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

**July 16, 2002**

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**PRELIMINARY REPORT OF**
**THE ABA TASK FORCE ON CORPORATE RESPONSIBILITY**

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On March 28, 2002, Robert Hirshon, President of the American Bar Association, 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.

The Task Force respectfully submits this preliminary report in response to that charge. The report is the product of extended meetings of the full Task Force, numerous formal and informal meetings of various subgroups of the Task Force, and the fund of professional experience and judgment that the members of the Task Force bring to bear.[1]

This preliminary report is intended to serve as a vehicle to elicit comments from interested observers, within the ABA and elsewhere, through a written comment

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[1] The Task Force also notes with particular gratitude the contributions of Mary Ann Jorgenson, Chair of the ABA Section of Business Law Committee on Corporate Laws, and Stanley Keller, Chair of the ABA Section of Business Law Committee on Federal Regulation of Securities, special advisers to the Task Force.

process and one or more public hearings to be scheduled this fall. With such input, the Task Force intends to generate a final report before the end of 2002.

The Task Force's recommendations are set out and explained below. They are recited in summary outline form in Exhibit A to this report. Not all members of the Task Force endorse each recommendation and view expressed in this report, but the report taken as a whole reflects a consensus of the members of the Task Force.

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# I. INTRODUCTION AND OVERVIEW

## A. Background of Recent Failures of Corporate Responsibility

Few events in business history since the Great Depression have had the public impact of the stunning collapse of Enron Corp. and other major companies in the past year. Although President Hirshon's charge to the Task Force specifically refers to Enron, that company is merely one of the most notorious in a disturbing series of recent lapses at large corporations involving false or misleading financial statements and alleged misconduct by executive officers.[2] Investor confidence in the quality and

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[2] Among the more notable recent disclosures:

- After months of questioning of its financial statements, WorldCom announced on June 25, 2002 that it had overstated its earnings before interest, taxes, depreciation and amortization (EBITDA) by over $3.8 billion in the five previous quarters. *See* WorldCom press release dated June 25, 2002, exhibit to Form 8-K dated June 25, 2002. This huge overstatement apparently arose in significant part due to a strategy of treating operating costs such as maintenance as capital investments instead. As it announced the accounting errors, WorldCom also announced that it would eliminate 20% of its work force. Over $115 billion in mid-1999, WorldCom's market capitalization is now less than $1 billion. *See* Simon Romero and Alex Berenson, "WorldCom Says It Hid Expenses, Inflating Cash Flow $3.8 Billion," New York Times, June 26, 2002, p. A1.

- On June 25, 2002, Adelphia Communications filed for protection under Chapter 11 of the bankruptcy laws, some three months after revealing that it had guaranteed loans of $2.3 billion to members of the Rigas family, Adelphia's controlling shareholders. Joseph B. Treaster, "Adelphia Files for Bankruptcy," New York Times, June 26, 2002, p. C2. Adelphia's common stock, which had reached a high of nearly $28 per share just last December, is now essentially worthless. Peter Lauria, "Adelphia Bottoms Out," The Daily Deal, June 27, 2002.

- The market capitalization of the stock of Tyco International has fallen by some $100 billion this year, driven by the indictment of its former chief executive officer on charges of state sales tax evasion, and by concerns about the use of

integrity of public company corporate governance is compromised, and the pace of calls by the President, Congress, the SEC, stock markets and other interested groups for regulatory reform has quickened dramatically.[3]

Given the charge to the Task Force to examine "systemic issues relating to corporate responsibility," the threshold consideration in evaluating recent failures in "corporate responsibility" is defining that term. At the very least, "corporate responsibility" should be understood to include behavior by the executive officers and

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corporate funds for the personal benefit of the chief executive officer and the general counsel of the company. *See* Alex Berenson, "Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System," New York Times, June 10, 2002, p. C1.

- Gary Winnick, the former head of now bankrupt Global Crossing Ltd., sold over $700 million of his stock in that company from 1999, when the price reached $60 per share, through the end of 2001, soon before its bankruptcy filing following allegations that the company's revenues were inflated due to swaps without economic substance. *See* Jill Stewart, "Master of Disaster: How L.A.'s Super-rich Gary Winnick is Trying to Wash Blood from the Global Crossing Implosion off his Hands -- and Make More Money in the Bargain," New Times Los Angeles, April 25, 2002.

