

MORE WORK FOR COUNSEL: RATTING ON COLLEAGUES

*How not to undermine
corporate clients' trust*

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Recent corporate scandals have resulted in increased scrutiny of corporate business practices. Congress and regulators have responded to a perceived crisis in the business community not only by changing the obligations of accountants, CEOs, CFOs, audit committees and boards of directors, but also by placing new obligations on corporate counsel.

The Sarbanes-Oxley Act and forthcoming Security and Exchange rules will impose on attorneys the affirmative duty to report evi-

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dence of any material securities laws violations or breach of fiduciary duties to the general counsel or chief executive officer. These reporting obligations will increasingly force attorneys to act in a policing role, potentially undermining the trust in their relationships with clients. In light of this new legislation, what should counsel do to maintain their role as advisors and counselors?

Rule 1.13 of the American Bar Association's Model Rules of Professional Conduct sets forth the ethical duties imposed on attorneys representing an organization. Model Rule 1.13(b) requires an attorney who knows that an officer or employee is engaged in an action, or intends to act, in violation of law, resulting in substantial injury to the organization, to "proceed as is reasonably necessary in the best interest of the organization."

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Rule 1.13(b) permits counsel to consider a range of possible actions in responding, one of which might be to bring the matter to the attention of a "higher authority in the organization," which could include the CEO or board of directors, "if warranted by the seriousness of the matter." Model Rule 1.13 does not, however, require a lawyer to take a particular course of action.

The model rules require counsel to "know" that a party engaged or may engage in illegal conduct and then to proceed as is "reasonably necessary." The model rules provide counsel with broad discretion in deciding what actions to take and impose a high threshold before counsel must act.

Congress, through the Sarbanes-Oxley Act, addressed what arguably was perceived as a weakness in the model rules, by removing counsel's discretion and imposing strict reporting requirements.

Section 307 of the Sarbanes-Oxley Act directs the SEC to issue rules by January 2003 setting forth minimum standards of professional conduct for attorneys practicing before the SEC by representing a public company in any capacity.

The forthcoming SEC rules will require

counsel to report to the chief legal counsel or CEO evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent. If there is not an "appropriate" response, counsel must report the evidence to the audit committee, the full board or another committee of the board consisting entirely of outside directors.

The Sarbanes-Oxley Act lowers the applicable knowledge threshold. The model rules define "knowledge" of a legal violation as "actual knowledge of the fact in question." An attorney must "know" of a violation of a legal obligation before being required to act. Mere suspicion does not trigger a reporting obligation. Further-more, while prudent counsel will investigate allegations of misconduct, the model rules generally do not place an affirmative obligation on counsel to do so.

The Sarbanes-Oxley Act, however, changes counsel's obligations dramatically. Pursuant to the act, the SEC will issue rules imposing a duty on an attorney to report to the chief legal counsel or CEO if he or she

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has “evidence” of a securities law violation or breach of fiduciary duty. The obligation to report arises solely by virtue of counsel being in possession of “evidence.” The act does not provide counsel with discretion to weigh the credibility or probity of the evidence.

Consider a situation where corporate counsel discovers a document that references an unreported contractual relationship with an off-balance sheet entity. On its face, the document is not a violation of the securities laws, but may constitute “evidence” of either a securities law violation or a breach of fiduciary duty.

Under the knowledge standard of the model rules, counsel would not necessarily have an obligation to report this to a “higher authority.” Under the Sarbanes-Oxley Act, however, counsel may be required to report this evidence to the general counsel or chief executive officer.

In addition to lowering the reporting threshold, the Sarbanes-Oxley Act virtually eliminates counsel’s discretion to determine how to respond to evidence of a material violation by removing the continuum of choices and requiring a report to the chief legal officer or CEO. Counsel also must monitor the response by the recipient of the report to determine whether the response taken was “appropriate”—a standard that remains as yet undefined.

Section 307 of the Sarbanes-Oxley Act will in all likelihood result in SEC rules that

extensively increase the frequency with which an attorney must consider reporting wrongful conduct of company personnel. This reporting requirement may in turn create conflicts between company executives and attorneys.

Counsel who learn of material violations of the securities or other laws must therefore try to balance their reporting and monitoring obligations with their ethical obligations to act as advisors. At risk is the trust of a company’s key business personnel, without which counsel’s job is impossible.

A few suggestions are worth noting about preserving trust while meeting these new obligations. First, counsel should make certain that the company has in place a corporate compliance program, adopted at the highest level of the corporation, and overseen not only by counsel but also by other senior corporate officials. The compliance program should have an established procedure for dealing with suspected violations of the law and a mechanism that encourages reports of illegal or unethical conflict. If these procedures are in place and used in practice, counsel will be perceived as following a company-wide, mandatory compliance program.

Second, counsel should recognize that while the Sarbanes-Oxley Act creates risks for a failure to report, the risks of over reporting also are significant. Nothing would undermine confidence more quickly

than frequent trips to the CEO with possible evidence of a material violation. Over reporting may also result in senior executives choosing not to consult with counsel before acting, thereby placing the company at greater risk.

Consulting with outside counsel for another opinion in close situations will help mitigate the risk of both under and over reporting.

Third, counsel should be careful that these new reporting obligations do not compromise the attorney-client privilege. Although the privilege may be under attack in certain other instances, for example, increased pressure to waive the privilege when cooperating with a government investigation, or in cases where counsel has provided both legal and business advice, here the privilege should not be affected.

Finally, counsel represents the corporation, not senior executives. Counsel’s duties are owed to the corporation and its shareholders. At times it may be difficult to reconcile the obligation of owing a duty to the corporation, not corporate executives, because counsel will need to be more attentive when challenging actions and explanations of individual senior executives. Counsel may want to be more proactive in recommending that individual executives obtain separate counsel, or that the board of directors appoint a special committee to investigate questionable conduct. ■

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