertrude E. Rush and Wiley A. Branton Awards from the National Bar Association.

Mr. Grey earned his BS from Virginia Commonwealth University and JD from Washington and Lee University.

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Sara L. Hays

Sara L. Hays is senior vice president and general counsel for Hyatt Hotels Corporation and is responsible for providing legal counsel in all aspects of Hyatt's hospitality operation and transactions, including intellectual property matters, acquisitions, negotiation of hotel and timeshare management, and development and ownership of Hyatt Hotels & Resorts. She is a member of Hyatt's managing committee.
Outside of Hyatt, Ms. Hays is a member of ACC and the ABA. She is also president of the Alumni Council of Carleton College.

Ms. Hays graduated from Carleton College, magna cum laude, and was elected to Phi Beta Kappa. She received her JD from Northwestern University School of Law, where she is a member of the Law Board and holds an MBA from the Kellogg School of Management.

Michele J. Hooper

Michele J. Hooper is managing partner of The Directors' Council. She is a cofounder of the firm which specializes in corporate board of director recruitment and advisory services.

Previously, Ms. Hooper served as president and CEO of Stadtlander Drug Company, Inc. Prior to joining Stadtlander, Ms. Hooper was appointed corporate vice president, Caremark International, a spinoff of Baxter International, and president of International Business Group. Ms. Hooper held various senior management positions at Baxter including president, Baxter Canada.

Ms. Hooper serves on the corporate boards of directors of Target Corporation, PPG Industries, Inc., AstraZeneca PLC, and Davita Inc. as well as chairs the audit committees for Target and PPG. Formerly, Ms. Hooper served on the board of Seagram Company Ltd. Ms. Hooper is president of the Chicago chapter of the National Association of Corporate Directors and sits on the advisory boards of American Telecare, L.E.K. Consulting, and Equis Corporation. She is a board member of the Center for Disease Control Foundation, the Joffrey Ballet, and Evanston Northwestern Healthcare. She is a member of The Economic Club of Chicago, the World President's Organization (WPO), and Executive Leadership Council (ELC).

Ms. Hooper holds a BA from the University of Pennsylvania and a MBA from the University of Chicago.

James R. Jenkins

James R. Jenkins is senior vice president and general counsel of Deere & Company in Moline, Illinois. Mr. Jenkins is chief legal officer for Deere & Company worldwide, with executive management responsibility for the law, patent, corporate compliance, and public affairs departments.

Before he joined Deere & Company, Mr. Jenkins was vice president, secretary, and general counsel at Dow Corning Corporation in Midland, Michigan. He served in a variety of

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leadership roles while at Dow Corning, including participation on the corporate executive, finance, trademark, and public policy committees, as well as the senior management team responsible for the resolution of the silicone breast implant controversy.

Mr. Jenkins is a member of the American Law Institute, the Executive Leadership Council, the Association of General Counsel, and he currently serves on the boards of the American Arbitration Association, ACC, the Alma College board of trustees, the Corporate ProBono advisory board, the Davenport Putnam Museum, the Center for Active Seniors Inc., and the Genesis Medical Center.

A native of the Chicago area, Mr. Jenkins received a BA from the University of Michigan. During 1967-1970 he served in the U.S. Army, including a year as an interrogation officer at the Combined Military Interrogation Center, Saigon, Vietnam, and was awarded a Bronze Star for meritorious service. He received a JD from the University of Michigan Law School.

Harold Morgan
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*The in-house bar association*SM

To: The American Bar Association Task Force on Corporate Responsibility
Chairman, James H. Cheek, III
Reporter, Lawrence A. Hammermesh

From: American Corporate Counsel Association (ACCA)

Re: Support of the Task Force's Final Report and Recommendations to the ABA House of Delegates, Report Nos. 119A, 119B, and 119C.

Date: July 29, 2003

The American Corporate Counsel Association has reviewed carefully your Report and Recommendations to the American Bar Association's House of Delegates. For the reasons set forth in this memorandum, ACCA strongly supports the Recommendations of the Task Force, and urges members of the ABA House of Delegates to vote for each of them. We believe that the adoption of the Recommendations is critically important, not only for in-house corporate counsel, but also for the professional integrity and independence of all lawyers seeking to act with the highest ethical standards in the best interests of their clients.

ACCA is a bar association for corporate counsel, with over 14,000 individual members who represent over 6,000 organizational clients across the United States. ACCA is founded on and committed to supporting the highest standards of professionalism for our members and the outside counsel they retain. Since in-house counsel are singularly and intimately committed to the professional representation of the single organizational client that employs them, they are perhaps even more focused than the lawyer for many clients on the need for constant attention to the professional responsibilities they owe to the clients they serve. Accordingly, we have followed the progress of this Task Force and assessed the value of its ensuing recommendations with close scrutiny. We were prepared to protest the Task Force's findings; we are pleased, however, to instead heartily support their report.

The Task Force Recommendation to amend Model Rule 1.6(b) is necessary and appropriate to prevent a client from using a lawyer's services to commit a crime or fraud that results in substantial financial injury to innocent third parties. This amendment would apply in extremely limited situations, and does not impact the daily relationship between lawyers and clients, even when clients have significant remedial needs. Underlying this policy is our fundamental belief that clients, whether corporations or individuals, should not be able to abuse a lawyer's services under the cloak of the duty of confidentiality; the proposed amendment of Model Rule 1.6(b) permits a lawyer caught in this unlikely and unhappy circumstance to *exercise professional discretion* in deciding whether or not to disclose a client's confidence in the pursuit of a remedy to a wrongdoing that unwittingly involved the lawyer's services. The correctness of this policy is even clearer in the glaring hindsight of the Enron-type financial frauds. The fact that the Task Force Recommendation is consistent with the current rules of ethics in 42 states only adds support to our contention that it represents what is already in fact an accepted standard of professionalism at the bar. Indeed, the experience of ACCA members practicing in these 42

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States indicates that the adoption of this rule nationwide will do no damage to the preservation of an appropriate and trusting relationship between a lawyer and her client, and will not result in any increased liability concerns for lawyers, either. Indeed, we believe that in *not* adopting the rule, the remaining jurisdictions are doing a disservice to their clients, their bar, and the professional standards upon which we stake our professionalism. The ABA should not be out of step with the practical experience and policy dictates of the State bars its Model Rules serve.

Regarding the Recommendation to amend Model Rule 1.13, we believe the proposal will help to overcome the current rule's lack of clarity and usefulness. The proposed revisions to the "up-the-ladder" reporting elements of the rule provide needed guidance, yet still preserve the lawyer's necessary discretion to assess and react to each client's situation with a uniquely tailored action plan, permitting – but not mandating – any one particular course. We are confident that the amendment will assist our members and all lawyers representing an organizational client in protecting the organization against illegal conduct that would substantially injure it.

We also note that passage of this Task Force's Recommendations regarding Model Rules 1.6 and 1.13 are important for additional reasons that may not be apparent from the face of the recommendations themselves. Many ACCA members have watched very closely, and with great concern, the entrance of the Securities and Exchange Commission (SEC) into the regulation of lawyer conduct, pursuant to the mandates of Sarbanes-Oxley Section 307 (now codified as SEC rules in 17 CFR, Part 205). We are particularly concerned about still-threatened SEC rules that would expand further the SEC's authority over attorney conduct in such a way as to completely remove lawyer discretion, replacing it with a requirement of a noisy withdrawal and an inappropriate "policing" role. Like it or not, the organized bars, responsible for the self-regulation of our profession, must consider the concerns of Congress, the SEC, and the investing public, which concerns led to this federally imposed rule governing public company attorney conduct. We believe that the Task Force Recommendations effectively address these concerns, and, according to statements made by SEC officials, may go a long way toward alleviating the need for further lawyer conduct rulemaking by the SEC.

Perhaps most importantly to our members, ACCA commends this Task Force for its vision in including a final proposal on recommended governance policies and procedures. These proposals have not received the attention they deserve. While not everyone may agree about the appropriate application of each of the Task Force's governance recommendations in every corporate client environment, it is our belief that history may look back at the this Task Force's contributions and cite as foremost amongst them their focus on the importance of the lawyer's role – and in particular, the in-house lawyer's role – vis a vis the Board, the corporation's culture of ethics and compliance, and the organizational client's governance processes.

The Recommendations made by this Task Force to the House of Delegates are timely, meaningful, reasonable, and – most importantly – balanced in their effort to move the bar and the role of lawyers forward in promoting corporate responsibility in the post-Enron world, while still holding high the principles which singularly define us as lawyers.

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All-Member Email Text: American Corporate Counsel Association, August 1, 2003

Help Improve the Rules of Professional Conduct!

Dear ACCA Member:

We need your help to support the passage of the recommendations of the ABA Corporate Responsibility Task Force (the "Cheek Commission") at the upcoming meeting of the American Bar Association's (ABA) House of Delegates.

Use the URL listed in the body of this email to identify and then contact the ABA Delegates who represent your state, and urge them to vote for these recommendations on August 11 and 12. (If you are comfortable doing so, please forward this email to your law firm relationship partners, and encourage them to support the Cheek Commission recommendations, as well.)

Background:

During the past year, we have seen near constant attention on corporate governance issues and the role of lawyers in promoting better governance and compliance, for both private and public company clients. Two landmark events, representing the culmination of this focus on attorney conduct, take place in the first two weeks of August, and their outcomes will immeasurably impact our profession and your client's service.

First, on August 5th, the SEC's new rules on attorney conduct for lawyers "appearing and practicing before the Commission" go into effect (17 CFR, Part 205) [you've already head a lot from us on this rule and you can find out more by going to http://www.acca.com/legres/corpresponsibility/attorney.php.] Currently, the rule does not contain a requirement that attorneys "report out" non-compliant behaviors to regulators – instead they must report allegations of un-remedied wrongdoing all the way up to the board. As you may recall, the SEC proposal for reporting out is still hanging overhead; SEC officials have withheld further action for the moment, as they watch closely the second event, detailed below, in order to determine if additional SEC lawyer conduct rules will be needed.

The second event, on August 11 and 12, is the Annual Meeting of the ABA House of Delegates in San Francisco. The ABA House will vote on a series of recommendations that are critical to the ethical rules governing ALL lawyers (not just those subject to the SEC rules). The recommendations of the ABA Corporate Responsibility Task Force, otherwise known as the "Cheek Commission," are crucial and well-balanced reforms that will provide appropriate guidance to lawyers and send appropriate signals to government regulators and the public that lawyers are members of a responsible, self-regulating profession. The Task Force report recommends the adoption of amendments to the Model Codes of Professional Conduct (Rules 1.6 and 1.13), as well as to "leading

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practice" governance norms, all of which promote the better representation of your entity-client's best interests and the public's trust in the integrity of our profession.

We drafted a letter to the ABA that describes our position and our reasons for supporting these recommendations. It can be found at:

http://www.acca.com/public/accapolicy/aba_corpresp.pdf

The Corporate Responsibility Task Force's Final Report, background materials the Task Force offered to the ABA House for its consideration, plus the testimony of the many lawyers and bars (including ACCA) who appeared before the Task Force to contribute to its deliberative process, can be found at:

http://www.abanet.org/buslaw/corporateresponsibility/

If you can help us by placing some calls or sending emails to ABA delegates representing your state, we have created a document that lists the contact information for them for your reference:

http://www.acca.com/public/reference/aba_delegatelist.pdf

When calling or emailing Delegates, please note that you are calling to urge the Delegate's support of the Corporate Responsibility Task Force Recommendations, on the House agenda as Report Numbers 119A, 119B, and 119C.

The opposition to the passage of these reforms is well-organized and very vocal. And we believe that many Delegates of the ABA House who oppose these reforms are not acting in a representative capacity, especially when one considers that 42 states have already adopted the "reforms" recommended by this Task Force – a small minority of states, and the ABA Model Rules, constitute the hold-outs. The opponents of reform argue that changes to the Model Rules will start us down a slippery slope that threatens lawyer professionalism. ACCA believes that a LACK of action in response to the question "Where were the lawyers?" is a far greater threat to our professionalism, an invitation to every regulatory agency to step into the void and promulgate their own attorney conduct rules, and most importantly, a threat to the future ability of in-house lawyers to provide effective legal services to their clients.

The ABA House of Delegates functions to ensure that ABA policy is representative of the interests and concerns of the communities the ABA serves. Join your peers in the corporate community (as well as other important constituencies, such as the ABA Business Law Section, the ABA Law Practice Management Section, and the Conference of Chief Justices) in supporting these important reforms for the benefit of the bar, the public, and the clients we serve. If we, as a self-regulating profession, do not seek to address issues of the lawyer's appropriate role in ensuring corporate responsibility on our own, we can certainly expect to see more regulation of the profession in the future by

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governmental entities who doubt our resolve to govern our own conduct in our client's and the public's best interests.

The ABA Annual Meeting commences next week. Given Delegates' presumed travel schedules, we urge you to contact your Delegates to ask their support before August 5. If you have questions about this email or ACCA's policy, direct them to ACCA's General Counsel, Susan Hackett, at 202/293-4103, ext. 318; hackett@acca.com.

Sincerely,

The Advocacy Committee of ACCA's Board of Directors

(For a board membership list, see http://www.acca.com/about/board.php.)

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REPORT OF
THE AMERICAN BAR ASSOCIATION
TASK FORCE ON CORPORATE RESPONSIBILITY*

March 31, 2003

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Section of Business Law Committee on Federal Regulation of Securities:
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***The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be considered as representing the policy of the American Bar Association.**

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I. BACKGROUND OF THE TASK FORCE

On March 28, 2002, Robert Hirshon, President of the American Bar Association ("ABA"), appointed a task force with the following charge:

> The Task Force on Corporate Responsibility shall examine systemic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States. The Task Force will examine the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants. The issues will be studied in the context of the system of checks and balances designed to enhance the public trust in corporate integrity and responsibility. The Task Force will allow the ABA to contribute its perspectives to the dialogue now occurring among regulators, legislators, major financial markets and other organizations focusing on legislative and regulatory reform to improve corporate responsibility.

On July 16, 2002, the Task Force submitted its Preliminary Report in response to this charge.[1] That Report preliminarily recommended reforms in two principal areas: internal corporate governance (relating to the composition, conduct and responsibilities of the public corporation's board of directors and its committees) and the professional conduct of lawyers. During the months following release of the Preliminary Report, the Task Force convened hearings on its preliminary recommendations in Chicago, New York and Palo Alto, California. Twenty-seven witnesses submitted written and oral testimony at those hearings,[2] and the Task Force received a variety of other written and oral comments on its Preliminary Report.

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[1] The Preliminary Report of the Task Force is published at 58 BUS. LAW. 189 (2002), and is available at http://www.abanet.org/buslaw/corporateresponsibility/home.html (the "Task Force Web Site").

[2] The written and oral testimony submitted at these hearings is available on the Task Force Web Site.

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After succeeding Robert Hirshon as President of the ABA, Alfred P. Carlton, Jr. reappointed the Task Force and, in his testimony to the Task Force in Chicago, encouraged the Task Force to draw "broad public policy conclusions which lead to policy recommendations for the ABA House of Delegates … that go beyond the technical aspects of corporate securities law and the ABA's model rules of professional conduct."[3] This Report responds to the Task Force's founding charge from Robert Hirshon and to President Carlton's call for broad policy conclusions.[4]

II. OVERVIEW OF THE REPORT

The policy conclusions expressed in this Report address the mechanisms of public corporation governance in the United States,[5] with particular emphasis on the role of lawyers. Consistent with its charge to examine "systemic issues,"

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[3] Testimony of Alfred P. Carlton, Jr., at 91, available on the Task Force Web Site.

[4] Not all members of the Task Force endorse each recommendation and every view expressed in this Report, but the Report taken as a whole reflects a consensus of the members of the Task Force. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be considered as representing the policy of the American Bar Association.

[5] As used in this Report, the term "public corporation" means generally a company that has a class of stock sufficiently widely held as to require registration under Section 12 of the Securities Exchange Act of 1934 ("Exchange Act") or the filing of reports pursuant to Section 15(d) of that Act. The Task Force believes that many of its recommendations will be relevant to and constructive in the governance of other organizations and entities. Nevertheless, this Report primarily addresses public corporations because: the charge to the Task Force explicitly addresses "public companies;" the greatest risk to investors involves public companies; most large companies are publicly held; and the existing pattern of regulation of public corporations through federal securities law and securities trading markets facilitates prompt reform.

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the Task Force has not attempted to determine the legal, ethical or moral responsibility of any individual person or organization associated with any particular failure of corporate responsibility.[6] The aim of the Task Force, rather, has been to examine public corporation governance mechanisms to determine how they might be modified in ways that would enhance corporate responsibility.

The term "corporate responsibility" is not self-defining. In framing its recommendations, the Task Force has understood that term to include, at the very least, behavior by the executive officers and directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders. In the Task Force's view, moreover, the term "corporate responsibility" also embraces ethical behavior beyond that demanded by minimum legal requirements.[7]

From that threshold perspective, the ABA is well positioned to draw public policy conclusions and to contribute to the ongoing debate on matters of public corporation governance that affect corporate responsibility. Particularly through its Section of Business Law, the ABA has long been an important source of

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6 For examples of proceedings in which such determinations are being made, *see In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F.Supp.2d 549 (S.D.Tex. 2002); Joint Committee on Taxation's Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (Feb. 19, 2003), available at the Task Force Web Site; *SEC v. WorldCom, Inc.,* Litigation Release No. 17866 (Nov. 26, 2002), available at http://www.sec.gov/litigation/litreleases/lr17866.htm; *SEC v. HealthSouth Corporation and Richard M. Scrushy*, Litigation Release No. 18044 (March 20, 2003), available at http://www.sec.gov/litigation/litreleases/lr18044.htm.

7 The Task Force's Preliminary Report (at 4-6) articulated this definition of "corporate responsibility." No comments were submitted questioning that definition, and the Task Force adopts it for purposes of this Report.

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guidance in the formulation of model laws and best practices of corporate governance.[8] The professional careers of its members have included intensive practical experience with and study of public corporations and the legal and ethical framework within which those businesses carry on their activities. Likewise, the ABA's Standing Committee on Ethics and Professional Responsibility, along with numerous other groups within the ABA, has worked for decades on refining and redefining the sensitive and critical role of legal counsel in the area of corporate governance.[9]

The Task Force has drawn upon this experience in responding to the turbulent events in corporate governance since the fall of 2001, and has distilled from those events governance policy recommendations relating to the role of the corporate lawyer (set forth in Part IV of this Report), recommended changes to the Model Rules of Professional Conduct (set forth in Part V of this Report), and

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[8] The ABA Section of Business Law, through its Committee on Corporate Laws, has prepared the Model Business Corporation Act, which has been widely followed by the states, and has also published the *Corporate Director's Guidebook* (3rd ed. 2001). That committee continually considers revisions to the Model Act; a fourth edition of the Guidebook, reflecting recent developments and making additional best practices recommendations, is currently in preparation and is expected to be published later this year. The Section of Business Law, through its Committee on Federal Regulation of Securities, has long been actively involved in addressing compliance with federal securities laws, particularly requirements for public corporations to provide full and accurate disclosure.

[9] A recent example of such work is the ABA's extensive comment letter submitted to the SEC on the rules of attorney conduct proposed by the SEC in November 2002, available at http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm.

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recommended corporate governance practices (set forth in Part VI of this Report).

