REPORT

I. BACKGROUND OF THE RESOLUTION

The Task Force on Corporate Responsibility ("Task Force") respectfully submits the foregoing resolution (the "Governance Policy Resolution") in response to the following charge, presented to it by Robert Hirshon, then President of the American Bar Association, upon appointment of the Task Force on March 28, 2002:

> 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. During the months following release of the Preliminary Report, the Task Force convened public hearings on its preliminary recommendations in Chicago, New York City and Palo Alto, California and received a variety of written and oral comments on its Preliminary Report.[1]

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."[2] The Governance Policy Resolution responds to the Task Force's founding charge from Robert Hirshon and to President Carlton's call for broad policy conclusions.[3]

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[1] The Preliminary Report of the Task Force is published at 58 BUS. LAW. 189 (2002), and is available, along with the oral and written testimony submitted in the Task Force's public hearings, at http://www.abanet.org/buslaw/corporateresponsibility/home.html (the "Task Force Web Site").

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

[3] Not all members of the Task Force endorse each recommendation and every view expressed in the 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

II. CONTEXT OF THE GOVERNANCE POLICY RESOLUTION

The Governance Policy Resolution addresses the mechanisms of public corporation governance in the United States,[4] with particular emphasis on the role of lawyers. Rather than attempt to determine the legal, ethical or moral responsibility of any individual person or organization associated with any particular failure of corporate responsibility,[5] the Task Force has sought 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. 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.[6]

The Governance Policy Resolution has not been developed in a static environment. Since the Task Force was appointed, many reforms significantly affecting corporate governance and responsibility have been effected or proposed:

- The Sarbanes-Oxley Act of 2002[7] 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

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the American Bar Association and, accordingly, should not be considered as representing the policy of the American Bar Association.

[4] As used in this recommendation and in the Task Force's 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.

[5] 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.

[6] 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 its Report.

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

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 Sarbanes-Oxley Act of 2002 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,[8] and established a prohibition against personal loans to directors and executive officers of public corporations.[9]

- 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,[10] Congress adopted Section 307 of the Sarbanes-Oxley Act of 2002, requiring the Securities and Exchange Commission ("SEC") to promulgate rules of professional conduct for lawyers appearing and practicing before the SEC.

- 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.[11]

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

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.[12] At the same time, however, it is generally acknowledged that direct operational control of American public corporations is, and must remain, primarily in the hands of their senior executive officers.[13]

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8 Sarbanes-Oxley Act of 2002, Section 301.

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

10 *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 .

11 The NYSE and Nasdaq proposed corporate governance listing standards are available at http://www.nyse.com/abouthome.html?query=/about/report.html and http://www.nasdaq.com/about/ProposedRules.stm#boards, respectively.

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

13 As used in this Supporting Statement, 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.

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.[14] 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.[15] 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, 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 effective counseling of the key participants in the corporate governance process, including the directors, auditors and counsel.[16] 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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[14] *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.

[15] *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).

[16] *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).

- Boards of directors, whose responsibilities include the duty to oversee management performance in the best interests of the corporation.[17] 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.[18]

- 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.[19] Because of their importance to the integrity of the capital markets, and because of concerns arising from cases in which the reliability of public corporation audits 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.[20]

- 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.[21]

- 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 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.

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

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[17] *E.g.*, *In re Caremark Int'l Inc. Deriv. Lit.*, 698 A.2d 959 (Del. Ch. 1996); Model Business Corporation Act Annotated §8.31 (2000/01/02 Supp. at 8-204, 8-216P).

[18] *See, e.g.,* the NYSE and Nasdaq listing standard proposals identified in note 11, *supra*.

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

[20] *Id.;* Sarbanes-Oxley Act of 2002, §§101-110.

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

- 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.[22] 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 nonetheless expects that the states – and the statutory language of the ABA-sponsored Model Business Corporation Act ("MBCA") – will 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.

- 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,[23] and in recent months both the NYSE and the Nasdaq, at the prompting of the SEC, have proposed a broad array of new governance listing requirements.[24]

- Federal legislation has from time to time imposed substantive and procedural mandates that specifically affect corporate governance, such as: requiring

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

[23] 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).

[24] *See* note 11, *supra.*

accurate books and records and internal controls, and proscribing improper payments;[25] prohibiting extension of credit in the form of a personal loan to any director or executive officer;[26] 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."[27]

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 excluded from such assertions.[28] 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. 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 active and informed stewardship of the best interests of the corporation has in too many instances fallen short.*[29]

In addressing this problem, the Task Force focused in part upon the directors of the public corporation, who 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

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

[26] 15 U.S.C. §78m(k), Section 13(k) of the Exchange Act, added by Section 402 of the Sarbanes-Oxley Act of 2002.