At least until the collapses that put some of these companies, as well as Enron, into bankruptcy, the common stock of all of these companies had been traded on the New York Stock Exchange or the Nasdaq National Market.

[3] The chairman and chief executive officer of the investment banking firm of Goldman Sachs recently remarked publicly that, "I cannot think of a time when business over all has been held in less repute." Patrick McGeehan, "Goldman Chief Urges Reforms in Corporations," New York Times, June 6, 2002, p. A1; *see also* Gretchen Morgenson, "What If Investors Won't Join the Party?," New York Times, June 2, 2002, p. C4 (reporting a May UBS/Gallup poll indicating that "84 percent feel that [the accounting impropriety] issue is punishing stock prices, ranking it ahead of conflict in the Middle East and terrorism."). *See also* The Business Roundtable Statement on Restoring Investor Trust, July 8, 2002, *available at* http://www.brt.org/press.cfm/728; Statement of the Chairs of the Conference Board Commission on Public Trust 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.[4] Participants in the

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Private Enterprise, July 10, 2002, *available at* http://www.conferenceboard.org/economics/press.cfm?pressid=3000.

The responses of public officials to these concerns include: Remarks by the President on Corporate Responsibility, delivered on July 9, 2002, *available at* http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html; "President Outlines Plan to Improve Corporate Responsibility," Remarks by the President at Malcolm Baldrige National Quality Award Ceremony (March 7, 2002) *available at* http://www.whitehouse.gov/news/releases/2002/03/20020307-3.html; H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, sponsored by Representative Oxley and approved by the House of Representatives on April 24, 2002; S. 2673, sponsored by Senator Sarbanes and approved (as H.R. 3763) by the Senate on July 15, 2002; and H.R. 5118, sponsored by Representative Sensenbrenner and approved by the House of Representatives on July 16, 2002. The SEC has proposed a number of regulatory reforms, including the formation of a Public Accountability Board, CEO certification of financial reports, and the approval of New York Stock Exchange and NASD rules affecting the conduct of security analysts. Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624, June 26, 2002, *available at* http://www.sec.gov/rules/proposed/33-8109.htm; Certification of Disclosure in Companies' Quarterly and Annual Reports, SEC Release No. 34-46079, June 17, 2002, *available at* http://www.sec.gov/rules/proposed.shtml; SEC Release No. 34-45908; File No. SR-NASD-2002-21; SR-NYSE-2002-09 (May 10, 2002), *available at* http://www.sec.gov/rules/sro/34-45908.htm.

[4] Section 2.01 of the American Law Institute's Principles of Corporate Governance expresses the consensus of the legal and business community that:

> (a) Subject to subsection (b) ... , a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.
>
> (b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

corporate governance process require a fresh recognition that executives are employees, and that corporate responsibility can only be achieved when officers and directors both recognize that they are obliged to advance the interests of others. In their roles as corporate fiduciaries, the corporation does not belong to them.

Judged by this concept of corporate responsibility, the system of corporate governance at many public companies has failed dramatically. It is a clear failure of corporate responsibility, for example, if a corporation belatedly and precipitously discloses that the equity on its balance sheet has been overstated by *billions* of dollars. It is a clear failure of corporate responsibility if employees whose retirement accounts are heavily invested in the corporation's stock are assured by management of the

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> (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
> (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
> (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

This language expresses a balance in which corporations are generally entitled, and indeed obligated, to seek to maximize their wealth for the benefit of their shareholders. That entitlement is tempered, on the other hand, by the corporation's obligation to act within the bounds of the law, and its power to engage in charitable activities and follow reasonable ethical considerations even if doing so fails to maximize the corporation's wealth.