These recommendations have not been developed in a static environment. Since the Task Force was appointed, many reforms significantly affecting corporate responsibility have been effected or proposed:

- The Sarbanes-Oxley Act of 2002[10] has brought about, among many other things, extensive federal regulation of the accounting profession, including the creation of an external regulatory organization (the Public Company Accounting Oversight Board), detailed prescriptions governing the auditing work of the firms that certify the financial statements of public corporations, and limits on the scope of non-auditing services that such firms may supply.
- The Securities and Exchange Commission ("SEC"), as well as state regulators and the National Association of Securities Dealers, has also addressed perceived weaknesses in the integrity of securities analysts' assessments of companies' performance and prospects, by adopting regulations requiring such analysts to certify the independence of their reports and to disclose any compensation received from the issuer that is the subject of the reports.[11]

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[10] P.L. 107-204, 107th Cong., 2d sess. (July 30, 2002).

[11] The SEC adopted Regulation AC, pursuant to Section 501 of the Sarbanes-Oxley Act of 2002, on February 20, 2003. The text of Regulation AC is available at http://www.sec.gov/rules/final/33-8193.htm .

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- The SEC has also adopted, both on its own initiative and at the direction of the Sarbanes-Oxley Act of 2002, rules implementing enhanced and accelerated disclosure requirements.[12]
- The Sarbanes-Oxley Act of 2002 also prescribed the adoption of substantive requirements for the composition and responsibilities of the audit committees of public corporations with shares listed with the public markets,[13] and established a prohibition against personal loans to directors and executive officers of public corporations.[14]
- In response to concern that existing rules of professional conduct did not sufficiently direct the lawyer for the corporation to report illegal conduct to the corporation's board of directors,[15] Congress adopted Section 307 of the Sarbanes-Oxley Act of 2002,[16] requiring the SEC to promulgate rules

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[12] Sarbanes-Oxley Act of 2002, Section 409, adding new Section 13(l) of the Exchange Act; SEC Release No. 33-8128, Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Sep. 5, 2002, available at http://www.sec.gov/rules/final/33-8128.htm.

[13] Sarbanes-Oxley Act of 2002, Section 301.

[14] *Id.*, Section 402(a), enacting Section 13(k) of the Exchange Act, 15 U.S.C. §78m(k).

[15] *See, e.g.,* letter of Professors Richard W. Painter, *et al.*, to SEC Chairman Harvey Pitt, dated March 7, 2002, available at http://www.abanet.org/buslaw/corporateresponsibility/pitt.pdf.

[16] Section 307 requires the SEC to issue rules:

> 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

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of professional conduct for lawyers "appearing and practicing"[17] before the SEC. In specified circumstances, those rules will require lawyers to report to the highest levels of corporate authority material violations of the securities laws and other failures of legal compliance. The SEC adopted these rules (the "Part 205 Rules")[18] on January 29, 2003, and has proposed additional rules of conduct that in some circumstances would require a lawyer to withdraw as counsel and to have that withdrawal reported outside the company by the lawyer or, alternatively, by the company.[19] In describing these proposed rules, the SEC noted with approval this Task Force's Preliminary Report, and its Chairman at the

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> 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.

17 The term "appearing and practicing" before the SEC is defined for purposes of the SEC's new rules of professional conduct to include "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 SEC. 17 CFR §205.2(a).

18 17 CFR Part 205, effective Aug. 5, 2003.

19 Release Nos. 33-8186; 34-47282; IC-25920, available at http://www.sec.gov/rules/proposed/33-8186.htm .

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same time indicated that further rulemaking would be influenced by action taken by the ABA.[20]

- Major stock markets – notably the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") – have submitted to the SEC proposed listing standards for public corporations that will extensively reshape the responsibilities and operating processes of the board of directors, committees of the board, and senior corporate officers, and extend the authority of shareholders.[21]

The Task Force generally endorses these initiatives and adds recommendations of its own – particularly those relating to the role and responsibilities of lawyers –that complement and supplement those initiatives. The Task Force believes that implementation of its recommendations would significantly enhance corporate responsibility through changes in practices and attitudes that address identified failures of corporate governance. These recommendations acknowledge, however, that effective responses to concerns about public corporation behavior and corporate responsibility must draw upon and operate within the institutional and historical framework of public corporation

[20] *Id.*; speech by former SEC Chairman Harvey Pitt, Jan. 29, 2003, available at http://www.sec.gov/news/speech/spch012903hlp.htm.

[21] The corporate governance listing standards proposed by the NYSE on August 16, 2002, as modified on March 12, 2003, are available at http://www.nyse.com/abouthome.html?query=/about/report.html. The listing standards proposed by Nasdaq on November 20, 2002, as modified on March 11, 2003, are available at http://www.nasdaq.com/about/ProposedRules.stm#boards . These listing standards proposals must be (and have not yet been) formally published for comment and ultimately approved by the SEC.

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governance in the United States, taking into account the significant changes that have been made in that framework in the last year. The Task Force also recognizes that recommendations that enhance processes and structural mechanisms will not operate with full effectiveness in the absence of attentive and dedicated service by committed and qualified corporate directors, officers and lawyers.

III. THE FRAMEWORK OF PUBLIC CORPORATION GOVERNANCE IN THE UNITED STATES

To most effectively communicate the content and significance of the recommendations in this Report, it is helpful to outline the foundational elements of public corporation governance in which the recommendations would operate.

A. The Participants in Public Corporation Governance

The laws governing the organization and governance of public as well as privately held companies in the United States universally establish that the business and affairs of the corporation are to be managed by or under the direction of its board of directors.[22] At the same time, however, it is generally acknowledged that the board of directors of a public corporation has no practical ability to manage or directly supervise every aspect of the corporation's business and affairs. Direct operational control of American public corporations is, and must remain, primarily in the hands of their senior executive officers.[23]

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[22] *See, e.g.,* 8 *Del. C.*§141(a); Model Business Corporation Act §8.01(b).

[23] As used in this Report, the term "senior executive officer" means the chief executive officer, the chief operating officer, the chief financial officer, and those officers who perform the functions of one or more of those positions. *Cf.*

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This concentration of day to day managerial control in the senior executive officers may give rise to potential conflicts of interest and other motivational problems that present persistent challenges for effective corporate governance. First, senior executive officers of public companies may sometimes succumb to the temptation to serve personal interests by maximizing their own wealth or control through manipulation or misreporting of corporate information, at the expense of long-term corporate well-being.[24] Second, senior executive officers are often motivated to report good news, and are averse to reporting news of business setbacks, mistakes, or worse, out of selfish concern that such reports might adversely reflect on them.[25] Third, senior executive officers may also be motivated to report information and analysis incorrectly or incompletely to the board of directors out of concern that individual directors might pursue unproductive or even disruptive inquiries or initiatives of their own. And finally,

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Securities Act Rule 405, 17 CFR §230.405; Exchange Act Rule 3b-7, 17 CFR §240.3b-7.

24 For example, it has been suggested that increased reliance on stock options in executive compensation packages during the 1990's encouraged senior executive officers to promote short term stock price performance through accounting maneuvers, at the expense of long term growth and stability. *See* The Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations, Part I: Executive Compensation (Sep.17, 2002) available at http://www.conference-board.org/knowledge/governCommission.cfm, at 4. It may be that executive compensation packages that are structured more carefully to reward long term performance would more closely align the interests of senior executive officers with corporate and investor interests. *See id.* at 5; Business Roundtable, Principles of Corporate Governance (May 2002), available at http://www.brtable.org/pdf/704.pdf, at 19.

25 *See, e.g.,* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory Of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms*), 146 U. PA. L. REV. 101, 130-146 (1997).

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senior executive officers may be motivated to report information and analysis incorrectly or incompletely to the public out of a concern about harming shareholder interests by reporting news that may adversely affect the corporation's stock price. Unchecked, these various motivations on the part of senior executive officers can significantly harm the interests of the corporation and the investors, employees, customers and other constituencies affected by the corporation's business.

To check such potentially harmful motivations, and to focus the attention of senior executive officers on the interests of the corporation and its shareholders, our system of corporate governance has long relied upon the active oversight and advice of the key participants in the corporate governance process, including the directors, auditors and counsel.[26] Corporate responsibility and sound corporate governance thus depend upon the active and informed participation of independent directors and advisers who act vigorously in the best interest of the corporation and are empowered to exercise their responsibilities effectively.

There are many participants in the governance of public companies who contribute to the oversight of corporate conduct with a view to enhancing corporate responsibility. The private sector participants include:

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[26] *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION (1976); Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976)

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- Boards of directors, whose responsibilities include the duty to oversee management performance in the best interests of the corporation.[27] These governing bodies have increasingly included outside directors (directors not employed by the corporation), and the standards for evaluating their independence from the corporation's senior executive officers have evolved significantly in recent years.[28]
- Public accounting firms, which are required to opine that public corporation financial statements fairly present the financial position and results of operations of the enterprise in conformity with generally accepted accounting principles.[29] Because of their importance to the integrity of the capital markets, and because of concerns arising from

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[27] *See, e.g., In re Caremark Int'l Inc. Deriv. Lit.*, 698 A.2d 959 (Del. Ch. 1996); Business Roundtable May 2002 Principles of Corporate Governance at 1; Model Business Corporation Act Annotated §8.31 (2000/01/02 Supp. at 8-204, 8-216P; American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994) §3.02(a); The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations Part 2 (Jan. 9, 2003), at 3, available at http://www.conference-board.org/knowledge/governCommission.cfm.

[28] *See, e.g.,* the NYSE and Nasdaq listing standard proposals identified in note 21, *supra*. The Task Force has not formulated a definition of director independence for purposes of its recommended corporate governance policies. Inevitably, the appropriate definition of that term will depend upon the nature of the corporation's business and ownership structure. The Task Force notes the significant progress made by the NYSE and the Nasdaq in developing definitions of director independence in their recent listing standard proposals, and acknowledges that, while trading marketplace arbitrage should be avoided, precise uniformity may be unwarranted. In all events the Task Force's initial concern in this regard (Preliminary Report at 14) has been substantially alleviated by the formulation of the pending NYSE and Nasdaq proposals.

[29] *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002).

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Enron, WorldCom and other cases in which the reliability of audits of public corporation financial statements has been compromised, the auditing firms for public companies have been subjected in the last year to sweeping regulatory reforms, including the creation of a new national rulemaking and disciplinary commission, the Public Company Accounting Oversight Board, which is itself subject to the oversight and enforcement authority of the SEC.[30]

- Shareholders, particularly institutional investors, who exercise ultimate power to elect and remove directors, and who increasingly seek to influence corporate policy through governance proposals and nominations to the board of directors.[31] Institutional shareholders, of course, have internal limitations of their own: just as with senior executive officers, those who manage institutional investments have some degree of personal interest in reporting positive results of their investment decisions and actions, and may tend to look uncritically at such results, especially where investment success or related compensation are measured by short-term stock price performance.
- Legal counsel who provide advice to public corporations, through their directors, officers and employees, on compliance with the corporation's legal obligations. The competition to acquire and keep client business, or

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30 *Id.;* Sarbanes-Oxley Act of 2002, §§101-110.

31 *See, e.g.,* The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations (January 9, 2003), at 15-20, 27.

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the desire to advance within the corporate executive structure, may induce lawyers to seek to please the corporate officials with whom they deal rather than to focus on the long-term interest of their client, the corporation.

Other private sector participants who do not have direct, formal governance responsibility nonetheless perform important roles in promoting corporate responsibility.

- Securities analysts evaluate corporate performance and prospects and communicate their findings to clients and the investor community. There have recently been significant challenges, however, to the independence and quality of such evaluations, and suggestions that some analyst reports are significantly influenced by direct or indirect compensation paid to the analysts by the companies on which they report.[32]
- Credit rating agencies evaluate the financial performance and strength of issuers of debt securities and play an important role in alerting investors to significant changes in the financial condition of public companies. In response to Congressional direction in Section 702 of the Sarbanes-Oxley Act of 2002, the SEC has released a study calling for further evaluation of a variety of issues raised by the role of credit rating agencies, including

[32] *See, e.g.,* Gretchen Morgenson, "Accord Highlights Wall Street Failures," New York Times, Dec. 20, 2002 at C1; SEC Release No. 33-8193 (Feb. 20, 2003) available at http://www.sec.gov/rules/final/33-8193.htm#P23_2296 . Rules recently adopted by the SEC, NYSE and Nasdaq impose more stringent requirements for disclosure of potentially conflicting interests on the part of analysts. *See* note 11, *supra*; SEC Release No. 34-45908 (May 10, 2002), available at http://www.sec.gov/rules/sro/34-45908.htm

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potential conflicts of interest, barriers to entry and the desirability of enhanced regulatory oversight.[33]

Finally, these private sector participants operate in a framework of legal rules established by other institutions that supply important regulatory support for corporate responsibility.

- The courts interpret and enforce the fiduciary responsibilities of corporate directors and officers. Indeed, courts can be expected to identify and give effect to evolving expectations regarding oversight responsibility, conflicts of interest and director independence, and the Task Force believes that such common law development may improve the level of corporate responsibility. State courts also promulgate and supervise enforcement of rules of professional conduct applicable to lawyers in their representation of public corporations.
- State legislatures define basic rules of corporate governance and often supplement the common law by establishing or refining key duties of corporate directors and officers.[34] Recognizing that precise uniformity among state corporate statutes is neither a generally accepted goal nor easy to achieve, and that state corporate laws must accommodate the needs of both private and publicly held enterprises, the Task Force

[33] Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, Jan. 24, 2003, available at http://www.sec.gov/news/studies/credratingreport0103.pdf .

[34] *See, e.g.,* Model Business Corporation Act §8.30 (standards of conduct for directors), and §8.42 (standards of conduct for officers).

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nonetheless expects that the states – and the drafters of the ABA-sponsored Model Business Corporation Act – will continue to examine legislative initiatives to complement other recent legal reforms to improve corporate responsibility.

- The SEC promulgates rules implementing the federal securities laws adopted by Congress, including the extensive reforms effected by the Sarbanes-Oxley Act of 2002. By proscribing some conduct and prescribing and enforcing requirements for disclosure by public companies in areas including financial performance, executive compensation, codes of conduct and transactions between the corporation and its directors and officers, by ensuring effective exercise of the shareholder franchise, and in many other ways, the SEC performs a critical role in enhancing corporate responsibility.
- Stock exchanges (such as the NYSE) and other securities markets (particularly Nasdaq) establish, subject to review by the SEC, standards for admission of a public corporation's shares to trading. Such listing standards have established important governance requirements,[35] and in recent months both the NYSE and the Nasdaq, at the prompting of the

[35] For an excellent description of the development of stock exchange governance listing standards, *see* Special Study Group of the Committee on Federal Regulation of Securities, Section of Business Law, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487 (2002).

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SEC, have proposed a broad array of new governance listing requirements.[36]

- Federal legislation has from time to time imposed substantive and procedural mandates that specifically affect corporate governance, such as: requiring accurate books and records and internal controls, and proscribing improper payments;[37] prohibiting extension of credit in the form of a personal loan to any director or executive officer;[38] and requiring that a public corporation's periodic financial reports be accompanied by a certification by the chief executive officer and the chief financial officer that the information they contain "fairly presents, in all material respects, the financial condition and results of operations of the issuer."[39]

B. Identifying and Responding to Shortcomings in Outside Oversight of Public Corporation Governance

Despite the range of private sector participants who have been in a position to contribute to public corporation governance, the last several years have witnessed spectacular failures of corporate responsibility. Knowledgeable observers have asserted that through inaction, inattention, indifference or, in some cases, conflicting personal interests or loyalties, some of these participants bear significant responsibility for these failures, and lawyers have not been

36 *See* note 21, *supra.*

37 *See* 15 U.S.C. §§78m(b), Section 13(b) of the Exchange Act.

38 15 U.S.C. §78m(k), Section 13(k) of the Exchange Act, added by Section 402 of the Sarbanes-Oxley Act of 2002.

39 18 U.S.C. §1350, enacted by Section 906 of the Sarbanes-Oxley Act of 2002.

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excluded from such assertions.[40] Inordinate self-interest on the part of corporate executives in short term corporate stock price levels, and instances in which that self-interest has led to aggressive accounting or assumption of extreme business risks, were not tempered by the checks and balances which the general corporate governance scheme expected from the directors or the professional firms engaged by the corporation to provide review and advice. Questionable treatment of financial information evaded audit scrutiny, and important disclosures were not made. Nothing in the record developed in the Task Force's public hearings has called into question the core conclusion, articulated in the Task Force's Preliminary Report, that *the exercise by independent participants of*

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40 *See, e.g.,* Coffee, *supra* note 29; Joel Seligman, *No Man Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371 (2002); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002). With respect to the conduct of lawyers, *see* Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143 (2002); Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. by William C. Powers, Jr., Chair, dated February 1, 2002, available at http://news.findlaw.com/hdocs/docs/enron/sicreport/; *In re Enron Corp. Securities, Derivative & ERISA Lit.*, 235 F.Supp.2d 549, 704-05 (S.D.Tex. 2002) (denying motion to dismiss securities law claims against Vinson & Elkins arising out of its representation of Enron); Dennis K. Berman, "Global Crossing Board Report Rebukes Counsel," Wall Street Journal, Mar. 11, 2003, at B9; Mike France, "What About the Lawyers?," Business Week, Dec. 23, 2002 at 58-62; Matthew Brelis and Jeffrey Krasner, "Auditor Knew of Tyco Deals, Prosecutor Says PWC Says It Didn't Know Loans Hadn't Been OK'd," Boston Globe, Feb. 8, 2003, at E-1 (reviewing criminal charges against Mark Belnick, former general counsel of Tyco International, Ltd.).

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active and informed stewardship of the best interests of the corporation has in too many instances fallen short.[41]

The events of the last two years compellingly call for significant reforms and "consciousness raising" in our system of corporate governance. As previously described, there have already been numerous such reform initiatives.[42] The Task Force believes, however, that important reforms remain to be developed or implemented in a number of areas. The policy principles recommended in this Report address two of these areas: the role of lawyers and the role of directors. These principles are intended to enhance the ability of corporate counsel and directors to discharge their corporate governance responsibilities more effectively. In the next two parts of this section, we review briefly some of the background premises that have led us to recommend the policies articulated in this Report.

C. The Role of Lawyers for the Public Corporation

Lawyers are and should be important participants in corporate governance and important contributors to corporate responsibility. Lawyers employed by the corporation and outside lawyers retained by the corporation often serve as key advisers to senior management and usually participate in the negotiation, structuring and documentation of the corporation's significant business transactions. Additionally, lawyers often serve as counselors to the board to assist it in performing its oversight function. In such roles, lawyers obviously do

41 Preliminary Report at 10.

42 *See* Part II, *supra*.

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and should play a critical role in helping the corporation recognize, understand and comply with applicable laws and regulations, as well as to identify and evaluate business risks associated with legal issues. The Task Force believes that a prudent corporate governance program should call upon lawyers – notably the corporation's general counsel[43] – to assist in the design and maintenance of the corporation's procedures for promoting legal compliance.