[27] 18 U.S.C. §1350, enacted by Section 906 of the Sarbanes-Oxley Act of 2002.

[28] E.g., Coffee, *supra* note 19; 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/; 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.

[29] Preliminary Report at 10.

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.

- 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.[30] Directors 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 personal interests or loyalties.[31] Thus, "[d]*irectors cannot guarantee*

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[30] 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).

[31] Courts have observed 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).

corporate compliance; they can only be expected to undertake and execute good faith efforts to ensure that it occurs."[32]

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.[33] Direct legislative action or the imposition of legal sanctions to change this culture may 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 encourage such changes largely by augmenting the independence of outside directors from senior executive officers, affording such directors greater responsibilities in the selection of board nominees and in the oversight of financial reporting and legal compliance and encouraging 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 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.[34] 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[35] and an active, independent oversight role.

The events of the last two years compellingly call for significant reforms and "consciousness raising" in our system of corporate governance. As previously

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

[33] 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.

[34] 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 36.

[35] *See* The Business Roundtable May 2002 Principles of Corporate Governance at 3.

described, there have already been numerous such reform initiatives.[36] The Task Force believes, however, that important reforms remain to be developed or implemented in a number of areas. The Governance Policy Resolution addresses two of these areas: the role of lawyers and the role of directors. The elements of that resolution are intended to enhance the ability of corporate counsel and directors to discharge their corporate governance responsibilities more effectively.

IV. ENHANCING THE CONTRIBUTION OF LAWYERS TO THE EFFECTIVE GOVERNANCE OF 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 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[37] – to assist in the design and maintenance of the corporation's procedures for promoting legal compliance.

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 Governance Policy Resolution includes two policies that the Task Force believes are of particular importance in this regard. First, the board of directors should establish a practice of regular, executive session meetings between the general counsel[38] and a committee of independent directors.[39] 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

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[36] *See* Part II, *supra*.

[37] As used in the Report, the term "general counsel" refers to the lawyer having general supervisory responsibility for the legal affairs of the corporation. *See* Recommendation n. 1.

[38] 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* Recommendation n. 1.

[39] 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* Governance Policy Resolution ¶¶3 and 7b.

material violations or potential violations of law by the corporation or of material violations or potential violations of duties to the corporation.

Communication Between General Counsel and Independent Directors

The general counsel of a corporation works day to day with senior management and typically reports to the CEO or another senior executive officer. 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.[40] 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 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.[41]

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[40] Indeed, the regulations adopted by SEC pursuant to Section 307 of the Sarbanes-Oxley Act of 2002 (the "Part 205 Rules") may impose such an obligation as a matter of federal law. *See* 17 CFR §§205.3(b)(1) and (b)(2).

[41] 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 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, 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 employee or department that 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. 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

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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.

and direct it to a place in the corporate structure where appropriate action can be taken.[42]

V. ENHANCING THE CONTRIBUTION OF DIRECTORS TO PUBLIC CORPORATION GOVERNANCE

The Task Force recommends the governance practices set forth in Part VI of its Report 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).[43] 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.[44]

The Task Force recognizes that there are different ways of implementing these governance practices, ranging from state law changes to trading market listing standards to federal statutory or SEC regulatory prescriptions to institutionally sponsored "best practices." In its Eighth Policy, the Task Force sets forth its conclusion that the statutory language of the MBCA, state legislatures and courts interpreting state law 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. In addition, the Task Force urges that the ABA and appropriate entities within the ABA proceed promptly to evaluate and, where appropriate, develop other specific ways in which to implement the Task Force's policy recommendations.

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

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[42] 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.

[43] 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.

[44] Part VI of the Task Force's Report catalogues these various counterparts, which can be found in the proposed listing standards of the New York Stock Exchange and Nasdaq, certain provisions of the Sarbanes-Oxley Act of 2002 and SEC regulations implementing such provisions, and corporate governance policies of organizations like The Conference Board and The Business Roundtable.

recent corporate failures. Lawyers for the corporation should play an important role in corporate governance and the governance policy 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. For the foregoing reasons, the Task Force respectfully urges that the House of Delegates adopt the proposed governance policies.

Respectfully submitted,
The Task Force on Corporate Responsibility
James H. Cheek, III, Chair