While some state statutes (so-called "constituency statutes") purport to embrace a hierarchy in which shareholders are entitled to no greater consideration than employees or communities or other corporate constituencies, those statutes tend to have no different practical impact than the law in states that follow the American Law Institute approach. *See* Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion,* 45 BUS. LAW. 2253, 2271 (1990) ("Those statutes that merely empower directors to consider the interests of other constituencies are best taken as a legislative affirmation of what courts would be expected to hold, in the absence of a statute."). In

corporation's financial prospects and then discover that the value of that stock has promptly vanished as a result of earnings misstatements and self-dealing by corporate officers. It is a clear failure of corporate responsibility if executive officers aware of potential accounting irregularities sell millions of dollars of stock to public investors who are unaware of such information. It is a clear failure of corporate responsibility for insiders to borrow enormous amounts from their companies without adequate security beyond inflated stock of the company itself. And it is a clear failure of corporate responsibility when outside directors, auditors and lawyers, who have important roles in our system of independent checks on the corporation's management, fail to avert or even discover – and sometimes actually condone or contribute toward the creation of – the grossest of financial manipulations and fraud.

At least with the benefit of hindsight, the 1990's can be seen to have created a potent recipe for failures of corporate responsibility. Among other things:

- Stock prices grew enormously and almost continuously, leading many investors to expect double digit annual returns on investment as a matter of course.[5] Executive officers were expected to meet growth expectations of Wall Street analysts that became increasingly unrealistic. The only hope for meeting expectations was a willingness to undertake significant risk or to manipulate data so that they would indicate the desired results.

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all states, shareholder interests have primacy as a practical matter because only shareholders are entitled to vote in the election of corporate directors.

[5] *See* Harris Collingwood, "The Earnings Cult," New York Times Magazine 68 (June 9, 2002).

- Aided by dramatic stock price growth, equity-based executive compensation – particularly in the form of stock options – as a means intended to align the interests of managers and shareholders became increasingly prevalent and lucrative. There were unanticipated consequences. Executive officers were endowed with powerful personal incentives to meet near term Wall Street earnings expectations and to avoid any negative impact upon current stock market prices.[6] Directors faced significant pressures to produce executive compensation and benefit packages that were attractive in an ever-escalating executive compensation marketplace. The reasonableness of compensation and its structure, as well as the motivations being created, may not have received sufficient independent consideration.
- Outside professionals hired by the corporation – particularly its accountants and lawyers – faced increasing pressures of consolidation and global competition, and they found it necessary to compete more keenly to identify ways to enhance their relationships with their corporate clients. As accounting and law firms grew larger, the need increased to put in place internal controls that would allow those firms to assure the necessary quality controls and independent judgment. Corporate executives' self-interest in assuring a rising corporate stock price, and the frequent need to be aggressive in accounting matters and in assuming business risks were not tempered by the checks and balances which the general

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[6] David Wessel, "Why Boardroom Bad Guys Have Emerged en Masse: The 1990's Magnified Shifts in Business Mores as Watchdogs Napped," Wall Street Journal

corporate governance scheme expected from outside directors and professional firms engaged by the corporation to provide independent review and advice. Questionable treatment of financial information evaded audit screens, and important disclosures were not made. Unfortunately, judgments at all levels of the governance system were compromised and, in too many instances, seriously flawed.

### B. Identifying Critical Causes of Failures of Corporate Responsibility

The Task Force believes that most executive officers, directors and professional advisers act honestly and in good faith. Direct operational control of American public companies is and must remain primarily in the hands of their executive officers. It has always been recognized, however, that executive officers and other employees of public companies may succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being. To check such temptation, and to focus the corporation on the interests of the shareholders, our system of corporate governance has long relied upon the active oversight and advice of independent participants in the corporate governance process, such as the outside directors, outside auditors and outside counsel. 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 interests of the corporation and are empowered effectively to exercise their responsibilities.

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(June 20, 2002).

*The core conclusion of the Task Force, however, is that, as evidenced by recent failures of corporate responsibility, the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short.* Unless the governance system is changed in ways designed to encourage such active and informed stewardship, the Task Force believes that public trust and investor confidence in the corporate governance system will not be restored.

No set of legal rules or guidelines can guarantee that such active care will be achieved in practice.[7] Even the most stringent definition of independence will not generate the backbone to act independently and objectively which the Task Force believes is necessary to an effective system of corporate governance. And certainly, no reasonable amount of active care will invariably prevent fraud or other misconduct by corporate management. The Task Force nonetheless believes that its recommendations would significantly enhance corporate governance practices and ethical principles to make it more likely that the system of checks and balances involving outside directors, auditors and corporate counsel will work effectively to help ensure that the corporation is ethically and legally responsible and managed in the long run best interests of the corporation and its shareholders.