This conception of the lawyer as a promoter of corporate compliance with law emanates from the basic values of the legal profession. It follows naturally from the ABA's goal "to increase public understanding of and respect for the law, the legal process, and the role of the legal profession."[44] It is also in keeping with the ABA's Model Rules of Professional Conduct,[45] which emphasize the lawyer's responsibility "[a]s advisor [to] provide[] a client with an informed understanding of the client's legal rights and obligations and explain[] their practical implications."[46]

The Model Rules reinforce this positive relationship between lawyers and their clients in a number of other ways. They require the lawyer to be competent

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43 As used in this Report, the term "general counsel" refers to the lawyer having general supervisory responsibility for the legal affairs of the corporation. *See* n. 63, *infra*.

44 ABA Goals and mission statement, Goal IV, available at http://www.abanet.org/about/goals.html.

45 Referred to in this Report as "Model Rules" or "Rules." These rules are the template used by most state authorities in formulating and promulgating the rules that bind the lawyers admitted to practice in those states. The Model Rules are available at http://www.abanet.org/cpr/mrpc/mrpc_toc.html.

46 Model Rules Preamble ¶[2].

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and diligent in rendering legal services;[47] to respect the client's right to decide on objectives;[48] to consult with the client about the means by which the client's objectives are to be accomplished;[49] to protect the client's information; and to avoid conflicts of interest. The obligations of confidentiality and loyalty, however, never permit the lawyer to "counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent."[50] To the contrary, the lawyer is not permitted to "continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent."[51]

The Task Force acknowledges that lawyers for the corporation – whether employed by the corporation or specially retained -- are not "gatekeepers" of corporate responsibility in the same fashion as public accounting firms. Accounting firms' responsibilities require them to express a formal public opinion, based upon an independent audit, that the corporation's financial statements fairly present the corporation's financial condition and results of operations in

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47 Model Rules 1.1, 1.3.

48 Model Rule 1.2.

49 Model Rule 1.4(a)(2).

50 Model Rule 1.2(d). One of the witnesses in the Task Force hearings usefully suggested that this aspect of Model Rule 1.2 deserved to be expressed in a separate rule. Statement of Mark L. Tuft on behalf of the Bar Association of San Francisco, at 12, available on the Task Force Web Site.

51 Model Rule 1.2, Comment [10].

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conformity with generally accepted accounting principles.[52] The auditor is subject to standards designed to assure an arm's length perspective relative to the firms they audit. In contrast, as several commentators pointed out in the public hearings on the Preliminary Report, corporate lawyers are first and foremost counselors to their clients.[53] Except in clearly defined circumstances in which other considerations take precedence, an alternative view of the lawyer as an enforcer of law may tend to create an atmosphere of adversity, or at least arm's length dealing, between the lawyer and the corporate client's senior executive officers that is inimical to the lawyer's essential role as a counselor promoting the corporation's compliance with law.

Nevertheless, lawyers for the public corporation must bear in mind that their responsibility is to the corporation, and not to the corporate directors, officers or other corporate agents with whom they necessarily communicate in representing the corporation. This is the bedrock principle recognized in Rule 1.13(a) of the Model Rules. Outside lawyers retained by the corporation and lawyers employed by the corporation both must exercise professional judgment in the interests of the corporate client, independent of the personal interests of the corporation's officers and employees.

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52 *See, e.g.,* R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERC. L. REV. 829, 841-843 (2003); Coffee, *supra* note 29, at 1405 ("Characteristically, the gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction"); *see* Regulation S-X Rule 2-02, 17 CFR §210.2-02.

53 *See* note 84, *infra.*

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Lawyers who provide legal advice to corporate clients most effectively fulfill that duty of independent professional judgment by gaining a thorough understanding of the client's objectives, so that they can most readily identify means to achieve those objectives that comply with applicable law. Yet while that depth of understanding of the corporate client depends upon active and close involvement with the corporation's officers, lawyers must at the same time retain the professional detachment that allows them to recognize and point out issues of legal compliance, even at the risk of being perceived as unduly pessimistic or obstructive of the business plans sought by the corporation's executive officers. There are times, moreover, when the corporate lawyer must recognize that his or her own independence may be compromised by relationships with senior executive officers; at such times, the lawyer's responsibility may require him or her to assure that the corporate client retains other counsel who can exercise the requisite professional detachment.[54]

The recommendations in this Report relating to lawyers are intended to enhance the lawyer's ability to exercise and bring to bear independent professional judgment, and thereby enhance the lawyer's ability to promote

[54] It has been suggested that such considerations warrant, as a matter of regular practice, the retention of counsel other than general corporate counsel to advise the board of directors or one or more of its committees. The Task Force believes that such a practice generally would not be desirable. Apart from the added cost of additional counsel, the division of management and the board of directors into two separately counseled factions may result in less open communication, less constructive collaboration between directors and senior executive officers, and, ultimately, less effective oversight by the board of directors. The Task Force recognizes, however, that there are situations in which separate counsel, for the board or one or more of its committees, may be necessary or desirable.

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corporate responsibility without undermining the constructive and collaborative relationship that must exist with the client so that compliance with law can be most effectively promoted.

D. The Role of Directors

The directors of a public corporation are expected to serve an important function in overseeing the conduct of senior executive officers. The ability of outside directors to discharge that function effectively, however, has at times been compromised by the practical realities of the relationship between such directors and the senior executive officers – particularly the chief executive officer – of the corporation:

- Outside directors have at times been overly dependent upon and overly passive with respect to senior executive officers, particularly the chief executive officer; conversely, such officers too often have looked on outside directors as a sounding board but not as persons to be encouraged to press issues or independently raise troubling questions.
- Outside directors too often have relied almost exclusively upon senior executive officers, and advisers selected by such officers, for information and guidance about corporate affairs.
- Outside directors too often have failed to devote adequate time and attention to discharge their oversight responsibilities that demand a relatively detailed understanding of a number of aspects of the corporation's activities and its material transactions.

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- Outside directors too often have deferred to the senior executive officers to set agendas for meetings of the board, select director nominees, initiate the analysis of and in effect determine executive compensation, select the key advisers to the board and its committees (*e.g.*, compensation consultants), and select the outside auditors for the company.
- Too often, even when an outside adviser is formally engaged by the board of directors or by a committee of the board, the adviser's view of the senior executive officers as the client has influenced the advice rendered.

The Task Force recognizes that it is not desirable for directors to try to manage the corporation directly and comprehensively, and that there are inherent limitations on the abilities of outside directors to assure corporate responsibility.[55] Directors cannot be expected to know all aspects of corporate activity, and they will necessarily rely to a significant extent upon information supplied by the corporation's senior executive officers and other corporate agents. Moreover, it is widely accepted that competent directors are not expected to serve in an environment in which they can be held personally liable for injury to the corporation arising from honest mistakes or omissions, as long as they act on a reasonably informed basis, in good faith and free of conflicting

[55] At least one commentator has thoughtfully questioned the utility of listing standards that require more extensive reliance upon outside directors as a means to enhance corporate responsibility and performance. Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. J. 370 (2002).

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personal interests or loyalties.[56] Thus, "[d]*irectors cannot guarantee corporate compliance; they can only be expected to undertake and execute good faith efforts to ensure that it occurs*."[57]

It is the sense of the Task Force, however, that many corporate boards have developed a culture of passivity with respect to senior executive officers, in which those officers are not subject to meaningful director oversight.[58] Direct legislative action or the imposition of legal sanctions to change this culture may

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[56] The rationale for this relatively expansive legal deference to good faith action of directors has several components. First, it is widely agreed that director liability for ordinary negligence would unduly discourage socially useful decisions by directors to pursue risky but potentially rewarding business strategies. *See Gagliardi v. Tri-Foods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996); *Joy v. North*, 692 F.2d 880, 884-86 (2d Cir. 1982). Second, the complexity of business decisions by directors creates a likelihood of undue hindsight bias in evaluating unfavorable outcomes. Hal R. Arkes and Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias,* 73 OR. L. REV. 587, 588, 591-93 (1994). Third, and in light of such complexity, director liability for good faith conduct promotes excessively costly precautionary measures, has a chilling effect on candid exchanges of information and criticism, and promotes overextended adherence to failed business strategies in order to avoid admissions of mistake. *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797 (2001).

[57] Strine, *supra*, 57 BUS. LAW. at 1393 (emphasis in original).

[58] SEC Chairman William H. Donaldson recently articulated this same view:

> Over the past decade or more, at too many companies, the chief executive position has steadily increased in power and influence. In some cases, the CEO had become more of a monarch than a manager. Many boards have become gradually more deferential to the opinions, judgments and decisions of the CEO and senior management team. This deference has been an obstacle to directors' ability to satisfy the responsibility that the owners - the shareholders - have delegated and entrusted to them.

Remarks at the 2003 Washington Economic Policy Conference, Mar. 24, 2003, available at http://www.sec.gov/news/speech/spch032403whd.htm.

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produce a confrontational climate in the board room which would have undesirable consequences. The Task Force believes, rather, that desirable changes in attitude can most effectively be encouraged by a variety of structural and procedural reforms. The policies and practices recommended in this Report with respect to the role of the board of directors attempt to address issues of outside director attitude largely by suggesting means to enhance the independence and resources of the outside directors, and to increase the flow of material information and analysis to those directors. In this respect, the recommendations in this Report support the basic thrust of the new listing standards proposed by the NYSE and the Nasdaq, and the governance recommendations made by the Conference Board and the Business Roundtable and, in the United Kingdom, by the recent Higgs Report.[59] All of these authorities have urged the adoption, either through listing standards or best practices guidelines, of processes that augment the independence of outside directors from senior executive officers, afford such directors greater responsibilities in the selection of board nominees and in the oversight of financial reporting and legal compliance and encourage such directors to become generally more active and assertive in their supervisory roles.

Changes in structure and process alone, however, will never fully accomplish the enhancements in corporate responsibility contemplated by this

[59] 20 January 2003 Report of Derek Higgs to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry, entitled *Review of the role and effectiveness of non-executive directors*, available at http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf .

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Report. Even the most stringent prescriptions for involvement of outside directors will not generate the backbone to ***act*** independently and objectively which the Task Force believes is necessary to an effective system of corporate governance.[60] The goal of the policies and practices recommended in this Report will only be fully achieved if outside directors abandon the passive role many have been content to play, and replace it with a new culture stressing constructive skepticism[61] and an active, independent oversight role.

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The foregoing considerations form the backdrop to the Task Force's recommendations set forth in the following sections of this Report. The Task Force recognizes that there are different ways of implementing these recommendations, ranging from state law changes to trading market listing standards to federal statutory or SEC regulatory prescriptions to institutionally sponsored "best practices." The Task Force does not take a position on which method is preferable in any particular case, but urges that the ABA and

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[60] Business Roundtable May 2002 Principles of Corporate Governance, at 2 ("[e]ven the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice."); Donaldson, *supra* note 58 ("a 'check the box' approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, 'politically correct' dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires.").

[61] *See* The Business Roundtable May 2002 Principles of Corporate Governance at 3; Phyllis Plitch, "Ex-Sec Chief Advocates Openness," Ft. Lauderdale Sun-Sentinel, Mar. 23, 2003 (quoting former SEC Chairman Arthur Levitt).

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appropriate entities within the ABA proceed promptly to evaluate and, where appropriate, develop specific ways in which to implement the Task Force's recommendations.

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IV. RECOMMENDED POLICIES OF CORPORATE GOVERNANCE

To improve the governance of public corporations[62] and enhance corporate responsibility, the Task Force recommends the corporate governance practices set forth in Part VI and adoption of the following governance policies as ABA policy:

1. **The board of directors of a public corporation must engage in active, independent and informed oversight of the corporation's business and affairs, including its senior management.**

2. **In order to improve the effectiveness of such oversight, the board of directors of a public corporation should adopt governance principles (more fully specified in Part VI of this Report) that (a) establish and preserve the independence and objectivity of directors by eliminating disabling conflicts of interest and undue influence or control by the senior management of the corporation and (b) provide the directors with timely and sufficient information and analysis necessary to the discharge of their oversight responsibilities.**

3. **The directors should recognize and fulfill an obligation to disclose to the board of directors information and analysis known to them that is relevant to the board's decision making and oversight responsibilities. Senior executive officers should recognize and fulfill an obligation to disclose, to a supervising officer, the general counsel, or the board of directors or committees of the board, information and analysis relevant to such persons' decision making and oversight responsibilities.**

4. **Providing information and analysis necessary for the directors to discharge their oversight responsibilities, particularly as**

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[62] While these recommendations address public corporations, the Task Force believes that many nonpublic organizations and entities would benefit from many of these policies and recommends that all organizations and entities consider whether these policies would promote compliance with law and ethical standards.

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they relate to legal compliance matters, requires the active involvement of general counsel for the public corporation.[63]

5. **A lawyer representing a public corporation shall serve the interests of the entity, independent of the personal interests of any particular director, officer, employee or shareholder.**

6. **The general counsel of a public corporation should have primary responsibility for assuring the implementation of an effective legal compliance system under the oversight of the board of directors.**

7. **Public corporations should adopt practices in which:**

   a. **The selection, retention, and compensation of the corporation's general counsel are approved by the board of directors.**

   b. **General counsel meets regularly and in executive session with a committee of independent directors to communicate concerns regarding legal compliance matters, including potential or ongoing material violations of law by, and breaches of fiduciary duty to, the corporation.**

   c. **All reporting relationships of internal and outside lawyers for a public corporation establish at the outset a direct line of communication with general counsel through which these lawyers are to inform the general counsel of material potential or ongoing violations of law by, and breaches of fiduciary duty to, the corporation.**

8. **The Model Business Corporation Act and the general corporation laws of the states, and the courts interpreting and applying the duties of directors, should more clearly delineate the oversight responsibility of directors generally, and the unique role that independent directors play in discharging that responsibility in public company settings.**[64]

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[63] If a public corporation has no internal general counsel, it should identify and designate a lawyer or law firm to act as general counsel. The responsibility for implementing these recommended policies may necessarily be delegated to some extent by the general counsel to subordinate lawyers.

[64] Among the specific oversight matters which should be considered in relation to the Model Business Corporation Act or its commentary and the state corporate laws as well as in relation to important guidance such as the *Corporate*

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9. Engagements of counsel by the board of directors, or by a committee of the board, for special investigations or independent advice should be structured to assure independence and direct reporting to the board of directors or the committee.

10. The SEC and state attorney disciplinary authorities should cooperate in sharing information in order to promote effective and appropriate enforcement of rules of conduct applicable to counsel to public corporations.

11. The courts, law schools and lawyer professional organizations such as the ABA should promote awareness of, and adherence to, the professional responsibilities of lawyers in their representation of public corporations.

12. Law firms and law departments should adopt procedures to facilitate and promote compliance with rules of professional conduct governing the representation of public corporations.[65]

Director's Guidebook, are at least the following: selecting, evaluating and compensating the chief executive officer and other members of senior management; reviewing, approving, and monitoring fundamental financial and business strategies and the performance of the company relative to those strategies; assessing major risks facing the company; and ensuring that reasonable processes are in place to maintain the integrity of the company and the corresponding accountability of senior management, including processes relating to integrity of financial reporting, compliance with law and corporate codes of legal and ethical conduct, and processes designed to prevent improper related party transactions. Federal law (particularly the securities laws, including the rules and regulations adopted by the SEC) also plays a significant role in affecting and promoting corporate responsibility.

[65] In its Preliminary Report (at 43), the Task Force stated the intention to consider issues involving potential conflicts of interest arising out of lawyers' business and investment relationships with clients. The testimony submitted to the Task Force, however, did not significantly focus on such issues, and the Task Force therefore recommends that further review of the issues be undertaken by interested professional organizations, including the appropriate ABA entities.

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V. RECOMMENDATIONS CONCERNING THE ROLE OF LAWYERS

In formulating recommendations relating to the role of lawyers, the primary goal of the Task Force has been to enhance the ability of lawyers to promote compliance with law. The recommendations relating to lawyers are found in the corporate governance policies set forth in Part IV and in the Model Rule changes discussed in this Part. These recommendations address two principal subjects: (1) the role of lawyers in facilitating the flow of information and analysis concerning legal compliance issues within the organizations they represent (including public corporations); and (2) the limitations on the ability of the lawyer to disclose to third parties information concerning criminal or fraudulent conduct by the client.

Many of the corporate governance policy recommendations set forth in Part IV address the development of prudent practices to facilitate communication between the lawyer and the corporate client in relation to legal compliance matters. The Task Force believes that the development of such practices, by encouraging early and regular attention to and communication about potential problems of legal compliance, will significantly diminish the occurrence of material violations of law.

The Task Force recognizes, however, that even where the recommended practices are applied, corporate officers and employees may take actions that involve the corporation in material violations of law. Such actions may occur where officers or employees reject legal advice, or where they fail to consult a lawyer. The Task Force believes that the Model Rules (particularly Rules 1.13

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and 1.6) that address the professional responsibility of lawyers when such circumstances arise should be revised in order to promote legal compliance.[66]

A. Facilitating the Flow of Information and Analysis Within Organizational Clients.

In their role of promoting their organizational clients' compliance with law, a key function of lawyers is to bring issues of legal compliance to the attention of appropriate authorities within the organization. The Task Force believes that there are two useful approaches to enhancing the efficacy of this role. The first (set forth in Section 1 below and in the policies set forth in Part IV) involves the adoption by public corporations of practices and procedures in which both employed (in-house) lawyers and outside lawyers for the corporation can more readily and effectively convey to appropriate organizational authorities information and analysis concerning issues of legal compliance. The second approach (set forth in Section 2 below) supplements the first approach by recommending that the Model Rules (especially Rule 1.13) be amended to address more effectively the relatively unusual situation in which action or threatened action by an organization's employee violates a law or legal obligation and is likely to cause substantial injury to the organization.

[66] This Report continues the practice traditionally used in the Model Rules of speaking about the responsibilities of individual lawyers. However, in many cases involving representation of publicly held corporations, the corporate client is advised by a law firm. The interplay of lawyer obligations to the corporation and lawyer obligations to each other in the context of law firm practice are generally addressed in Model Rules 5.1 and 5.2. A direct, detailed analysis of the responsibilities of a law firm and the lawyers within the firm and the procedures that would facilitate discharge of their responsibilities would be a useful addition to the literature on professional responsibilities, and the Task Force recommends that an appropriate committee of the ABA undertake such an analysis.

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1. *Establishing Lines of Communication*

The Task Force recommends the adoption of corporate governance policies that would facilitate and encourage independent oversight of potential violations of law and breaches of duty to the corporation. Among the policies set forth in Part IV are two policies which the Task Force believes are of particular importance. First, the board of directors should establish a practice of regular, executive session meetings between the general counsel[67] and a committee of independent directors.[68] Second, each retention of outside counsel to the corporation should establish two things at the outset of the engagement: (1) a direct line of communication between outside counsel and the corporation's general counsel; and (2) the understanding that outside counsel are obliged to apprise the general counsel, through that direct line of communication, of material violations or potential violations of law by the corporation or of material violations or potential violations of duties to the corporation. The reasons for these recommended practices are set forth below.

<u>Communication Between General Counsel and Independent Directors</u>

The general counsel of a corporation works day to day with senior management and typically reports to the CEO or another senior executive officer.

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[67] Reference to the general counsel includes, where appropriate, the general counsel's staff and, where no office of general counsel has been established to perform this function, outside counsel performing a similar role with respect to corporate governance, compliance or disclosure. *See* note 63, *supra*.

[68] In recommending such meetings, the Task Force recognizes that their purposes may be fulfilled in many instances by meetings in which only the chair of the committee is present, especially if the chair is expected to report to the committee relevant information learned at such meetings. *See* Part IV, *supra*, recommendations 3 and 7b.

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Although this interaction is necessarily with individual members of management, the general counsel's client is the corporation. This creates a tension whose positive resolution demands a number of practical steps.

Where the general counsel concludes that action or inaction of an officer or employee with whom counsel works is breaching or will breach a duty to the corporation, or is violating or will violate a law, such that substantial injury to the corporation is likely to ensue, counsel may have to confront the issue of communicating with a higher corporate authority on the subject.[69] If the relevant officer or employee is a senior executive officer or, most difficult, the CEO, general counsel must determine whether to go up the corporate ladder to a committee of independent directors or to the entire board. Knowing that doing so may destabilize the relationships among senior executive officers and directors, the general counsel may be reluctant to communicate with the board of directors or a committee of the board.

The Task Force believes, however, that such impediments to communication to higher corporate authorities can be minimized or eliminated if the board of directors adopts a practice in which the general counsel, as a matter of routine, periodically meets privately with a committee of independent directors. The value of such meetings will be maximized if the committee has instructed

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[69] Indeed, the Part 205 Rules may impose such an obligation as a matter of law. *See* 17 CFR §205.3(b)(2) ('Unless the chief legal officer … reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and … may refer a report of evidence of a material violation to a qualified legal compliance committee [of the board of directors]."); and §205.3(b)(1).

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general counsel to use those occasions to report on material violations or potential violations of law, breaches of duty to the corporation and other substantial legal concerns, such as significant litigation and contingent liabilities, relating to the welfare of the corporation that have come to general counsel's attention. The committee should make clear to general counsel the expectation that such reports will reveal what investigation of facts has been made, what steps have been taken to deal with any violation or breach that has occurred, and the steps taken or recommended to make sure such violation or breach does not recur. Use of this procedure would establish an expectation by the board that the general counsel will report concerns about significant legal compliance issues, and would to some extent insulate such communications from being perceived by senior executive officers as disruptive. Indeed, the fact that the general counsel is expected to make such disclosure may persuade the CEO to take corrective action or personally report such issues directly to the committee.[70]

The Task Force therefore believes that a practice of having routine, periodic private meetings (designed to elicit specific information) between the general counsel and an appropriate committee of independent directors would significantly enhance the general counsel's ability to assure that critical issues,

[70] The committee may respond to the general counsel by agreeing with the CEO's position that the corporation must, as a matter of business strategy, take the risk of engaging in the conduct questioned by the general counsel. At that point, general counsel would need to evaluate whether the Part 205 Rules and the applicable rules of professional conduct require or permit the lawyer to take any further action.

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including all issues of material law and fiduciary duty violations, are reviewed by appropriate corporate authorities.

Communication between Outside Counsel and General Counsel

The corporation is commonly served by a number of outside counsel who interact with specific corporate employees. Many outside counsel may not have regular contact with the corporation's senior executive officers (including the CEO), and they typically do not interact with the board of directors or its independent members. In the absence of such contact, outside counsel who knows of facts from which such counsel concludes that a duty to the corporation is being or has been breached or that the corporation may be violating or potentially violating the law is unlikely to have access to the corporation's resources that would permit an appropriate investigation to be made.

In such a circumstance, Model Rule 1.13 or the Part 205 Rules may require the outside counsel to communicate with higher corporate authorities, and such communication may be a desirable contribution to corporate governance even if the rules of professional conduct do not mandate it. There are frequently significant practical obstacles, however, to outside counsel bringing such misconduct to the attention of appropriate corporate authorities. In many situations operational personnel will hire (or be perceived as hiring) outside counsel and be responsible for future hires of counsel. Consequently, outside counsel may be discouraged from fulfilling the professional responsibility to the corporation out of concern over offending the personal desires or interests of the

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employee or department which retains counsel. The outside counsel must nevertheless comply with applicable rules of professional conduct.

Such compliance, as well as otherwise beneficial communication of concerns about legal compliance, can be fostered by the adoption of a practice under which the general counsel makes clear to outside counsel, at the outset of the representation and in periodic communications thereafter, that when outside counsel knows of facts from which such counsel concludes that an officer or employee is engaged in conduct which has resulted or will result in material violations of law or fiduciary duty to the company, outside counsel should communicate those facts to the general counsel.[71] General counsel may have additional information, typically has the resources to investigate further, and is charged with responsibility to pursue such inquiries in appropriate situations. General counsel's instruction that outside counsel make his or her concerns known to the general counsel is designed to elicit important information and analysis and direct it to a place in the corporate structure where appropriate action can be taken.[72]

2. Reinforcing the Obligation to Communicate with Higher Corporate Authorities

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[71] Certainly this is the practice contemplated in the Part 205 Rules; under those rules, if a lawyer is required to report evidence of a material violation, that duty may be satisfied by reporting to the corporation's chief legal officer. 17 CFR §205.3(b)(1).

[72] This procedure may not be effective where outside counsel knows or has reason to believe that general counsel will not handle the problem properly either because of a disabling conflict of interest or because of weakness or incompetence. In those cases, the applicable rules of professional conduct should guide the outside counsel in dealing with presenting concerns about corporate misconduct to higher levels of authority within the corporation.

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Like the practices recommended in the previous section, Model Rule 1.13 addresses internal communications among the organization's lawyers, officers, employees and ultimate governing body. The first provision of that Rule recognizes that, for purposes of a lawyer's professional responsibilities, the client is the organization itself. It provides:

> (a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.[73]

Rule 1.13 next addresses the actions to be taken by the lawyer within the organizational client. The key provision, in current Rule 1.13(b), is that the lawyer must take appropriate action in the best interest of the client, namely the organization. While this obligation is a mandate, the Rule cannot and does not prescribe precisely what action is appropriate; the lawyer is obligated to exercise informed professional judgment in determining what steps are "reasonably necessary in the best interest of the organization." That can be determined, in specific detail, only in the context of the circumstances in which the problem arises. The current rule suggests, very generally, a few kinds of action open to the lawyer, but mandates none of them. The Task Force has concluded that these provisions confuse rather than clarify the mandatory nature of the lawyer's obligations under the rule, and accordingly recommends that they be deleted.[74]

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[73] The full text of existing Model Rule 1.13 and its Commentary is reproduced in Appendix A to this Report, along with a version marked to show the changes recommended by the Task Force. The Task Force is not recommending any change to Rule 1.13(a).

[74] For similar reasons, the Task Force recommends that the Comments to the present Rule be modified so as to remove or revise statements that

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In lieu of those open-ended provisions, the Task Force recommends two substantive revisions to Rule 1.13(b). The first is a refinement of the definition of the circumstances that trigger the lawyer's duty to take action within the organization. The second clarifies the circumstances in which the lawyer is required to communicate with a higher authority within the organization. Currently, Rule 1.13(b) requires a lawyer for an organizational client to act when the lawyer "knows"[75] that a person within the organization is violating or intends to violate the law and is likely to cause substantial injury to the organization. The Task Force recommends that this prerequisite be revised to differentiate between knowledge of facts and evaluation of legal consequences. As under the current rule, the starting point of the recommended rule is subjective: the obligation to take action would arise only on the basis of the facts known to the lawyer.[76] The

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discourage the lawyer from taking a matter up to higher authority within the organizational client.

[75] As defined in Model Rule 1.0(f), the terms "knowingly," "known," or "knows" refer to actual knowledge and do not include knowledge that could be imputed to the lawyer. Actual knowledge can, however, be inferred from circumstances. Furthermore, lawyers cannot close their eyes to the obvious, *i.e*. the lawyer may be deemed to "know" that which the lawyer consciously avoided knowing. *See* Comment [8] to Model Rule 4.2 and *ABA Formal Ethics Opinion* 346 (1982) (lawyers cannot "shut their eyes to what was plainly to be seen").

[76] In its Preliminary Report, the Task Force considered whether the triggering standard should be "reasonably should know," a standard that under Rule 1.0(j) denotes that "a lawyer of reasonable prudence and competence would ascertain the matter in question." The proposal to incorporate that standard in the trigger to required action under Rule 1.13 drew substantial criticism from those who presented testimony or statements to the Task Force. *See, e.g.,* written testimony of Prof. Thomas D. Morgan dated Sep. 20, 2002, at 16-17; written testimony of the New York County Lawyers' Association dated Oct. 25, 2002, at 5-6; written statement of Prof. Stephen Gillers, dated Oct. 25, 2002, at 2; written testimony of Patricia Lee Refo on behalf of the ABA Section of Litigation, at 13-15; written submission of the American Corporate Counsel

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proposed trigger for requiring action by the lawyer then proceeds to an objective test, namely, whether a reasonable lawyer who knows such facts would, in similar circumstances, conclude that the conduct in which a constituent is engaging or intends to engage constitutes a violation of law or duty to the organization that is likely to result in substantial injury to the organization. This standard recognizes that there is a range of reasonable conduct, and that a lawyer satisfies that standard by acting within that range. Moreover, it does not imply any duty on the lawyer's part to investigate or inquire further as to information provided by a client or the client's agent, or by a person to whom the lawyer has been referred by the client.[77] Although the lawyer is under no duty to investigate or inquire, however, the lawyer may not simply accept such information at face value if to do so would be unreasonable in the circumstances.

The second substantive change to Rule 1.13(b) recommended by the Task Force addresses the lawyer's obligation to report wrongdoing to higher authority in the organizational client. Currently, that rule identifies "reporting up" as a potential course of action when the lawyer has discerned an actual or threatened violation of law or violation of legal obligation to the organization, but the Rule imposes no clear obligation to pursue that course of action. The Task

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Association dated Nov. 11, 2002, at 6, all available on the Task Force Web Site. The concern of the critics was that this standard may impose a duty, of uncertain extent, to investigate that could only be evaluated after the fact with the benefit of hindsight. They noted also that the lawyer may not be able to insist that the client pay for, or even permit, the investigation that may, in the light of hindsight, prove to have been necessary.

[77] This standard is thus similar to the standard used to trigger the "reporting up" obligations in the Part 205 Rules. *See* §§ 205.3(b)(2) and 205.2(e).

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Force believes, however, that the Rule should more actively encourage such action, by requiring that the lawyer refer the matter to higher authority in the organization – including, if warranted, the organization's highest authority -- unless the lawyer reasonably believes that it is not necessary to do so.[78]

Thus, Rule 1.13(b) as recommended by the Task Force would provide:

> (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.

It is important to emphasize that Rule 1.13 is *not* a guide to "best legal practices." It provides instruction in the extraordinary circumstance of a significant failure of governance that puts or threatens to put the interest of the organization into serious legal jeopardy, and the nature of the required response of the lawyer for the organization if this extraordinary circumstance should occur. It does not limit the responsibility of the lawyer to act always in the best interest of the organization, and it certainly permits the lawyer to bring to the attention of the client, including its highest authority, matters not covered by the Rule, but which

[78] Thus, unlike the relatively rigid reporting requirements in the Part 205 Rules, proposed Rule 1.13 would continue to allow the lawyer to exercise professional judgment in determining the appropriate way to proceed in the best interest of the organization.

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the lawyer reasonably believes to be of sufficient importance that the client needs to be informed of them.

In its deliberations, the Task Force considered whether the lawyer's duties under the Rule should continue to be triggered only by matters that are "related to the representation." The Task Force's Preliminary Report recommended that the Rule require the lawyer to act with respect to any known violation, even if not related to the representation.[79] Others pointed out, however, that it would be unfair to hold responsible a lawyer working in one field of the law to understand that facts of which he was aware should have led to a conclusion of law violation in a field with which he was unfamiliar.[80] The Task Force is persuaded by this analysis and recommends that this qualification be retained in the Rule.[81]

The Task Force also recommends that Rule 1.13 be amended to include a new provision to assure that the organization's highest authority is made aware that a lawyer for the organization has withdrawn or is discharged in circumstances addressed by the Rule. In some instances, the actions of the

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[79] Preliminary Report at 29. Some commentators supported that preliminary recommendation. *See, e.g.,* letter of Prof. Myles V. Lynk dated Sep. 17, 2002, at 5.

[80] *See, e.g.,* statement of Mark L. Tuft on behalf of the Bar Association of San Francisco, Nov. 11, 2002, at 15, available on the Task Force Web Site.

[81] The Part 205 Rules are triggered if "an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware" of a violation. This does not seem to require a nexus with the representation. The rule proposal read differently: "If, in appearing and practicing before the Commission in the representation of an issuer, an attorney becomes aware ... ." This wording seems to require that the knowledge be obtained in the course of the representation. The release promulgating the Part 205 Rules gave no explanation for the change.

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lawyer within the organization, pursuant to Rule 1.13(b), may fail to prevent or avoid action that seriously threatens the interest of the organization. Current Rule 1.13(c) provides that a lawyer, in this circumstance, may choose to withdraw.[82] In that event, or if the organizational client discharges the lawyer because of the lawyer's actions under Rule 1.13(b) in reporting to higher authority, the lawyer's professional obligations to act in the best interest of the organization should require the lawyer to take reasonable steps to assure that the organization's highest authority is aware of the withdrawal or discharge, and the lawyer's understanding of the circumstances that brought it about. Therefore, the Task Force recommends the adoption of a new Rule 1.13(e) providing:

> (e) 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.

Finally, because the corporate failures that prompted the appointment of the Task Force were concerned exclusively with public corporations, the Task Force also explored the possibility of suggesting a new Model Rule, patterned on Model Rule 1.13, but limited to organizations with publicly traded securities. The Task Force concluded, however, that it was not appropriate to craft a special rule.[83] In any situation in which an organization has multiple owners or members

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[82] In the interest of clarity, the Task Force recommends that this choice be reflected in the Commentary to the Rule, through reference to Rule 1.16, rather than by reference in the text of the Rule itself.

[83] The Part 205 Rules, of course, do establish obligations applicable only to lawyers representing public corporations.

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(such as minority owners in a closely held business) other than the organization's managers, the lawyer's duty to the organizational client is an important safeguard. Thus, the modifications of the duties defined in Model Rule 1.13 recommended by the Task Force are likely to be of value to corporations without publicly traded securities, charitable organizations, other not-for-profit entities, and governmental organizations. Conversely, the Task Force has not identified any particular respect in which the recommended modifications to Rule 1.13 would be appropriate for public corporations but inappropriate for other organizational clients.

B. Confidentiality and its Limitations

1. *Existing Law and Policy*

As many of those commenting on the Task Force's Preliminary Report emphasized, the attorney-client relationship is one of trust and confidence, dependent upon strong recognition of the lawyer's general duty to maintain the confidence of client information.[84] It is a fundamental principle of the client-lawyer relationship that, except with the client's informed consent, the lawyer

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84 *See, e.g.,* testimony of Hon. Charles B. Renfrew on behalf of the American College of Trial Lawyers; Preliminary Statement of Attorneys' Liability Assurance Society, Inc., at 6-7; testimony of Patricia Lee Refo on behalf of the ABA Section of Litigation, at 11-12; letter of Oct. 30, 2002 on behalf of the Los Angeles County Bar Association; testimony of the State Bar of California Committee on Professional Responsibility, at 7-10. All of these submissions are available on the Task Force Web Site. *See also* Comment c to RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §68 (2000) (discussing the rationale for the attorney-client privilege, including the view that "clients would be unwilling to disclose personal, embarrassing, or unpleasant facts unless they could be assured that neither they nor their lawyers could be called later to testify to the communication.").

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must not reveal to third parties information relating to the representation.[85] This principle underlies the trust that should be the keystone of the client-lawyer relationship. A client must feel free to seek legal assistance and to communicate fully and frankly with the client's lawyer. Without such full and frank communication the lawyer will be unable to represent the client effectively. Many legal rules are complex and most are fact-specific in their application. Lawyers are better situated than non-lawyers to appreciate the effect of legal rules and to identify facts that determine whether a legal rule is applicable. Full disclosure by clients facilitates efficient presentation at trials and other proceedings and in a lawyer's advising functions.

In the view of the Task Force, however, some commentators who emphasized the importance of trust and confidence in the attorney-client relationship have ignored exceptions to confidentiality principles that have developed to serve other policy purposes. Such exceptions are already well established in the Model Rules and in the lawyer disciplinary rules of most states. For example:

- Where a lawyer's withdrawal from representation will not avoid continued assistance to a client's crime or fraud, the lawyer may be required under the existing Model Rules to "disaffirm an opinion, document or affirmation or the like" previously given by the lawyer.[86]

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85 This paragraph paraphrases Comment [2] to Model Rule 1.6.

86 Model Rule 4.1(b), and Comment [3]. As that comment explains, Model Rule 4.1(b)'s duty to disclose is simply "a specific application of the principle set forth in Rule 1.2(d) and addresses the situation where a client's crime or fraud takes the form of a lie or misrepresentation."

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- Where a lawyer representing a client in an adjudicative proceeding knows that the client has testified falsely, the lawyer may be required, not merely permitted, to disclose the falsity to the tribunal, even if the result is the client's loss of the case and a prosecution for perjury.[87]
- To the extent reasonably believed to be necessary, the lawyer is allowed to disclose information relating to the representation of a client in order to establish a claim or defense in a case against the client, including an action seeking recovery of legal fees.[88]
- The lawyer disciplinary rules of forty-one states permit a lawyer to disclose client information in order to prevent a client from perpetrating a fraud that constitutes a crime, and eighteen states permit such disclosure to rectify substantial loss resulting from client crime or fraud in which the client used the lawyer's services.[89]

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[87] Model Rule 3.3(b), and Comments [10] – [11].

[88] Model Rule 1.6(b)(3), and Comment [9].

[89] States that permit disclosure to prevent crime: Alaska (Alaska Rules of Prof'l Conduct R. 1.6 (2001)); Arizona (Ariz. Rules of Prof'l Conduct ER 1.6 (2002)); Arkansas (Ark. Rules of Prof'l Conduct R. 1.6 (2002)); Colorado (Colo. Rules of Prof'l Conduct R 1.6 (2002)); Connecticut (Conn. Rules of Prof'l Conduct R. 1.6 (2002)); Florida (Fla. Rules of Prof'l Conduct R. 1.6(2002)); Georgia (Ga. State Bar R. 1.6 (2002)); Hawaii (Haw. Rules of Prof'l Conduct R.1.6 (2002)); Idaho (Idaho Rules of Prof'l Conduct. R. 1.6 (2002)); Illinois (Ill. Rules of Prof'l Conduct R.1.6 (2002)); Indiana (Ind. Rules of Prof'l Conduct R.1.6 (2002)); Iowa (Iowa Code or Prof'l Responsibility DR 4-101(2002)); Kansas (Kan. Sup. Ct. Rules R. 1.6 (2001)); Massachusetts (Mass. Rules of Prof'l Conduct R. 1.6 (2002)); Maryland (Md. Rules of Prof'l Conduct R. 1.6 (2002)); Maine (Me. R. Bar 3.6 (2002)); Michigan (Mich. Rules of Prof'l Conduct R 1.6 (2002)); Minnesota (Minn. Rules of Prof'l Conduct R. 1.6 (2001)); Mississippi (Miss. Rules of Prof'l Conduct R. 1.6 (2002)); Nebraska (Neb. Code of Prof'l Responsibility DR 4-101 (2002)): Nevada (Nev. Rules of Prof'l Conduct R. 156(2002)); New

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All of these exceptions could be said to detract from the atmosphere of confidentiality conducive to clients' disclosure of important information to their

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Hampshire (N.H. Rules of Prof'l Conduct R. 1.6 (2002)); New Jersey (N.J. Rules of Prof'l Conduct R. 1.6 (2002)); New Mexico (N.M Rules of Prof'l Conduct R.16-106 (2002)); New York (N.Y. Code of Prof'l Responsibility DR 4-101(2002)); North Carolina (N.C. Rules of Prof'l Conduct R. 1.6 (2002)); North Dakota (N.D. Rules of Prof'l Conduct R. 1.6 (2002)); Ohio (Ohio Code of Responsibility DR4-101) (2002)); Oklahoma (Okla. Rules of Prof'l Conduct R.1.6 (2002)); Oregon (Or. Code of Prof'l Responsibility DR 4-101(2002)); Pennsylvania (Pa. Rules of Prof'l Conduct R.1.6 (2002)); South Carolina (S.C. Rules of Prof'l Conduct R. 1.6 (2001)); Tennessee (Tenn. Rules of Prof'l Conduct R. 1.6 (2003)); Texas (Tex. Rules of Prof'l Conduct R. 1.05(2002)), Utah (Utah Rules of Prof'l Conduct R. 1.6 (2002)); Vermont (Vt. Rules of Prof'l Conduct R. 1.6(2001)); Virginia (Va. Rules of Prof'l Conduct R. 1.6 (2002)); Washington (Wash. Rules of Prof'l Conduct R. 1.6 (2002)); Wisconsin(Wis. Rules of Prof'l Conduct R. 1.6 (2002)); West Virginia (W. Va Rules of Prof'l Conduct R. 1.6 (2002)); Wyoming (Wyo. Rules of Prof'l Conduct R. 1.6(2002)).