### C. Subjects of the Task Force's Recommendations

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[7] The Business Roundtable's May 2002 Principles of Corporate Governance (p. 2) acknowledge that "[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."

Effective reform of the corporate governance process will require comprehensive changes. In some areas in need of such change, the Task Force has not at this time formulated specific recommendations.[8] There are two principal areas, however, in which the Task Force believes that the ABA can meaningfully contribute to the current public policy debate on corporate responsibility. The first area involves internal corporate governance, particularly the composition and processes of the board of directors and its core committees. The ABA, particularly through its Business Law Section, has long been an important source of guidance in the formulation of internal rules of corporate governance.[9] The Task Force benefits from the collective experience

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[8] There are three significant limitations on the scope of this report. First, 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 governance. Second, the Task Force has also not at this time formulated recommendations on specific policy initiatives relating directly to public company audits, executive compensation and benefit plans, security analysts or employee retirement benefit plans. It is nevertheless the sense of the Task Force that meaningful reforms in these areas are necessary to complement the reforms it is proposing with respect to boards of directors and corporate lawyers. In particular, the Task Force supports the formation of a new, independent public oversight board for the accounting profession (although the Task Force has not reached any conclusion regarding specific attributes – composition or powers, for example – of such a board). The Task Force also believes that executive compensation practices, including the provisions and accounting for stock options, need to be carefully considered in reviewing reform necessary to enhancing corporate responsibility. Third and finally, the Task Force's recommendations concerning internal corporate governance standards are limited to corporations having publicly traded stock. In part, this limitation arises from the charge to the Task Force, which explicitly addresses "public companies." This limitation to public companies is appropriate in any event because the greatest risk to investors involves public companies; most large companies are publicly held; and the existing pattern of regulation through federal securities law and securities trading markets facilitates prompt reform.

[9] ABA Business Law Section Committee on Corporate Laws, Corporate Director's Guidebook (3rd ed. 2001).

of its members whose professional careers have involved deep practical experience with, and broad study of, public corporations and the legal and ethical framework within which those corporations carry on their activities. The Task Force recommends that the ABA consider and endorse a series of corporate governance initiatives that are intended to enhance the likelihood that key corporate actors and advisers will act to further the interests of the corporation and its shareholders. These initiatives are set forth and explained in part II of this report.

The second area in which this report of the Task Force offers recommendations involves the ethical and governance framework within which the corporate lawyer can advance corporate responsibility. For many years the ABA has studied and formulated policies designed to encourage lawyers to promote corporate responsibility. Recent criticism of lawyers' conduct demonstrates that this study and formulation of policy has not yet achieved its objective and must be a continuing effort. The Task Force proposes that the ABA's Standing Committee on Ethics and Professional Responsibility consider a number of modifications to the ABA's Model Rules of Professional Conduct, and the Task Force also recommends a governance process designed to establish effective channels for chief legal officers and outside corporate counsel to communicate with independent directors. These recommendations, which are set forth and explained in part III of this report, are designed to make more effective the contributions of lawyers to corporate responsibility.

## II. RECOMMENDATIONS REGARDING INTERNAL CORPORATE GOVERNANCE

### A. Introductory Perspective

Although the model for outside directors today posits an attitude of independence from senior management in carrying out their oversight function, in practice many aspects of the outside directors' role have reflected a dependence on senior management. Typically, senior management plays a significant part in the selection of directors, in proposing the compensation for directors, in selecting their committee assignments, in setting agendas for their meetings, and in evaluating their performance. In addition, directors often defer to management for the selection of the key advisers to the board and its committees (*e.g.*, compensation consultants), as well as the outside auditors for the company.

Recommendations to create active independent oversight must address these realities and bring about actual change. More specifically, such recommendations should serve four subsidiary purposes: (1) encourage qualified individuals to serve as independent directors; (2) create expectations and attitudes on the part of such individuals that establish active, informed and objective oversight as a behavioral norm; (3) create mechanisms that empower those individuals to exercise such oversight; and (4) reinforce those mechanisms with appropriate public disclosure obligations.