States that require such disclosure: Florida (Fla. Rules of Prof'l Conduct R. 1.6(2002)); New Jersey (N.J. Rules of Prof'l Conduct R. 1.6 (2002)); Virginia (Va. Rules of Prof'l Conduct R. 1.6(2002); Wisconsin (Wis. Rules of Prof'l Conduct R. 1.6(2002)).

States that permit disclosure to rectify substantial loss resulting from client crime or fraud using the lawyer's services: Connecticut (Conn. Rules of Prof'l Conduct R. 1.6 (2002)); Hawaii (Haw. Rules of Prof'l Conduct R.1.6 (2002)); Massachusetts (Mass. Rules of Prof'l Conduct R. 1.6 (2002)); Maryland (Md. Rules of Prof'l Conduct R. 1.6 (2002)); Michigan (Mich. Rules of Prof'l Conduct R. 1.6 (2002)); Minnesota (Minn. Rules of Prof'l Conduct R. 1.6 (2001)); Nevada (Nev. Rules of Prof'l Conduct R. 156 (2002)); New Jersey (N.J. Rules of Prof'l Conduct R 1.6 (2002)); North Carolina (N.C. Rules of Prof'l Conduct R. 1.6 (2002)); North Dakota (N.D. Rules of Prof'l Conduct R. 1.6 (2002)); Ohio (Ohio Code of Prof'l Responsibility DR 7-102(B)(1) (2002)); Oklahoma (Okla. Rules of Prof'l Conduct R. 1.6(2002)); Oklahoma (Okla. Rules of Prof'l Conduct R. 1.6 (2002)); Pennsylvania (Pa. Rules of Prof'l Conduct R. 1.6(2002)); South Dakota (S.D. Rules or Prof'l Conduct R. 1.6 (2002); Texas (Tex. Rules of Prof'l Conduct R. 105 (2002)); Utah (Utah Rules of Prof'l Conduct (2002)); Virginia (Va. Rules of Prof'l Conduct R. 1.6(2002)); Wisconsin (Wis. Rules of Prof'l Conduct R. 1.6 (2002)).

States that require such disclosure: Hawaii (Haw. Rules of Prof'l Conduct R. 1.6 (2002)); Ohio (Ohio Code of Prof'l Responsibility DR 4-101(2002)); Oklahoma (Okla. Rules of Prof'l Conduct R. 1.6 (2002)).

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lawyers, yet these limitations exist and serve similarly important policy purposes, including the protection of the ultimate client or third parties, and the protection of the professional integrity of the lawyer. This balancing of competing policy interests represents a carefully developed system of lawyer regulation. The Task Force believes that the ABA and the legal profession must be mindful of these competing policies in reviewing the Model Rules as applicable to the lawyer for the organizational client as well as mindful of the potential for further regulatory intrusion into the critical domain of the attorney-client relationship.[90]

The Model Rules' treatment of the lawyer's obligation of confidentiality is significantly out of step with the policy balance reflected in the rules of professional conduct in most of the states, in Section 67 of the RESTATEMENT THIRD, THE LAW GOVERNING LAWYERS,[91] and in the recommendations of the ABA Commission on Evaluation of the Rules of Professional Conduct ("Ethics 2000 Commission").[92] The Task Force believes that this inconsistency has become

[90] As noted above, the SEC has deferred action on a proposal to require the lawyer to report illegal conduct to the SEC in order to permit further public comment and consideration of a company reporting alternative. Commenting on that action, former SEC Chairman Arthur Levitt noted: "The Commission wisely delayed action requiring lawyers who uncover securities law violations to resign and notify the SEC if the company does not take appropriate action. This does not mean the issue should die. The legal community and the SEC have a duty to find a creative solution that doesn't pierce attorney-client confidentiality yet sends a strong message to investors that their ultimate ownership will be honored." Arthur Levitt, Jr., "The SEC's Repair Job," Wall Street Journal, Feb. 10, 2003.

[91] The "RESTATEMENT."

[92] Ethics 2000 Report with Recommendation to the House of Delegates (August 2001), available at http://www.abanet.org/cpr/e2k-report_home.html.

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increasingly dissonant in the last year, as public opinion has demanded that lawyers play a greater role in promoting corporate responsibility.[93]

2. *Conforming Model Rule 1.6 to Existing Law and Policy*

The Task Force therefore recommends that Model Rule 1.6(b) be amended, as proposed by the Ethics 2000 Commission, to provide that:

> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: …
>
> > (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; [and]
> >
> > (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; … .

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

93 *See* Lisa H. Nicholson, *A Hobson’s Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper,* 16 GEO. J. LEGAL ETHICS 91 (2002).

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furtherance of a serious crime or fraud must be balanced against the importance to the client-lawyer relationship of the principle of confidentiality.[94]

The Model Rules leave no room for doubt as to whether a lawyer may permit his services to be used by a client for criminal or fraudulent activity. Model

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[94] The Task Force's Preliminary Report (at 32) proposed a balance in which the lawyer would be required, not just permitted, to disclose client information "in order to prevent client conduct known to the lawyer to involve a crime, including violations of federal securities laws and regulations, in furtherance of which the client has used or is using the lawyer's services, and which is reasonably certain to result in substantial injury to the financial interests or property of another." This proposal engendered strong criticism (*see* notes 76 and 84, *supra*), and the Task Force has determined to modify that recommendation. The ABA's comment letter to the SEC on the proposed Part 205 Rules (note 9, *supra*) explains the reasons for that modification in the following passage commenting on the proposal to require lawyers to report to the SEC:

> We believe that the proposed Section 307 rules that mandate withdrawal from representation, notice to the SEC and disaffirmance risk destroying the trust and confidence many issuers have up to now placed in their legal counsel, creating divided loyalties and driving a wedge into the attorney-client relationship. Providing notice to the SEC that the attorney has withdrawn "for professional considerations" and disaffirming specific documents will have a similar effect as a violation of client confidences, and may itself be a violation of the attorney's duties to the client under state court rules, because it will promptly trigger an enforcement investigation and potentially civil lawsuits. As a consequence, some issuers might not even consult qualified attorneys regarding close issues of whether or not to disclose information in a filing or otherwise because the attorney might engage in a noisy withdrawal even though all that may have been involved was a matter of business judgment as to the materiality of certain information.
>
> Moreover, mandating withdrawal and disaffirmance removes the flexibility that lawyers need in order to have time to counsel their corporate clients effectively. In some instances, premature withdrawal and disaffirmance of documents might seriously and unfairly harm the issuer and its shareholders or create disruption in the market for issuer's securities, when more time spent with managers or expert advisers might have avoided the need for the attorney to employ so extreme a measure. Such consultations also may prove the attorney to be wrong in believing any material violation will occur.

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Rule 1.2(d) provides that a lawyer "shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent." And Model Rule 4.1 provides that, in the course of representing a client, a lawyer "shall not knowingly . . . make a false statement of material fact or law to a third person," and that a lawyer shall not knowingly "fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client." But what if the client has misled the lawyer, leading the lawyer to believe that the client is pursuing a lawful and honest purpose while in fact using the lawyer's work product to perpetrate a crime or fraud? In such circumstances should the lawyer be prohibited from taking action to prevent or rectify such misuse of the lawyer's services?

The Ethics 2000 Commission believed, and the Task Force agrees, that the use of the lawyer's services for such improper ends constitutes an abuse by the client of the client-lawyer relationship, forfeiting the client's absolute entitlement to the protection of Model Rule 1.6. In such circumstances, the Task Force believes that the lawyer must be permitted, where the crime or fraud has resulted or is reasonably certain to result in substantial injury to the financial interests or property of third parties, to reveal information relating to the representation as reasonably believed necessary to prevent the commission of, or to prevent or rectify the consequences of, the crime or fraud.[95]

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[95] Comment f to RESTATEMENT §67 further explains:

> Once use or disclosure of information has been made to prevent, rectify, or mitigate loss under Subsection (2), the lawyer is not further warranted in actively assisting the victim on an ongoing basis in pursuing a remedy

As noted earlier, there is a long-standing exception to Model Rule 1.6 that permits a lawyer to reveal information relating to a representation "to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client." We believe that it is at least as important to society, and to the integrity of the profession, to permit disclosure in order to prevent the lawyer's services from being used in the commission of a crime or fraud as it is to permit disclosure in order to collect the lawyer's fee or to protect the lawyer from a client's unmeritorious civil claim.

In opposition to the proposal to amend Model Rule 1.6, it has been suggested that the disclosure to third parties permitted under the laws of most states is "rarely if ever employed," and there is therefore no need to amend Rule 1.6.[96] The Task Force is not persuaded by this suggestion. Even if the authorization to disclose afforded by most states' disciplinary rules is not often used, the existence of the such authority gives lawyers the opportunity to use that power to encourage the client to remediate or refrain from unlawful conduct.

3. *Confidentiality for the Organizational Client*

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against the lawyer's client or in any similar manner aiding the victim or harming the client. Thus, a lawyer is not warranted under this Section in serving as legal counsel for a victim …, volunteering to serve as witness in a proceeding by the victim, or cooperating with an administrative agency in obtaining compensation for victims. The lawyer also may not use or disclose information for the purpose of voluntarily assisting a law-enforcement agency to apprehend and prosecute the client, unless the lawyer reasonably believes that such disclosure would be necessary to prevent, rectify, or mitigate the victim's loss.

96 Statement of Patricia Lee Refo on behalf of the ABA Section of Litigation, Nov. 11, 2002, at 11, available on the Task Force Web Site.

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The balance of confidentiality considerations described above applies to both individual and organizational clients. The Task Force has focused, however, on two additional aspects of the duty of confidentiality that require further elaboration with respect to organizational clients. The first such aspect is the uncontroversial but perhaps not universally understood proposition that a lawyer does not violate Model Rule 1.6 by disclosing to an organizational constituent, acting as such, information relating to the representation that was imparted to the lawyer by another organizational constituent (*e.g.*, by sharing with a corporation's general counsel or its board of directors facts learned from a corporate officer). Organizational constituents thus cannot legitimately expect that the lawyer will not reveal to others within the organization information they have imparted to the lawyer.

The second aspect on which the Task Force has focused arises because, just as with individual clients, full and frank communication with the organization's lawyer is encouraged if organizational constituents expect that information they communicate to the organization's lawyer will not be revealed outside the organization (except as the organization may decide). That expectation is undoubtedly valuable to an organizational client as a general proposition. The organization may have a countervailing interest, however, when a lawyer's actions within the organization, including advice to the organization's highest authority, are unavailing to protect the organization against substantial injury arising from a constituent's violation of law. In such a circumstance, the organization's interest in having the lawyer proceed "as is reasonably necessary

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in the best interest of the organization"[97] may outweigh the organization's general interest in preserving confidentiality.[98]

The Task Force therefore recommends the adoption of the following new provision in Rule 1.13 that permits, but does not require, the lawyer for the organization to communicate with persons outside the organization in order to prevent substantial injury to the organization:

(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.

The Task Force agrees with the Reporter to the Restatement that Model Rule 1.6 " … should not be understood to preclude controlled disclosure beyond the organization in the limited circumstances where the wrongdoing is clear, the injury to the client organization is substantial, and disclosure would clearly be in

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[97] Model Rule 1.13(b).

[98] Existing Model Rule 1.13 reflects this tension between the two ethical policy considerations when it states that any measures taken by the lawyer should "be designed to minimize . . . the risk of revealing information relating to the representation to persons outside the organization." In the Task Force's recommended changes this proposition would become part of Comment [4] to Rule 1.13.

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the interest of the entity client."[99] The Task Force considers this especially important in the circumstance in which the board of directors or other highest authority of the organizational client is disabled from acting in the best interest of the organization, *e.g.*, because of self-interest or personal involvement in the violation.[100]

Because such disclosure may reveal client information otherwise protected under Rule 1.6(a), the proposed addition to Rule 1.13 contains strict conditions that must exist before any "reporting out" is allowed. The lawyer must have a heightened level of certainty as to the violation of law, and the actual or threatened violation must be "clear." Moreover, there is no permission to "report out" when the organizational governance failure involves a violation of legal duty to the organization but is not otherwise a violation of law. As under Rule 1.6, communication of client information outside the organization must be limited to information reasonably believed to be necessary to prevent substantial injury to the organization that is reasonably certain to occur. In most circumstances, this limitation would permit communication only with persons outside the organization who have authority and responsibility to take appropriate preventive action.

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[99] Comment f to RESTATEMENT § 96.

[100] Model Rule 1.14, which deals with clients who are natural persons suffering diminished capacity due to minority, mental impairment, or similar reasons, while not entirely apposite, is analogous. In those circumstances the lawyer for the disabled client is "impliedly authorized under Rule 1.6(a) to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests." The Task Force's proposed Model Rule 1.13(c) seeks to accomplish the same result for an organizational client where the capacity of its governing board or other highest authority to act in the best interest of the organization is diminished by its self-interest or personal involvement in the violation.

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The Task Force has also concluded that there are two circumstances in which a lawyer for an organizational client should not be permitted to reveal information relating to a representation, even where the governing authority is disabled from acting or unwilling to act in the organization's best interest. One such circumstance involves the lawyer who has been engaged by the organization to investigate whether an organizational constituent has committed a material violation of law or a breach of duty to the organization. The organization in such a circumstance has an especially compelling need for the ground rules of that investigation to promote open and frank communications between the investigating lawyer and organizational constituents. It is essential to minimize obstacles in the way of the investigating lawyer's testing the truth of the allegation.

In addition, a lawyer who has been engaged by an organization or a constituent to defend against a claim of a violation of law has an especially compelling need to obtain from organizational constituents all information that might support a meritorious defense to such a claim, without fear by the constituents that the lawyer may disclose the information to a third party. The importance of the advocate's role in our adversarial dispute resolution process justifies denying to a lawyer in this role the authority under Rule 1.13, as recommended by the Task Force, to reveal information relating to the representation outside the organization.[101]

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[101] The Task Force notes that the SEC made similar provision in §§205.3(b)(6) and (7) of the Part 205 Rules.

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The Task Force therefore recommends the addition of the following paragraph (d) in Rule 1.13 as a limitation on the recommended addition of Rule 1.13(c):

> (d) 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.

The Task Force considered whether to recommend a similar provision for investigative and defense lawyers in its Model Rule 1.6 proposals. The Task Force concluded, however, that such a provision is unnecessary. The exceptions proposed to be added to Model Rule 1.6 apply only if the lawyer's services have been, are being, or will be used by the client in the furtherance of the crime or fraud. It is unlikely at best that in such a circumstance the lawyer would or even could agree to represent the organization or a constituent in investigating or defending a claim arising out of the crime or fraud in which the lawyer's services were used. To the contrary, the lawyer would have a personal interest in exposing and preventing or rectifying any crime or fraud, and the lawyer should not undertake the investigation or defense.[102] Therefore, investigating and defense counsel engaged with respect to alleged crime or fraud should never be in a position to reveal information relating to that representation pursuant to the Task Force's recommended changes in Model Rule 1.6.

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102 *See* Model Rule 1.7(a)(2).

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While the recommendations of the Task Force focus on ways that lawyers for a corporation can be more effective in their counseling role to encourage compliance with legal obligations, the Task Force believes that lawyers who represent a corporation have a duty, whenever the situation may present itself, to strongly advise senior executive officers that actions they may be contemplating which violate the law, including the perpetration of a fraud, should not be taken and are always contrary to the legitimate interests of the corporation. Moreover, lawyers representing a corporation are encouraged whenever appropriate to bring a "public" perspective into their counseling which takes into account not merely specific legal obligations or requirements, but likely reactions of persons outside the corporation such as government officials and even the public at large, especially when those reactions may create legislative, regulatory or litigation risks. Indeed, lawyers for a corporation, particularly in-house counsel, are frequently expected to provide an ethical, as well as a legal, perspective in their advice to senior executive officers. The Task Force endorses this expectation and urges boards of directors and senior executive officers to invite their counsel to provide such perspective as being in the best interest of the corporation and related to the goal of instilling a culture of legal compliance and corporate responsibility.

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VI. RECOMMENDED CORPORATE GOVERNANCE PRACTICES

The Task Force recommends the governance practices set forth below as a means to improve the effectiveness of oversight by boards of directors of public corporations (with appropriate exceptions for corporations with controlling shareholders and for foreign private issuers).[103] In most if not all instances, practices substantially similar to these recommendations either have been or will be imposed by legislation or stock market listing standards, or are recommended by significant authorities on corporate governance. For each recommendation set forth below, such comparable law, listing standards and recommendations are briefly identified for purposes of comparison.

1. A substantial majority of the members of the board of directors should be independent of the corporation's senior executive officers, both in fact and in appearance.[104]

Among the other proponents of a similar requirement or guideline are:

- The NYSE, which has proposed such a principle as a standard (requiring a majority of independent directors) for listed companies other than companies with ownership of 50% or more of the corporation's voting stock. Proposed Rule 303A(1).

[103] Such exceptions are recognized in the listing standards currently proposed by the NYSE and Nasdaq. Those exceptions rest on important legal and practical considerations (including the rights associated with majority share ownership and the legal obligations of corporations organized under the laws of countries other than the United States). The Task Force recognizes that other legal or practical considerations may justify departure from some or all of the proposed practices, even for a public corporation, and the practice recommendations set forth here should be presumptively, but not invariably, applied.

[104] In implementing this recommendation, public corporations that maintain an executive committee of the board of directors should not constitute the membership of the committee and confer authority upon it so as to evade the substance of this recommendation.

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- Nasdaq (same). Proposed Rule 4350(c)(1).

- The Business Roundtable, which has recommended that "a substantial majority of directors of the board of a publicly owned corporation should be independent of management, both in fact and appearance, as determined by the board." May 2002 Principles of Corporate Governance, at 11.