In developing such recommended standards of internal corporate governance, there is no shortage of models to review, and the Task Force has been greatly assisted by the wide range of industry organizations that have recently made corporate

governance recommendations.[10] In many respects, those various organizations have urged standards of governance that reflect a developing consensus that we believe will materially improve the responsible conduct of corporate business.

Most of the recommendations below relating to internal corporate governance contemplate implementation through listing standards of the principal United States securities trading markets such as the New York Stock Exchange and the Nasdaq Stock Market. The Task Force is concerned, however, that the two principal trading marketplaces will not adopt substantially similar listing standards relating to corporate governance and that the other SRO's, such as the American Stock Exchange, the Midwest Stock Exchange and the Pacific Stock Exchange, may adopt none. The Task Force believes that substantial uniformity of governance standards applicable to public companies is desirable and would have the greatest impact on reliable corporate responsibility. Among the alternatives discussed by the Task Force to produce uniformity is to amend Section 19(c) of the Securities Exchange Act to empower the SEC to amend the rules of a self-regulatory organization to assure uniformity in listing

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[10] We refer, for example, to: (1) the Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee dated June 6, 2002; (2) May 24, 2002 announcement by the Nasdaq Stock Market, Inc.; (3) May 2002 Business Roundtable Principles of Corporate Governance, and its related July 2002 statement, *available at* http://www.brt.org/press.cfm/728 ; (4) March 2002 Financial Executives International, Observations and Recommendations Improving Financial Management, Financial Reporting and Corporate Governance; (5) Council of Institutional Investors Corporate Governance Policies, *available at* http://www.cii.org/corp_governance.htm. The Task Force has also been guided by the Corporate Director's Guidebook (3rd ed. 2001) prepared by the Committee on Corporate Laws of the ABA Business Law Section, and by the ALI Principles of Corporate Governance.

standards with respect to corporate governance matters.[11] The Task Force believes, however, that the most practical approach for adopting the proposed listing standards promptly – an approach that avoids direct federal regulation of matters of corporate governance historically governed by state law -- is for the self-regulatory organizations, acting with the support of the SEC or under the auspices of a jointly appointed Blue Ribbon Commission,[12] to adopt standards of governance that reflect the necessary improvements to the system of corporate checks and balances applicable to the largest public companies. If the desired uniformity is not achieved through this approach, however, serious consideration of alternatives such as amending Section 19(c) may be appropriate if other means are not found to avoid trading marketplace arbitrage.

The Task Force is not at this time addressing possible changes in state corporation law. State laws apply to a wide range of corporate entities, including closely held family businesses, and therefore the flexibility to accommodate different rules may be important. It is difficult in any event to coordinate state action on a uniform basis; on

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[11] The SEC currently can amend self-regulatory organization rules as it "deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of [the Securities Exchange Act] and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of [the Securities Exchange Act]. Securities Exchange Act §19(c), 15 U.S.C.§78s. The leading case construing the SEC's authority under this statute sharply circumscribed, or negated altogether, such authority in regard to the direct adoption of corporate governance listing standards. *The Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

[12] An example of such a commission is the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was composed of representatives of the New York Stock Exchange, Nasdaq, the SEC and other organizations interested in corporate governance. The 1999 report of that committee is available at http://www.nyse.com/abouthome.html?query=/about/report.html.

the other hand, there are ongoing mechanisms for improving the ability of state corporate laws to deal with conflicts or interest on the part of corporate directors and officers. For example, the Committee on Corporate Laws of the ABA Business Law Section, which developed and periodically revises the frequently followed Model Business Corporation Act, is expected later this year to propose significant changes to clarify and enhance the role of independent directors in the evaluation of conflict of interest transactions. Moreover, the state courts that review the fiduciary duties of care and loyalty of directors and officers 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 will improve the level of corporate responsibility.