- The Conference Board, which has recommended that "a substantial majority of the board should be composed of independent directors." January 9, 2003 Findings and Recommendations Part 2, at 23.

- The Higgs Report, which recommends that, for UK public companies, "at least half of the members of the board, excluding the chairman, should be independent non-executive directors." January 2003 Higgs Report at 35.

2. The independent directors should meet regularly outside the presence of any senior executive officer.

Comparable recommendations include:

- NYSE Proposed Rule 303A(3), requiring non-management directors to meet at regularly scheduled executive sessions without management.

- Nasdaq Proposed Rule 4350(c)(2), requiring independent directors to have regularly scheduled meetings at which only independent directors are present.

- Business Roundtable May 2002 Principles of Corporate Governance at 25 ("Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.").

- The Conference Board January 9, 2003 Findings and Recommendations Part 2 at 6 ("having frequent, regular meetings of the non-management directors is a key structural component for oversight of the CEO function.").

- Higgs Report at 34 ("the non-executive directors should meet at least once a year without the chairman or executives present").

3. The board of directors should establish a committee (described in these recommendations as the corporate governance committee)

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composed exclusively of independent directors with responsibility for the identification and nomination (or recommendation of nomination) of independent members of the board of directors, and for extending invitations to prospective independent board members.

Comparable recommendations include:

- NYSE Proposed Rule 303A(4), requiring a "nominating/corporate governance committee" composed exclusively of independent directors, with responsibility to "identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders."
- Nasdaq Proposed Rule 4350(c)(4), requiring the director nominations be approved either by a majority of the independent directors or by a nominations committee comprised solely of independent directors.
- Business Roundtable May 2002 Principles of Corporate Governance at 20-21, recommending that a corporate governance committee "perform[ ] the core function of recommending nominees to the board," and that "while it is appropriate for the CEO to meet with potential director nominees, the final responsibility for selecting director nominees rests with the board."
- Conference Board January 9, 2003 Findings and Recommendations Part 2 at 24, recommending that the "nominating/governance committee" be composed exclusively of independent directors and "be responsible for nominating qualified candidates to stand for election to the board."
- Higgs Report at 40, recommending that the nomination committee consist of a majority of independent non-executive directors, "which should lead the process for board appointments and make recommendations to the board."

4. **The corporate governance committee should appoint (or recommend to the full board of directors the appointment of) the persons to serve on each of the other standing committees of the board.**

Comparable recommendations include:

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- NYSE Proposed Rule 303A(4), commentary ("board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees.").

- Business Roundtable May 2002 Principles of Corporate Governance at 13 ("Decisions about committee membership should be made by the full board, based on recommendations from a committee responsible for corporate governance issues.").

- Conference Board January 9, 2003 Findings and Recommendations Part 2 at 24 ("the nominating/governance committee should recommend to the full board of directors … an appropriate board organization, including committee assignments.").

5. **The board of directors should establish an audit committee, composed exclusively of independent directors.**

   a. **The audit committee should meet regularly outside the presence of any senior executive officer.**

   b. **The audit committee should be:**

      i. **authorized to engage and remove the corporation's outside auditor (or if legally permissible, to recommend such engagement or removal to the Board), and to determine the terms of the engagement of the outside auditor;**

      ii. **authorized and afforded resources sufficient to engage independent accounting and legal advisers when determined by the committee to be necessary or appropriate; and**

      iii. **responsible for recommending or establishing policies relating to non-audit services provided by the corporation's outside auditor to the corporation and other aspects of the corporation's relationship with the outside auditor that may adversely affect that firm's independence.**

   c. **The resolution of the board of directors creating the committee should specify whether the foregoing decisions are to be made exclusively by the audit committee, or**

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(where legally permissible) by the full board of directors (or by the independent directors) upon the recommendation of the committee.

Section 301 of the Sarbanes-Oxley Act of 2002 requires the SEC to adopt rules requiring the national securities exchanges and national securities associations to adopt listing standards providing, among other things, that (i) each member of the audit committee be independent, (ii) the audit committee be "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed" by the company, and (iii) the audit committee have authority to engage independent counsel and other advisers. On January 8, 2003 the SEC proposed rules to implement these statutory requirements.[105] The Sarbanes-Oxley Act (§201, adding Section 10A(h) of the Exchange Act) also requires that public company auditing firms perform permitted non-audit services only upon advance approval by the audit committee.

The listing standards prescribed by Section 301 of the Sarbanes-Oxley Act of 2002 appear to require that the board of directors delegate to the audit committee direct and exclusive responsibility for the matters specified in the statute. The Task Force's recommendations differ in that they would allow the full board of directors (or all of the independent directors) to act on such matters, upon recommendation of the audit committee acting pursuant to the recommended procedures. The Task Force prefers this approach because of the potential benefits of information and insight that may be gained from other independent directors and even from directors who do not meet prevailing standards of independence.

6. **The board of directors should establish a compensation committee, composed exclusively of independent directors.**

    a. **The compensation committee should meet regularly outside the presence of any senior executive officer.**

    b. **The compensation committee should be responsible for determining, or making a recommendation with respect to, the compensation (including executive benefit plans) of the senior executive officers of the corporation.**

    c. **The compensation committee should be authorized and afforded resources sufficient to engage independent**

[105] Proposed Exchange Act Rule 10A-3, available at http://www.sec.gov/rules/proposed/34-47137.htm .

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executive compensation and legal advisers when determined by the committee to be necessary or appropriate.

d. In determining or recommending the amount, form and terms of compensation of senior executive officers, the compensation committee should (i) evaluate the performance of such officers, and (ii) be guided by, and seek to promote, the long term interests of the corporation and its shareholders.

e. The resolution of the board of directors creating the committee should specify whether the foregoing decisions are to be made exclusively by the compensation committee, or by the full board of directors (or by the independent directors) upon the recommendation of the committee.

f. In deliberating on the compensation of the chief executive officer, the compensation committee should meet outside the presence of any senior executive officer; the chief executive officer may, if the compensation committee chooses, participate in the deliberations on the compensation of any other officer.

Comparable recommendations include:

- NYSE Proposed Rule 303A(5), requiring a compensation committee, composed exclusively of independent directors, responsible for discharging “the board’s responsibilities relating to compensation of the company’s executives,” including review of the CEO’s performance and establishment of the CEO’s compensation level. The commentary to the proposed rule also provides that “the compensation committee charter should give that committee sole authority to retain and terminate [a compensation] consulting firm, including sole authority to approve the firm’s fees and other retention terms.”

- Nasdaq Proposed Rule 4350(c)(3), requiring that (i) CEO compensation be determined either by a majority of independent directors or a compensation committee comprised solely of independent directors, meeting in both cases in executive session, and (ii) other officer compensation be determined either by a majority of independent directors or a compensation committee comprised solely of independent directors, with the CEO entitled to be present but not to vote.

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- Business Roundtable May 2002 Principles of Corporate Governance at 21-22, recommending "a committee comprised solely of independent directors that addresses compensation issues," including "the corporation's overall compensation programs, and setting CEO and senior management compensation." The Business Roundtable Principles also recommend that "[a]ll incentives should further the corporation's long-term strategic plan and should be consistent with the culture of the corporation and the overall goal of enhancing enduring stockholder value." (*id.*).

- Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations, Part I: Executive Compensation at 8, recommending that: "The Compensation Committee should retain any outside consultants who advise it, and the outside consultants should report solely to the Committee;" … The Compensation Committee should be comprised solely of directors who are free of any relationships with the company (except for compensation received in their role as directors) and its management and who can act independently of management in carrying out their responsibilities; … The Compensation Committee should vigorously exercise continuous oversight over all matters of executive compensation policy; … The Compensation Committee should hold executive sessions as required (for example, to determine CEO pay and stock option grants) and the Committee should exercise its power to schedule meetings and set its own agenda." The Conference Board Commission also recommends that the compensation committee "establish, with the concurrence of the board, performance-based incentives that support and reinforce the corporation's long-term strategic goals set by the board … , and whose award is linked to achievement of specific strategic goals." (*Id.* at 9).

- Higgs Report at 61, recommending that "all members of the remuneration committee should meet the test of independence," that "the committee should have delegated responsibility for setting remuneration for all executive directors and the chairman," and that "the committee should be responsible for appointing remuneration consultants."

For the reasons explained in connection with its recommendations relating to the audit committee, the Task Force's recommendations relating to the compensation committee allow for the possibility that senior executive compensation be set by action of the full board of directors or all

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of the independent directors, upon recommendation of the compensation committee acting pursuant to the procedures recommended.

7. **The corporate governance committee (or another committee consisting exclusively of independent directors) should adopt (or recommend to the full board of directors) a corporate code of ethics and conduct that includes the establishment of one or more mechanisms through which information concerning violations of law by the corporation or its management personnel, or breaches of fiduciary duty to the corporation which could have a material effect on the corporation, not appropriately addressed by corporate officers, can be freely transmitted to more senior officers and, if necessary, to a committee consisting solely of independent directors.**

The Sarbanes-Oxley Act of 2002 in several ways addresses corporate codes of ethics and mechanisms for reporting violations of law or breaches of duty to the corporation. Section 406, as implemented by SEC rulemaking on January 20, 2003,[106] requires public companies to adopt (or disclose reasons for not adopting) codes of ethics for certain executive officers that include mechanisms for "the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code." Section 301 of the Act also requires that a listed company's audit committee "establish procedures for … the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

Recommendations comparable to the practices recommended here include:

- NYSE Proposed Rule 303A(10), requiring adoption of a code of business conduct and ethics that encourages "the reporting of any illegal or unethical behavior," with measures to "ensure that employees know that the company will not allow retaliation for reports made in good faith."

- Nasdaq Proposed Rule 4350(m), requiring "a code of conduct addressing, at a minimum, conflicts of interest and compliance with applicable laws, rules and regulations, with an appropriate compliance mechanism and disclosure of any waivers to executive officers and directors."

- Business Roundtable May 2002 Principles of Corporate Governance at 10, recommending that "a corporation should have a code of conduct

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[106] SEC Release 33-8177, available at http://www.sec.gov/rules/final/33-8177.htm .

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with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively."

- Conference Board January 9, 2003 Findings and Recommendations Part 2 at 25, recommending that boards considering adopting "programs to ensure that employees understand, apply, and adhere to the company's code of ethics," and "processes that encourage and make it safe for employees to raise ethical issues and report possible ethical violations."

8. **In addition to approvals required by law, a committee composed exclusively of independent directors and appointed for the purpose by or on the recommendation of the independent directors or a committee composed exclusively of such directors, should review and approve any material transaction between the corporation and any director or senior executive officer of the corporation (and any person or entity controlling or controlled by such director or officer, or in which such director or officer has a direct or indirect material financial interest), including (where permitted by law) a loan or guarantee by the corporation. Such review and approval should include (i) an explanation of why the transaction is in the best interests of the corporation without regard to the interest or desire of the individual (or related person or entity); (ii) a documented rationale for engaging in the transaction with a related party rather than with a third party; (iii) a specific determination of the fairness of the transaction; and (iv) a review of the public disclosure that may be appropriate for the transaction.**

   The Nasdaq has proposed adoption of a listing standard that would require that all "related party transactions" – defined as transactions required to be disclosed under Item 404 of SEC Regulation S-K – be approved by the corporation's audit committee or other body of independent directors.[107]

9. **The board of directors should charge a committee composed exclusively of independent directors (such as an audit committee or a legal compliance committee) with responsibility to obtain and evaluate regular reports from the corporate officers responsible for implementing the corporation's internal controls, codes of**

[107] Proposed Rule 4350(h), available at http://www.nasdaq.com/about/SR-NASD-2002-80_Amendment_1.pdf .

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ethics and compliance policies, including general counsel, the chief financial officer, the chief internal auditor and the chief compliance officer, on legal and compliance affairs of the corporation as directed by such committee, including, at a minimum, information about violations or potential violations of law and breaches of fiduciary duty by an executive officer or director that could have a material adverse effect on the corporation.

Comparable recommendations include:

- Conference Board January 9, 2003 Findings and Recommendations Part 2 at 33, recommending that "the internal auditor should have a direct line of communication and reporting responsibility to the audit committee, and he or she should attend all regularly scheduled audit committee meetings, report on the status of audits conducted by the internal audit group, report to the committee on other matters that the internal auditor, in his or her judgment, believes should be brought to the audit committee's attention, and meet with the audit committee in executive session."

- Business Roundtable May 2002 Principles of Corporate Governance at 18, recommending that "the audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers and the general counsel."

Section 404 of the Sarbanes-Oxley Act of 2002 required the SEC to prescribe rules requiring the annual report of a public corporation to include "an assessment … of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."[108]

10. The board of directors should consider and determine appropriate action on the following matters:

a. Processes for setting agendas and distributing information;

b. Policy concerning expected time commitments of directors, and the extent to which other directorships or other factors

[108] On October 22, 2002, the SEC proposed rules to implement the requirement of Section 404. Release No. 33-8138, available at http://www.sec.gov/rules/proposed/33-8138.htm. On January 27, 2003, however, the SEC deferred adoption of such rules. Release No. 34-47262, available at http://www.sec.gov/rules/final/34-47262.htm.

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(such as health) may impair a director's ability to satisfy such commitments;

c. **Policy concerning rotation of the chair and membership of the board of directors and its corporate governance, audit and compensation committees;**

d. **Whether to appoint a "lead" independent director or an independent director to serve as chair of the board of directors or to preside at meetings of non-management directors;**

e. **Establishment and maintenance of a training and education program for all directors, and particularly independent directors, in regard to (A) their legal and ethical responsibilities as directors, (B) the financial condition, the principal operating risks and the performance factors materially important to the business of the corporation and (C) the operation, significance and effects of compensation incentive programs and related party transactions; and**

f. **Periodic evaluations by the directors of (A) the effectiveness and adequacy of meetings of the Board of Directors and its committees, (B) the adequacy and timeliness of the information provided by management to the Board of Directors, (C) the diversity of experience of individual directors and (D) the contributions of each director.**

For recommendations relating to the foregoing subjects, see:

- Commentary to NYSE Proposed Rule 303A(3) (rotation of board committee chairs; identification of presiding director at meetings of independent directors); 303A(9) (director orientation and training; annual performance evaluation of the board and committees).

- Business Roundtable May 2002 Principles of Corporate Governance at 25 (board chair should "be responsive to individual directors' requests to add items to the agenda, and open to suggestions for improving the agenda"); 24 (evaluate whether acceptance of directorship "will compromise the ability to perform present responsibilities"); 13 (preferring CEO as board chair); 26 ("educational opportunities for directors on an ongoing basis"); 27-28 (evaluation of board, committees and individual directors); 21 (corporate governance committee to evaluate content and timeliness of information flow to the board).

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- Conference Board January 9, 2003 Findings and Recommendations Part 2 at 22 (director involvement in setting agenda); 21 (consider separating Chair and CEO); 24 (director orientation and training); 24 (evaluation of board, committees, and individual directors); 23 (diversity in director qualifications).

- Higgs Report, at 50-51 (assessment and facilitation of information flow to directors); 54-55 (assessment of time commitments associated with service as director); 23 (separate roles of chairman and chief executive); 47-49 (director training); 49-50 (evaluation of board, committee and director performance).

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CONCLUSION

The issues addressed by the Task Force are complex and vitally important to an effective system of checks and balances supporting improved corporate responsibility. Public confidence in the present system has eroded in the wake of highly publicized recent corporate failures. Lawyers for the corporation should play an important role in corporate governance and the recommendations of the Task Force will enhance the opportunity for the lawyer to be a more effective contributor to a workable system of checks and balances.

The Task Force analyzed carefully the many thoughtful comments on its original recommendations. As a result, the original recommendations have been modified in some respects and reaffirmed and expanded in other respects. The Task Force believes that the recommendations in this Report appropriately balance competing public policy concerns and should have a positive impact in improving public confidence in corporate responsibility.

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APPENDIX A

CURRENT RULES 1.6 AND 1.13 OF THE MODEL RULES OF PROFESSIONAL RESPONSIBILITY

CONFIDENTIALITY OF INFORMATION

RULE 1.6 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(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 a court order.

ORGANIZATION AS CLIENT

RULE 1.13 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(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

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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.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign in accordance with Rule 1.16.

(d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(e) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

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RECOMMENDED REVISIONS TO THE MODEL RULES OF PROFESSIONAL RESPONSIBILITY
(Marked to show proposed changes to existing Rules and Commentary)

RULE 1.6: CONFIDENTIALITY OF INFORMATION

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(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 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;

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

(53) 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

(64) to comply with other law or a court order.

Commentary

[1] This Rule governs the disclosure by a lawyer of information relating to the representation of a client during the lawyer's representation of the client. See

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Rule 1.18 for the lawyer's duties with respect to information provided to the lawyer by a prospective client, Rule 1.9(c)(2) for the lawyer's duty not to reveal information relating to the lawyer's prior representation of a former client and Rules 1.8(b) and 1.9(c)(1) for the lawyer's duties with respect to the use of such information to the disadvantage of clients and former clients.

[2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See Rule 1.0(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[3] The principle of client-lawyer confidentiality is given effect by related bodies of law: the attorney-client privilege, the work product doctrine and the rule of confidentiality established in professional ethics. The attorney-client privilege and work-product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other law. See also Scope.

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.

Authorized Disclosure

[5] Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation. In some situations, for example, a lawyer may be impliedly authorized to admit a

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fact that cannot properly be disputed or to make a disclosure that facilitates a satisfactory conclusion to a matter. Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers.

Disclosure Adverse to Client

[6] Although the public interest is usually best served by a strict rule requiring lawyers to preserve the confidentiality of information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. Paragraph (b)(1) recognizes the overriding value of life and physical integrity and permits disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm. Such harm is reasonably certain to occur if it will be suffered imminently or if there is a present and substantial threat that a person will suffer such harm at a later date if the lawyer fails to take action necessary to eliminate the threat. Thus, a lawyer who knows that a client has accidentally discharged toxic waste into a town's water supply may reveal this information to the authorities if there is a present and substantial risk that a person who drinks the water will contract a life-threatening or debilitating disease and the lawyer's disclosure is necessary to eliminate the threat or reduce the number of victims.

[7] Paragraph (b)(2) is a limited exception to the rule of confidentiality that permits the lawyer to reveal information to the extent necessary to enable affected persons or appropriate authorities to prevent the client from committing a crime or fraud, as defined in Rule 1.0(d), that is reasonably certain to result in substantial injury to the financial or property interests of another and in furtherance of which the client has used or is using the lawyer’s services. Such a serious abuse of the client-lawyer relationship by the client forfeits the protection of this Rule. The client can, of course, prevent such disclosure by refraining from the wrongful conduct. Although paragraph (b)(2) does not require the lawyer to reveal the client’s misconduct, the lawyer may not counsel or assist the client in conduct the lawyer knows is criminal or fraudulent. See Rule 1.2(d). See also Rule 1.16 with respect to the lawyer’s obligation or right to withdraw from the representation of the client in such circumstances, and Rule 1.13(c) which permits the lawyer, where the client is an organization, to reveal information relating to the representation in limited circumstances.

[8] Paragraph (b)(3) addresses the situation in which the lawyer does not learn of the client’s crime or fraud until after it has been consummated. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be prevented, rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to prevent or mitigate reasonably

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certain losses or to attempt to recoup their losses. Paragraph (b)(3) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.

[9~~7~~] A lawyer's confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer's personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized, paragraph (b)(2) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

[10~~8~~] Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, disciplinary or other proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person, for example, a person claiming to have been defrauded by the lawyer and client acting together. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(5~~3~~) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend also applies, of course, where a proceeding has been commenced.

[11~~9~~] A lawyer entitled to a fee is permitted by paragraph (b)(5~~3~~) to prove the services rendered in an action to collect it. This aspect of the rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary.

[12~~10~~] Other law may require that a lawyer disclose information about a client. Whether such a law supersedes Rule 1.6 is a question of law beyond the scope of these Rules. When disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by Rule 1.4. If, however, the other law supersedes this Rule and requires disclosure, paragraph (b)(6~~4~~) permits the lawyer to make such disclosures as are necessary to comply with the law.

[13~~11~~] A lawyer may be ordered to reveal information relating to the representation of a client by a court or by another tribunal or governmental entity claiming authority pursuant to other law to compel the disclosure. Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client

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privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 1.4. Unless review is sought, however, paragraph (b)(6~~4~~) permits the lawyer to comply with the court's order.

[14~~12~~] Paragraph (b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[15~~13~~] Paragraph (b) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in paragraphs (b)(1) through (b)(6~~4~~). In exercising the discretion conferred by this Rule, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (b) does not violate this Rule. Disclosure may be required, however, by other Rules. Some Rules require disclosure only if such disclosure would be permitted by paragraph (b). See Rules 1.2(d), 4.1(b), 8.1 and 8.3. Rule 3.3, on the other hand, requires disclosure in some circumstances regardless of whether such disclosure is permitted by this Rule. See Rule 3.3(c).

~~**Withdrawal**~~

~~[14] If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 1.16(a)(1). After withdrawal the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise permitted by Rule 1.6. Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like. Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. Where necessary to guide conduct in connection with this Rule, the lawyer may make inquiry within the organization as indicated in Rule 1.13(b).~~

Acting Competently to Preserve Confidentiality

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[16~~15~~] A lawyer must act competently to safeguard information relating to the representation of a client against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. See Rules 1.1, 5.1 and 5.3.

[17~~16~~] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this Rule.

Former Client

[18~~17~~] The duty of confidentiality continues after the client-lawyer relationship has terminated. See Rule 1.9(c)(2). See Rule 1.9(c)(1) for the prohibition against using such information to the disadvantage of the former client.

* * *

RULE 1.13: ORGANIZATION AS CLIENT

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(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. ~~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~~

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~~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~~

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, ~~seriousness of the matter, referral to~~ the highest authority that can act on behalf of the organization as determined by applicable law.

(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 is likely to result in substantial injury to the organization~~, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,

then the lawyer may~~:~~ ~~resign in accordance with Rule 1.16,~~ 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.

(d) 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.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to Paragraphs

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(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.

~~(d)~~ (f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

~~(e)~~ (g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Comment

The Entity as the Client

[1] An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. Officers, directors, employees and shareholders are the constituents of the corporate organizational client. The duties defined in this Comment apply equally to unincorporated associations. "Other constituents" as used in this Comment means the positions equivalent to officers, directors, employees and shareholders held by persons acting for organizational clients that are not corporations.

[2] When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational

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client in order to carry out the representation or as otherwise permitted by Rule 1.6.

[3] When 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 serious risk, are not as such in the lawyer's province. ~~However, different considerations arise~~ Paragraph (b) makes clear, however, that when the lawyer knows facts that would lead a reasonable lawyer under the circumstances to conclude that the organization ~~may~~ is likely to be substantially injured by action of ~~a~~ an officer or other constituent that violates a legal obligation to the organization or is in violation of law ~~In such a circumstance, it may be reasonably necessary for the lawyer to ask the constituent to reconsider the matter. If that fails, or if the matter is of sufficient seriousness and importance to the organization, it may be reasonably necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. Clear justification should exist for seeking review over the head of the constituent normally responsible for it. The stated policy of the organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy. Even in the absence of organization policy, however, the lawyer may have an obligation to refer a matter to higher authority, depending on the seriousness of the matter and whether the constituent in question has apparent motives to act at variance with the organization's interest. Review by the chief executive officer or by the board of directors may be required when the matter is of importance commensurate with their authority. At some point it may be useful or essential to obtain an independent legal opinion.~~ and might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious. The lawyer’s obligation to proceed as is reasonably necessary in the best interest of the organization is determined by the conclusions that a reasonable lawyer would, under the circumstances, draw from the facts known. The terms “reasonable” and “reasonably” imply a range within which the lawyer’s conduct will satisfy the requirements of Rule 1.13. In determining what is reasonable in the best interest of the organization the circumstances at the time of determination are relevant. Such circumstances may include, among others, the lawyer’s area of expertise, the time constraints under which the lawyer is acting, and the lawyer’s previous experience and familiarity with the client. For example, the facts suggesting a violation may be part of a large volume of information

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that the lawyer has insufficient time fully to comprehend. Or the facts known to the lawyer may be sufficient to signal the likely existence of a violation to an expert in a particular field of law but not to a lawyer who works in another specialty. Under such circumstances the lawyer would not have an obligation to proceed under Paragraph (b).

[4] In determining how to proceed under Paragraph (b), the lawyer should give due consideration to the seriousness of the violation and its consequences, 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. Ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the lawyer to ask the constituent to reconsider the matter; for example, if the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent persists in conduct contrary to the lawyer's advice, it will be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not obligated to proceed by Rule 1.13, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

[4][5] Paragraph (b) also makes clear that when reasonably necessary to enable the organization to address the matter in a timely and appropriate fashion the lawyer must refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

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Relation to Other Rules

[~~5~~][6] The authority and responsibility provided in this Rule are concurrent with the authority and responsibility provided in other Rules. In particular, this Rule does not limit or expand the lawyer's responsibility under Rule ~~1.6,~~ 1.8, 1.16, 3.3 or 4.1. Paragraph (c) of this Rule supplements Rule 1.6(b) by providing an additional basis upn which the lawyer may reveal information relating to the representation, but does not modify, restrict, or limit the provisions of Rule 1.6(b)(1) – (6). Under Paragraph (c) the lawyer may reveal such information only when the organization's highest authority insists upon or fails to address threatened or ongoing action that is clearly a violation of law, and then only to the extent the lawyer reasonably believes necessary to prevent reasonably certain substantial injury to the organization. It is not necessary that the lawyer's services be used in furtherance of the violation, but it is required that the matter be related to the lawyer's representation of the organization. If the lawyer's services are being used by an organization to further a crime or fraud by the organization, Rules 1.6(b)(2) and 1.6(b)(3) may permit the lawyer to disclose confidential information. In such circumstances Rule 1.2(d) ~~can~~ may also be applicable, in which event, withdrawal from the representation under Rule 1.16(a)(1) may be required.

[7] Paragraph (d) makes clear that the authority of a lawyer to disclose information relating to a representation in circumstances described in Paragraph (c) does 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. This is necessary in order to enable organizational clients to enjoy the full benefits of legal counsel in conducting an investigation or defending against a claim.

[8] A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to Paragraph (b) or (c), or who withdraws in circumstances that require or permit the lawyer to take action under either of these Paragraphs, must proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal, and what the lawyer reasonably believes to be the basis for his or her discharge or withdrawal.

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Government Agency

~~[6]~~ [9] The duty defined in this Rule applies to governmental organizations. Defining precisely the identity of the client and prescribing the resulting obligations of such lawyers may be more difficult in the government context and is a matter beyond the scope of these Rules. See Scope [18]. Although in some circumstances the client may be a specific agency, it may also be a branch of government, such as the executive branch, or the government as a whole. For example, if the action or failure to act involves the head of a bureau, either the department of which the bureau is a part or the relevant branch of government may be the client for purposes of this Rule. Moreover, in a matter involving the conduct of government officials, a government lawyer may have authority under applicable law to question such conduct more extensively than that of a lawyer for a private organization in similar circumstances. Thus, when the client is a governmental organization, a different balance may be appropriate between maintaining confidentiality and assuring that the wrongful act is prevented or rectified, for public business is involved. In addition, duties of lawyers employed by the government or lawyers in military service may be defined by statutes and regulation. This Rule does not limit that authority. See Scope.

Clarifying the Lawyer's Role

~~[7]~~ [10] There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged.

~~[8]~~ [11] Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

Dual Representation

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~~[9]~~ [12] Paragraph (g) recognizes that a lawyer for an organization may also represent a principal officer or major shareholder.

Derivative Actions

[~~10]~~[13] Under generally prevailing law, the shareholders or members of a corporation may bring suit to compel the directors to perform their legal obligations in the supervision of the organization. Members of unincorporated associations have essentially the same right. Such an action may be brought nominally by the organization, but usually is, in fact, a legal controversy over management of the organization.

~~[11]~~ [14]The question can arise whether counsel for the organization may defend such an action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the claim involves serious charges of wrongdoing by those in control of the organization, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 1.7 governs who should represent the directors and the organization.

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ABA Presidential Task Force on Corporate Responsibility

ABA HOUSE OF DELEGATES ADOPTS POLICIES RECOMMENDED BY ABA TASK FORCE ON CORPORATE RESPONSIBILITY [updated 09/02/2003]

- Recommendation to amend Rule 1.13 of the ABA Model Rules of Professional Conduct and to amend the related comments;
- Recommendation to amend Rule 1.6(b) of the ABA Model Rules of Professional Conduct and to amend the related comments; and
- Recommendation to adopt corporate governance policies and related governance practices

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ABA Corporate Responsibility Task Force Releases Final Report

Task Force Urges New Corporate Governance Policies and Lawyer Ethics Rules

Addresses Practices and Attitudes that Contributed to Failures

The final report of the American Bar Association Task Force on Corporate Responsibility urges changes in corporate governance policies to create a new culture of corporate responsibility stressing constructive skepticism and active independent oversight of corporate executives.

The task force's recommended corporate governance policies also are designed to enhance the role of corporate lawyers in the system of checks and balances needed to ensure corporate compliance with law. The report also makes recommendations for amendments to the ABA Model Rules of Professional Conduct to sharpen existing duties of the corporate lawyer to the corporate client and to act in the best interests of that client when faced with illegal conduct by executive officers.

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U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

January 20, 2003

MEMORANDUM

TO: Heads of Department Components
United States Attorneys

FROM: Larry D. Thompson
Deputy Attorney General

SUBJECT: Principles of Federal Prosecution of Business Organizations

As the Corporate Fraud Task Force has advanced in its mission, we have confronted certain issues in the principles for the federal prosecution of business organizations that require revision in order to enhance our efforts against corporate fraud. While it will be a minority of cases in which a corporation or partnership is itself subjected to criminal charges, prosecutors and investigators in every matter involving business crimes must assess the merits of seeking the conviction of the business entity itself.

Attached to this memorandum are a revised set of principles to guide Department prosecutors as they make the decision whether to seek charges against a business organization. These revisions draw heavily on the combined efforts of the Corporate Fraud Task Force and the Attorney General's Advisory Committee to put the results of more than three years of experience with the principles into practice.

The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation. The revisions make clear that such conduct should weigh in favor of a corporate prosecution. The revisions also address the efficacy of the corporate governance mechanisms in place within a corporation, to ensure that these measures are truly effective rather than mere paper programs.

Further experience with these principles may lead to additional adjustments. I look forward to hearing comments about their operation in practice. Please forward any comments to Christopher Wray, the Principal Associate Deputy Attorney General, or to Andrew Hruska, my Senior Counsel.

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Federal Prosecution of Business Organizations[1]

I. Charging a Corporation: General

A. General Principle: Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to address and be a force for positive change of corporate culture, alter corporate behavior, and prevent, discover, and punish white collar crime.

B. Comment: In all cases involving corporate wrongdoing, prosecutors should consider the factors discussed herein. First and foremost, prosecutors should be aware of the important public benefits that may flow from indicting a corporation in appropriate cases. For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal conduct that is pervasive throughout a particular industry, and thus an indictment often provides a unique opportunity for deterrence on a massive scale. In addition, a corporate indictment may result in specific deterrence by changing the culture of the indicted corporation and the behavior of its employees. Finally, certain crimes that carry with them a substantial risk of great public harm, e.g., environmental crimes or financial frauds, are by their nature most likely to be committed by businesses, and there may, therefore, be a substantial federal interest in indicting the corporation.

Charging a corporation, however, does not mean that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. Because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, even in the face of offers of corporate guilty pleas.

Corporations are "legal persons," capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents. To hold a corporation liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should consider the corporation, as well as the responsible individuals, as potential criminal targets.

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1 While these guidelines refer to corporations, they apply to the consideration of the prosecution of all types of business organizations, including partnerships, sole proprietorships, government entities, and unincorporated associations.

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Agents, however, may act for mixed reasons -- both for self-aggrandizement (both direct and indirect) and for the benefit of the corporation, and a corporation may be held liable as long as one motivation of its agent is to benefit the corporation. In *United States v. Automated Medical Laboratories*, 770 F.2d 399 (4th Cir. 1985), the court affirmed the corporation's conviction for the actions of a subsidiary's employee despite its claim that the employee was acting for his own benefit, namely his "ambitious nature and his desire to ascend the corporate ladder." The court stated, "*Partucci* was clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being and its lack of difficulties with the FDA." Similarly, in *United States v. Cincotta*, 689 F.2d 238, 241-42 (1st Cir. 1982), the court held, "criminal liability may be imposed on the corporation only where the agent is acting within the scope of his employment. That, in turn, requires that the agent be performing acts of the kind which he is authorized to perform, and those acts must be motivated -- at least in part -- by an intent to benefit the corporation." Applying this test, the court upheld the corporation's conviction, notwithstanding the substantial personal benefit reaped by its miscreant agents, because the fraudulent scheme required money to pass through the corporation's treasury and the fraudulently obtained goods were resold to the corporation's customers in the corporation's name. As the court concluded, "Mystic--not the individual defendants--was making money by selling oil that it had not paid for."

Moreover, the corporation need not even necessarily profit from its agent's actions for it to be held liable. In *Automated Medical Laboratories*, the Fourth Circuit stated:

> [B]enefit is not a "touchstone of criminal corporate liability; benefit at best is an evidential, not an operative, fact." Thus, whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation. The basic purpose of requiring that an agent have acted with the intent to benefit the corporation, however, is to insulate the corporation from criminal liability for actions of its agents which be inimical to the interests of the corporation or which may have been undertaken solely to advance the interests of that agent or of a party other than the corporation.

770 F.2d at 407 (emphasis added; quoting *Old Monastery Co. v. United States*, 147 F.2d 905, 908 (4th Cir.), cert. denied, 326 U.S. 734 (1945)).

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II. Charging a Corporation: Factors to Be Considered

A. General Principle: Generally, prosecutors should apply the same factors in determining whether to charge a corporation as they do with respect to individuals. *See* USAM § 9-27.220, *et seq*. Thus, the prosecutor should weigh all of the factors normally considered in the sound exercise of prosecutorial judgment: the sufficiency of the evidence; the likelihood of success at trial,; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of noncriminal approaches. *See* id. However, due to the nature of the corporate "person," some additional factors are present. In conducting an investigation, determining whether to bring charges, and negotiating plea agreements, prosecutors should consider the following factors in reaching a decision as to the proper treatment of a corporate target:

1. the nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime (*see* section III, *infra*);

2. the pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management (*see* section IV, *infra*);

3. the corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it (*see* section V, *infra*);

4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection (*see* section VI, *infra*);

5. the existence and adequacy of the corporation's compliance program (*see* section VII, *infra*);

6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies (*see* section VIII, *infra*);

7. collateral consequences, including disproportionate harm to shareholders, pension holders and employees not proven personally culpable and impact on the public arising from the prosecution (*see* section IX, *infra*); and

8. the adequacy of the prosecution of individuals responsible for the corporation's malfeasance;

9. the adequacy of remedies such as civil or regulatory enforcement actions (*see*

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section X, infra).

B. Comment: As with the factors relevant to charging natural persons, the foregoing factors are intended to provide guidance rather than to mandate a particular result. The factors listed in this section are intended to be illustrative of those that should be considered and not a complete or exhaustive list. Some or all of these factors may or may not apply to specific cases, and in some cases one factor may override all others. The nature and seriousness of the offense may be such as to warrant prosecution regardless of the other factors. Further, national law enforcement policies in various enforcement areas may require that more or less weight be given to certain of these factors than to others.

In making a decision to charge a corporation, the prosecutor generally has wide latitude in determining when, whom, how, and even whether to prosecute for violations of Federal criminal law. In exercising that discretion, prosecutors should consider the following general statements of principles that summarize appropriate considerations to be weighed and desirable practices to be followed in discharging their prosecutorial responsibilities. In doing so, prosecutors should ensure that the general purposes of the criminal law -- assurance of warranted punishment, deterrence of further criminal conduct, protection of the public from dangerous and fraudulent conduct, rehabilitation of offenders, and restitution for victims and affected communities -- are adequately met, taking into account the special nature of the corporate "person."

III. Charging a Corporation: Special Policy Concerns

A. General Principle: The nature and seriousness of the crime, including the risk of harm to the public from the criminal conduct, are obviously primary factors in determining whether to charge a corporation. In addition, corporate conduct, particularly that of national and multi-national corporations, necessarily intersects with federal economic, taxation, and criminal law enforcement policies. In applying these principles, prosecutors must consider the practices and policies of the appropriate Division of the Department, and must comply with those policies to the extent required.

B. Comment: In determining whether to charge a corporation, prosecutors should take into account federal law enforcement priorities as discussed above. *See* USAM § 9-27-230. In addition, however, prosecutors must be aware of the specific policy goals and incentive programs established by the respective Divisions and regulatory agencies. Thus, whereas natural persons may be given incremental degrees of credit (ranging from immunity to lesser charges to sentencing considerations) for turning themselves in, making statements against their penal interest, and cooperating in the government's investigation of their own and others' wrongdoing, the same approach may not be appropriate in all circumstances with respect to corporations. As an example, it is entirely proper in many investigations for a prosecutor to consider the corporation's pre-indictment conduct, *e.g.*,voluntary disclosure, cooperation, remediation or restitution, in determining whether to seek an indictment. However, this would not necessarily be appropriate in an antitrust investigation, in which antitrust violations, by definition, go to the

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heart of the corporation's business and for which the Antitrust Division has therefore established a firm policy, understood in the business community, that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government. As another example, the Tax Division has a strong preference for prosecuting responsible individuals, rather than entities, for corporate tax offenses. Thus, in determining whether or not to charge a corporation, prosecutors should consult with the Criminal, Antitrust, Tax, and Environmental and Natural Resources Divisions, if appropriate or required.

IV. Charging a Corporation: Pervasiveness of Wrongdoing Within the Corporation

A. General Principle: A corporation can only act through natural persons, and it is therefore held responsible for the acts of such persons fairly attributable to it. Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees or by all the employees in a particular role within the corporation, *e.g.*, salesmen or procurement officers, or was condoned by upper management. On the other hand, in certain limited circumstances, it may not be appropriate to impose liability upon a corporation, particularly one with a compliance program in place, under a strict *respondeat superior* theory for the single isolated act of a rogue employee. There is, of course, a wide spectrum between these two extremes, and a prosecutor should exercise sound discretion in evaluating the pervasiveness of wrongdoing within a corporation.