**B. Proposed Corporate Governance Recommendations**

Having discussed numerous suggestions for change in corporate governance principles, the Task Force has concluded that corporate responsibility of public companies must be materially improved. Such companies should adhere to each of the following standards of internal corporate governance:[13]

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[13] The Task Force recognizes that these recommended standards of internal corporate governance may not be uniformly appropriate for all types of public companies. For certain categories of public companies, such as investment companies governed by the Investment Company Act of 1940 and exchange traded funds (ETF's), compliance with the recommended standards may be unnecessary or unsuitable. In addition, application of certain of the recommended standards to majority owned subsidiaries or similarly controlled public companies, and to foreign private issuers as defined in SEC Rule 3b-4(c), presents complex issues which require further study.

1. A substantial majority of the members of the Board of Directors should be independent of management, both in fact and in appearance. The independent directors should meet routinely in executive session outside the presence of any senior corporate officer or director who is not independent. While the Task Force is not at this time recommending any particular formulation of the definition of the term "independent," the Task Force supports the concepts of independence recently proposed for adoption by the New York Stock Exchange.[14]

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[14] In its June 6, 2002 report, the New York Stock Exchange Corporate Accountability and Listing Standards Committee addresses the concept of director independence as follows:

> • No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.
>
> • In addition:
>
> – No director who is a former employee of the listed company can be independent" until five years after the employment has ended.
> – No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.
> – No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director.
> - Directors with immediate family members in the foregoing categories must likewise be subject to the five-year "cooling-off" provisions for purposes of determining "independence."

Report at 6-8. The NYSE Committee's report also observes, and the Task Force agrees, that "[w]e do not view ownership, or affiliation with the owner, of less than a controlling amount of stock as a *per se* bar to an independence finding." *Id.* at 8.

2. The Board of Directors should appoint a committee (described in these recommendations as the Corporate Governance Committee) composed entirely of independent directors, and which may consist of all of the independent directors. This committee should be responsible for the identification and nomination (or recommendation of nomination) of independent members of the Board of Directors, and for extending invitations to potential independent Board members. This committee should also appoint or recommend to the full Board of Directors the persons to serve on each of the other committees of the Board. The Corporate Governance Committee may consult with the chief executive officer or any other executive officer of the corporation regarding such nominations or recommendations, but the Committee should ultimately determine and approve such nominations and recommendations in executive session outside the presence of any executive officer or director who is not independent.

3. The Audit Committee of the Board of Directors should be composed entirely of independent directors. The Audit Committee should meet routinely outside the presence of any executive officer of the corporation or director who is not independent. The Audit Committee should (a) have the authority either to engage and remove the corporation's outside auditor, or to recommend such engagement or removal to the Board, and the authority to determine the terms of the engagement of the outside auditor; (b) have the authority and resources to engage independent accounting and legal advisers when determined by the Committee to be necessary or appropriate; and (c) recommend or establish

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. 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 by the full Board of Directors (or by all of the independent directors on the full Board) upon the recommendation of the committee.[15]

4. The Compensation Committee of the Board of Directors should be composed entirely of independent directors. The Compensation Committee should meet routinely outside the presence of any senior officer of the corporation or director who is not independent. The Compensation Committee should (a) determine, or make a recommendation with respect to, the compensation (including executive benefit plans) of the senior executive officers of the corporation, and (b) have the authority and resources to engage independent executive compensation and legal advisers when determined by the Committee to be necessary or appropriate. 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

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[15] This flexibility of permitting action by the full Board of Directors or all of the independent directors acting as a group is not explicitly contemplated in the recently proposed amendments to the listing standards of the NYSE. The Task Force believes, however, that such flexibility would be valuable as a means to obtain input from all independent directors, rather than just those who are appointed to serve on the Audit Committee. This same point applies as well to the Corporate Governance Committee and the Compensation Committee.

of Directors (or by all of the independent directors on the full Board) upon the recommendation of the committee.

5. The Corporate Governance Committee (or other committee consisting entirely of independent directors) should recommend for adoption by the full Board of Directors a corporate code of ethics and conduct that includes the establishment of a mechanism (such as a hot line, an ombudsman or compliance certification) through which information concerning violations of law by the corporation or its management personnel, or breaches of 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 the Audit or Corporate Governance Committee. In any investigation by the Board of Directors (or any committee) of such a violation or breach of duty, the Board (or committee) should have the authority to retain independent legal counsel.