B. Comment: Of these factors, the most important is the role of management. Although acts of even low-level employees may result in criminal liability, a corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged. As stated in commentary to the Sentencing Guidelines:

> Pervasiveness [is] case specific and [will] depend on the number, and degree of responsibility, of individuals [with] substantial authority ... who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an organization.

USSG §8C2.5, comment. (n. 4).

V. Charging a Corporation: The Corporation's Past History

A. General Principle: Prosecutors may consider a corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it, in determining whether to bring criminal charges.

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B. Comment: A corporation, like a natural person, is expected to learn from its mistakes. A history of similar conduct may be probative of a corporate culture that encouraged, or at least condoned, such conduct, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and yet it either had not taken adequate action to prevent future unlawful conduct or had continued to engage in the conduct in spite of the warnings or enforcement actions taken against it. In making this determination, the corporate structure itself, *e.g.*, subsidiaries or operating divisions, should be ignored, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates should be considered. *See* USSG § 8C2.5(c) & comment. (n. 6).

VI. Charging a Corporation: Cooperation and Voluntary Disclosure

A. General Principle: In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection.

B. Comment: In investigating wrongdoing by or within a corporation, a prosecutor is likely to encounter several obstacles resulting from the nature of the corporation itself. It will often be difficult to determine which individual took which action on behalf of the corporation. Lines of authority and responsibility may be shared among operating divisions or departments, and records and personnel may be spread throughout the United States or even among several countries. Where the criminal conduct continued over an extended period of time, the culpable or knowledgeable personnel may have been promoted, transferred, or fired, or they may have quit or retired. Accordingly, a corporation's cooperation may be critical in identifying the culprits and locating relevant evidence.

In some circumstances, therefore, granting a corporation immunity or amnesty or pretrial diversion may be considered in the course of the government's investigation. In such circumstances, prosecutors should refer to the principles governing non-prosecution agreements generally. *See* USAM § 9-27.600-650. These principles permit a non prosecution agreement in exchange for cooperation when a corporation's "timely cooperation appears to be necessary to the public interest and other means of obtaining the desired cooperation are unavailable or would not be effective." Prosecutors should note that in the case of national or multi-national corporations, multi-district or global agreements may be necessary. Such agreements may only be entered into with the approval of each affected district or the appropriate Department official. *See* USAM §9-27.641.

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In addition, the Department, in conjunction with regulatory agencies and other executive branch departments, encourages corporations, as part of their compliance programs, to conduct internal investigations and to disclose their findings to the appropriate authorities. Some agencies, such as the SEC and the EPA, as well as the Department's Environmental and Natural Resources Division, have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions.[2] Even in the absence of a formal program, prosecutors may consider a corporation's timely and voluntary disclosure in evaluating the adequacy of the corporation's compliance program and its management's commitment to the compliance program. However, prosecution and economic policies specific to the industry or statute may require prosecution notwithstanding a corporation's willingness to cooperate. For example, the Antitrust Division offers amnesty only to the first corporation to agree to cooperate. This creates a strong incentive for corporations participating in anti-competitive conduct to be the first to cooperate. In addition, amnesty, immunity, or reduced sanctions may not be appropriate where the corporation's business is permeated with fraud or other crimes.

One factor the prosecutor may weigh in assessing the adequacy of a corporation's cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors and employees and counsel. Such waivers permit the government to obtain statements of possible witnesses, subjects, and targets, without having to negotiate individual cooperation or immunity agreements. In addition, they are often critical in enabling the government to evaluate the completeness of a corporation's voluntary disclosure and cooperation. Prosecutors may, therefore, request a waiver in appropriate circumstances.[3] The Department does not, however, consider waiver of a corporation's attorney-client and work product protection an absolute requirement, and prosecutors should consider the willingness of a corporation to waive such protection when necessary to provide timely and complete information as one factor in evaluating the corporation's cooperation.

Another factor to be weighed by the prosecutor is whether the corporation appears to be protecting its culpable employees and agents. Thus, while cases will differ depending on the circumstances, a corporation's promise of support to culpable employees and agents, either

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[2] In addition, the Sentencing Guidelines reward voluntary disclosure and cooperation with a reduction in the corporation's offense level. *See* USSG §8C2.5)g).

[3] This waiver should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue. Except in unusual circumstances, prosecutors should not seek a waiver with respect to communications and work product related to advice concerning the government's criminal investigation.

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through the advancing of attorneys fees,[4] through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation. By the same token, the prosecutor should be wary of attempts to shield corporate officers and employees from liability by a willingness of the corporation to plead guilty.

Another factor to be weighed by the prosecutor is whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction). Examples of such conduct include: overly broad assertions of corporate representation of employees or former employees; inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation including, for example, the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed production of records; and failure to promptly disclose illegal conduct known to the corporation.

Finally, a corporation's offer of cooperation does not automatically entitle it to immunity from prosecution. A corporation should not be able to escape liability merely by offering up its directors, officers, employees, or agents as in lieu of its own prosecution. Thus, a corporation's willingness to cooperate is merely one relevant factor, that needs to be considered in conjunction with the other factors, particularly those relating to the corporation's past history and the role of management in the wrongdoing.

VII. Charging a Corporation: Corporate Compliance Programs

A. General Principle: Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program. In addition, the nature of some crimes, *e.g.*, antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.

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[4] Some states require corporations to pay the legal fees of officers under investigation prior to a formal determination of their guilt. Obviously, a corporation's compliance with governing law should not be considered a failure to cooperate.

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B. Comment: A corporate compliance program, even one specifically prohibiting the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior. See United States v. Basic Construction Co.*, 711 F.2d 570 (4th Cir. 1983) ("a corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if... such acts were against corporate policy or express instructions."). In *United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir. 1972), *cert. denied,* 409 U.S. 1125 (1973), the Ninth Circuit affirmed antitrust liability based upon a purchasing agent for a single hotel threatening a single supplier with a boycott unless it paid dues to a local marketing association, even though the agent's actions were contrary to corporate policy and directly against express instructions from his superiors. The court reasoned that Congress, in enacting the Sherman Antitrust Act, "intended to impose liability upon business entities for the acts of those to whom they choose to delegate the conduct of their affairs, thus stimulating a maximum effort by owners and managers to assure adherence by such agents to the requirements of the Act."[5] It concluded that "general policy statements" and even direct instructions from the agent's superiors were not sufficient; "Appellant could not gain exculpation by issuing general instructions without undertaking to enforce those instructions by means commensurate with the obvious risks." *See also United States v. Beusch,* 596 F.2d 871, 878 (9th Cir. 1979) ("[A] corporation may be liable for the acts of its employees done contrary to express instructions and policies, but ... the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation."); *United States v. American Radiator & Standard Sanitary Corp.,* 433 F.2d 174 (3rd Cir. 1970) (affirming conviction of corporation based upon its officer's participation in price-fixing scheme, despite corporation's defense that officer's conduct violated its "rigid anti-fraternization policy" against any socialization (and exchange of price information) with its competitors; "When the act of the agent is within the scope of his employment or his apparent authority, the corporation is held legally responsible for it, although what he did may be contrary to his actual instructions and may be unlawful.").

While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program

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5 Although this case and *Basic Construction* are both antitrust cases, their reasoning applies to other criminal violations. In the Hilton case, for instance, the Ninth Circuit noted that Sherman Act violations are commercial offenses "usually motivated by a desire to enhance profits," thus, bringing the case within the normal rule that a "purpose to benefit the corporation is necessary to bring the agent's acts within the scope of his employment." 467 F.2d at 1006 & n4. In addition, in *United States v. Automated Medical Laboratories*, 770 F.2d 399, 406 n.5 (4th Cir. 1985), the Fourth Circuit stated "that Basic Construction states a generally applicable rule on corporate criminal liability despite the fact that it addresses violations of the antitrust laws."

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or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. The Department has no formal guidelines for corporate compliance programs. The fundamental questions any prosecutor should ask are: "Is the corporation's compliance program well designed?" and "Does the corporation's compliance program work?" In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal conduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct; and any remedial actions taken by the corporation, including restitution, disciplinary action, and revisions to corporate compliance programs.[6] Prosecutors should also consider the promptness of any disclosure of wrongdoing to the government and the corporation's cooperation in the government's investigation. In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are the directors provided with information sufficient to enable the exercise of independent judgment, are internal audit functions conducted at a level sufficient to ensure their independence and accuracy and have the directors established an information and reporting system in the organization reasonable designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law. *In re: Caremark,* 698 A.2d 959 (Del. Ct. Chan. 1996).

Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a "paper program" or whether it was designed and implemented in an effective manner. In addition, prosecutors should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts. In addition, prosecutors should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it. This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents.

Compliance programs should be designed to detect the particular types of misconduct most likely to occur in a particular corporation's line of business. Many corporations operate in complex regulatory environments outside the normal experience of criminal prosecutors. Accordingly, prosecutors should consult with relevant federal and state agencies with the expertise to evaluate the adequacy of a program's design and implementation. For instance, state and federal banking, insurance, and medical boards, the Department of Defense, the Department

[6] For a detailed review of these and other factors concerning corporate compliance programs, see United States Sentencing Commission, GUIDELINES MANUAL, §8A1.2, comment. (n.3(k)) (Nov. 1997). *See* also USSG §8C2.5(f)

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of Health and Human Services, the Environmental Protection Agency, and the Securities and Exchange Commission have considerable experience with compliance programs and can be very helpful to a prosecutor in evaluating such programs. In addition, the Fraud Section of the Criminal Division, the Commercial Litigation Branch of the Civil Division, and the Environmental Crimes Section of the Environment and Natural Resources Division can assist U.S. Attorneys' Offices in finding the appropriate agency office and in providing copies of compliance programs that were developed in previous cases.

VIII. Charging a Corporation: Restitution and Remediation

A. General Principle: Although neither a corporation nor an individual target may avoid prosecution merely by paying a sum of money, a prosecutor may consider the corporation's willingness to make restitution and steps already taken to do so. A prosecutor may also consider other remedial actions, such as implementing an effective corporate compliance program, improving an existing compliance program, and disciplining wrongdoers, in determining whether to charge the corporation.

B. Comment: In determining whether or not a corporation should be prosecuted, a prosecutor may consider whether meaningful remedial measures have been taken, including employee discipline and full restitution.[7] A corporation's response to misconduct says much about its willingness to ensure that such misconduct does not recur. Thus, corporations that fully recognize the seriousness of their misconduct and accept responsibility for it should be taking steps to implement the personnel, operational, and organizational changes necessary to establish an awareness among employees that criminal conduct will not be tolerated. Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined the wrongdoers and disclosed information concerning their illegal conduct to the government.

Employee discipline is a difficult task for many corporations because of the human element involved and sometimes because of the seniority of the employees concerned. While corporations need to be fair to their employees, they must also be unequivocally committed, at all levels of the corporation, to the highest standards of legal and ethical behavior. Effective internal discipline can be a powerful deterrent against improper behavior by a corporation's employees. In evaluating a corporation's response to wrongdoing, prosecutors may evaluate the willingness of the corporation to discipline culpable employees of all ranks and the adequacy of the discipline imposed. The prosecutor should be satisfied that the corporation's focus is on the integrity and credibility of its remedial and disciplinary measures rather than on the protection of the wrongdoers.

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[7] For example, the Antitrust Division's amnesty policy requires that "[w]here possible, the corporation [make] restitution to injured parties...."

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In addition to employee discipline, two other factors used in evaluating a corporation's remedial efforts are restitution and reform. As with natural persons, the decision whether or not to prosecute should not depend upon the target's ability to pay restitution. A corporation's efforts to pay restitution even in advance of any court order is, however, evidence of its "acceptance of responsibility" and, consistent with the practices and policies of the appropriate Division of the Department entrusted with enforcing specific criminal laws, may be considered in determining whether to bring criminal charges. Similarly, although the inadequacy of a corporate compliance program is a factor to consider when deciding whether to charge a corporation, that corporation's quick recognition of the flaws in the program and its efforts to improve the program are also factors to consider.

IX. Charging a Corporation: Collateral Consequences

A. General Principle: Prosecutors may consider the collateral consequences of a corporate criminal conviction in determining whether to charge the corporation with a criminal offense.

B. Comment: One of the factors in determining whether to charge a natural person or a corporation is whether the likely punishment is appropriate given the nature and seriousness of the crime. In the corporate context, prosecutors may take into account the possibly substantial consequences to a corporation's officers, directors, employees, and shareholders, many of whom may, depending on the size and nature (e.g., publicly vs. closely held) of the corporation and their role in its operations, have played no role in the criminal conduct, have been completely unaware of it, or have been wholly unable to prevent it. Prosecutors should also be aware of non-penal sanctions that may accompany a criminal charge, such as potential suspension or debarment from eligibility for government contracts or federal funded programs such as health care. Whether or not such non-penal sanctions are appropriate or required in a particular case is the responsibility of the relevant agency, a decision that will be made based on the applicable statutes, regulations, and policies.

Virtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties, and the mere existence of such an effect is not sufficient to preclude prosecution of the corporation. Therefore, in evaluating the severity of collateral consequences, various factors already discussed, such as the pervasiveness of the criminal conduct and the adequacy of the corporation's compliance programs, should be considered in determining the weight to be given to this factor. For instance, the balance may tip in favor of prosecuting corporations in situations where the scope of the misconduct in a case is widespread and sustained within a corporate division (or spread throughout pockets of the corporate organization). In such cases, the possible unfairness of visiting punishment for the corporation's crimes upon shareholders may be of much less concern where those shareholders have substantially profited, even unknowingly, from widespread or pervasive criminal activity. Similarly, where the top layers of the corporation's management or the shareholders of a closely-held corporation were engaged in or aware of the wrongdoing and the conduct at issue

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was accepted as a way of doing business for an extended period, debarment may be deemed not collateral, but a direct and entirely appropriate consequence of the corporation's wrongdoing.

The appropriateness of considering such collateral consequences and the weight to be given them may depend on the special policy concerns discussed in section III, *supra*.

X. Charging a Corporation: Non-Criminal Alternatives

A. General Principle: Although non-criminal alternatives to prosecution often exist, prosecutors may consider whether such sanctions would adequately deter, punish, and rehabilitate a corporation that has engaged in wrongful conduct. In evaluating the adequacy of non-criminal alternatives to prosecution, *e.g.*, civil or regulatory enforcement actions, the prosecutor may consider all relevant factors, including:

1. the sanctions available under the alternative means of disposition;
2. the likelihood that an effective sanction will be imposed; and
3. the effect of non-criminal disposition on Federal law enforcement interests.

B. Comment: The primary goals of criminal law are deterrence, punishment, and rehabilitation. Non-criminal sanctions may not be an appropriate response to an egregious violation, a pattern of wrongdoing, or a history of non-criminal sanctions without proper remediation. In other cases, however, these goals may be satisfied without the necessity of instituting criminal proceedings. In determining whether federal criminal charges are appropriate, the prosecutor should consider the same factors (modified appropriately for the regulatory context) considered when determining whether to leave prosecution of a natural person to another jurisdiction or to seek non-criminal alternatives to prosecution. These factors include: the strength of the regulatory authority's interest; the regulatory authority's ability and willingness to take effective enforcement action; the probable sanction if the regulatory authority's enforcement action is upheld; and the effect of a non-criminal disposition on Federal law enforcement interests. *See* USAM §§ 9-27.240, 9-27.250.

XI. Charging a Corporation: Selecting Charges

A. General Principle: Once a prosecutor has decided to charge a corporation, the prosecutor should charge, or should recommend that the grand jury charge, the most serious offense that is consistent with the nature of the defendant's conduct and that is likely to result in a sustainable conviction.

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B. Comment: Once the decision to charge is made, the same rules as govern charging natural persons apply. These rules require "a faithful and honest application of the Sentencing Guidelines" and an "individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the Federal criminal code, and maximize the impact of Federal resources on crime." *See* USAM § 9-27.300. In making this determination, "it is appropriate that the attorney for the government consider, *inter alia*, such factors as the sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range ... is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *See* Attorney General's Memorandum, dated October 12, 1993.

XII. Plea Agreements with Corporations

A. General Principle: In negotiating plea agreements with corporations, prosecutors should seek a plea to the most serious, readily provable offense charged. In addition, the terms of the plea agreement should contain appropriate provisions to ensure punishment, deterrence, rehabilitation, and compliance with the plea agreement in the corporate context. Although special circumstances may mandate a different conclusion, prosecutors generally should not agree to accept a corporate guilty plea in exchange for non-prosecution or dismissal of charges against individual officers and employees.

B. Comment: Prosecutors may enter into plea agreements with corporations for the same reasons and under the same constraints as apply to plea agreements with natural persons. *See* USAM §§ 9-27.400-500. This means, *inter alia*, that the corporation should be required to plead guilty to the most serious, readily provable offense charged. As is the case with individuals, the attorney making this determination should do so "on the basis of an individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the federal criminal code, and maximize the impact of federal resources on crime. In making this determination, the attorney for the government considers, inter alia, such factors as the sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range ... is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *See* Attorney General's Memorandum, dated October 12, 1993. In addition, any negotiated departures from the Sentencing Guidelines must be justifiable under the Guidelines and must be disclosed to the sentencing court. A corporation should be made to realize that pleading guilty to criminal charges constitutes an admission of guilt and not merely a resolution of an inconvenient distraction from its business. As with natural persons, pleas should be structured so that the corporation may not later "proclaim lack of culpability or even complete innocence." *See* USAM §§ 9-27.420(b)(4), 9-27.440, 9-27.500. Thus, for instance, there should be placed upon the record a sufficient factual basis for the plea to prevent later corporate assertions of innocence.

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A corporate plea agreement should also contain provisions that recognize the nature of the corporate "person" and ensure that the principles of punishment, deterrence, and rehabilitation are met. In the corporate context, punishment and deterrence are generally accomplished by substantial fines, mandatory restitution, and institution of appropriate compliance measures, including, if necessary, continued judicial oversight or the use of special masters. *See* USSG §§ 8B1.1, 8C2.1, *et seq*. In addition, where the corporation is a government contractor, permanent or temporary debarment may be appropriate. Where the corporation was engaged in government contracting fraud, a prosecutor may not negotiate away an agency's right to debar or to list the corporate defendant.

In negotiating a plea agreement, prosecutors should also consider the deterrent value of prosecutions of individuals within the corporation. Therefore, one factor that a prosecutor may consider in determining whether to enter into a plea agreement is whether the corporation is seeking immunity for its employees and officers or whether the corporation is willing to cooperate in the investigation of culpable individuals. Prosecutors should rarely negotiate away individual criminal liability in a corporate plea.

Rehabilitation, of course, requires that the corporation undertake to be law-abiding in the future. It is, therefore, appropriate to require the corporation, as a condition of probation, to implement a compliance program or to reform an existing one. As discussed above, prosecutors may consult with the appropriate state and federal agencies and components of the Justice Department to ensure that a proposed compliance program is adequate and meets industry standards and best practices. *See* section VII, *supra*.

In plea agreements in which the corporation agrees to cooperate, the prosecutor should ensure that the cooperation is complete and truthful. To do so, the prosecutor may request that the corporation waive attorney-client and work product protection, make employees and agents available for debriefing, disclose the results of its internal investigation, file appropriate certified financial statements, agree to governmental or third-party audits, and take whatever other steps are necessary to ensure that the full scope of the corporate wrongdoing is disclosed and that the responsible culprits are identified and, if appropriate, prosecuted. *See* generally section VIII, *supra*.

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