6. In addition to approvals required by law, the Corporate Governance Committee, the Audit Committee or some other committee composed exclusively of independent directors and appointed for the purpose by or on the recommendation of the Corporate Governance Committee, should review and approve any material transaction between the corporation and any director or 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 a loan or guarantee by the

corporation.  Such review and approval should include (a) an explanation 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); (b) a documented rationale for engaging in the transaction with a related party rather than with a third party; (c) a specific determination of the fairness of the transaction; and (d) a review of the public disclosure that may be appropriate for the transaction.

7. The Corporate Governance Committee and the Audit Committee should establish procedures for regular meetings with the corporate officers responsible for implementing the corporation's internal controls, codes of ethics and compliance policies – such as general counsel, the chief internal auditor and the chief compliance officer.[16] At least a portion of such meetings should routinely be outside the presence of any other executive officer or director who is not independent.  At such meetings, the responsible officer should report on legal and compliance affairs of the corporation as directed by the committee.  The scope and content of such reports should be designed to elicit, at a minimum, information about violations or potential violations of law and breaches of duty by an executive officer or director that could have a material adverse effect on the corporation.[17]

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[16] The areas of internal controls may vary from company to company depending upon the nature of its business; in most cases they would include the internal audit function and compliance with relevant legal requirements (antitrust, insider trading, environmental, employment, etc.), and may include matters such as product safety.

[17] Thus, this recommended standard is closely related to the Task Force's recommendations (in Part IV(C) below) regarding lines of communication through which

The Task Force further believes that, in addition to the mandatory standards set forth above, best practices of corporate governance should include principles by which the Board of Directors takes the following actions:

1. Consider whether to implement other processes that may encourage active and informed input of the independent directors. Such processes may include (a) the appointment of a "lead" independent director,[18] or an independent director to serve as Chair of the Board of Directors, and (b) the adoption of processes for setting agendas and distributing information.

2. Consider whether to establish term limits or policies governing rotation of the chair and membership of the Board of Directors and its Corporate Governance, Audit and Compensation Committees, and the number of board and committee memberships.

3. Institute and maintain 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.

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general counsel and outside counsel can effectively communicate issues relating to violations of law and breaches of fiduciary duty by corporate officers or employees.

[18] For example, the New York Stock Exchange Corporate Accountability and Listing Standards Committee has proposed to require the designation and public identification of the independent director who will preside over regularly scheduled meetings of non-management directors. (NYSE Recommendations p. 7).

4. Institute procedures for 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.

## III. RECOMMENDATIONS REGARDING THE CONDUCT OF LAWYERS

### A. Introductory Perspective

The conduct of inside and outside lawyers representing companies involved in recent failures of corporate responsibility has been the subject of legislative inquiry and public criticism, and those lawyers have been the targets of civil litigation and hints of possible criminal prosecution[19]. Members of Congress and commentators have questioned whether, in light of the events that transpired, the rules of professional conduct governing lawyers adequately serve and protect the public interest in circumstances such as those that were present in such corporate failures.[20]

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[19] Illustrative material is available from the Task Force's web site, at: http://www.abanet.org/buslaw/corporateresponsibility/responsibility_relatedmat.html.

[20] Senator Edwards' remarks and his letter to SEC Chairman Harvey Pitt, 148 Cong Rec S 5652 (June 18, 2002) (urging imposition of corporate lawyer responsibilities through federal legislation), as well as the March 7, 2002 letter from Prof. Richard Painter, *et al.*, to Chairman Pitt, are available at the Task Force's web site. The bill passed by the Senate on July 15, 2002 (H.R. 3763) includes the following provision requiring the SEC to prescribe minimum standards of professional conduct for attorneys practicing before the Commission:

> Not later than 180 days after the date of enactment of this section, the Commission shall establish rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of public companies, including a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof) and, 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 or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the company, or to the board of directors.

In response to these concerns, the Task Force has reviewed applicable provisions of the ABA Model Rules of Professional Conduct ("Model Rules" or "Rules"), as most recently amended in February 2002.[21] Based on that review, the Task Force believes that the Model Rules should be amended in several important respects. The amendments proposed by the Task Force are designed to help lawyers comply with their duties to an organizational client in circumstances in which corporate officers engage in or countenance criminal, fraudulent or deceptive conduct likely to cause harm to the organization or its shareholders.

The Task Force has also concluded that it would promote corporate responsibility to adopt practices in which both outside and inside counsel to the corporation have a direct line of communication through which counsel may proceed in circumstances in which the lawyer reasonably believes that the corporate client is involved in a violation or potential violation of law or in a breach of duty that will adversely affect in a material manner the interests of the corporation. Finally, the Task Force recommends that the ABA further study and develop recommendations of “best practices” for law firms and corporate legal departments that are designed to promote effective and ethical representation of the corporation. All of these recommendations address the role of counsel for all corporations, and not just those with publicly traded stock.

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H.R. 3763 section 602(d).

[21] Controlling rules of professional conduct are usually promulgated by the highest court of the state in which the lawyer practices, and are frequently modeled upon the ABA Model Rules of Professional Conduct. The rules of professional conduct may also be relevant in determining attorney liability. *See* American Law Institute, Restatement (Third) of the Law Governing Lawyers, §52(2)(c) and cmt. f.

### B. Proposed Amendments to the Model Rules of Professional Conduct

The Model Rules encourage lawyers to embrace and observe moral and ethical considerations beyond legally required minimum standards. For example, the Preamble to the Model Rules states that "a lawyer is also guided by personal conscience." Likewise, the Scope of the Rules declares that "[t]he Rules do not . . . exhaust the moral and ethical considerations that should inform a lawyer, for no worthwhile human activity can be completely defined by legal rules. The Rules simply provide a framework for the ethical practice of law." Model Rule 2.1 provides that, in rendering advice, "a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation." The Comments to Model Rule 2.1 state that "[a]lthough a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied."

These broad and aspirational principles, while of profound importance, do not afford a sufficient guide to the corporate lawyer confronted with aberrant conduct by corporate officers and insiders. Such guidance should be given, in the view of the Task Force, by clear and precise direction in the Model Rules.[22] The amendments proposed by the Task Force to be considered by the Standing Committee on Ethics and Professional Responsibility reflect this objective. The background and content of the proposed amendments follow.

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**Model Rule 1.13.** Rule 1.13 ("Organization as Client") states that a lawyer employed or retained by an organization represents the entity ("the organization acting through its duly authorized constituents"). If confronted with corporate misconduct, the lawyer must consider whether, among other alternatives, to present the lawyer's concerns about that misconduct to a higher level of authority within the organization. Rule 1.13 provides that the lawyer shall proceed "as is reasonably necessary in the best interest of the organization" if the lawyer 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 premise of Rule 1.13 is that the organization is the lawyer's client and that the lawyer owes that client an obligation of protection from harm. Harm can result when an officer breaches a duty to the corporation (*e.g.*, wastes or misappropriates corporate assets), when the corporation will be caused to injure a third party who will then have a claim against the corporation or when the corporation will be exposed to a fine or penalty. In any such case, the lawyer's duty to protect the corporate client from harm requires the lawyer to serve the interests of the corporation and its shareholders rather than the interests of the individual officers or employees who are acting for the corporation.

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[22] The Task Force's recommendations address Model Rules 1.2, 1.6, 1.13, 1.16 and 4.1. Those Rules, in their current form, are reproduced in Exhibit B to this report.

The range of actions open to the lawyer under Rule 1.13 includes asking for reconsideration of the matter, taking the matter to higher authority in the organization or, in an extreme case, where higher authority fails to act, resigning from the representation in accordance with Rule 1.16 or disclosing confidential client information to a third party in accordance with Rule 1.6.[23]

Under existing Rule 1.13, only misconduct that is "related to the [lawyer's] representation" triggers the lawyer's obligation. In addition, the tone of Rule 1.13 (including its Comments) tends to discourage action by the lawyer to prevent or rectify corporate misconduct. Thus, for example, Rule 1.13(b) requires that any measure taken by the lawyer "be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization." The Task Force believes that this wording unduly emphasizes the avoidance of "disruption" of the organization while playing down the more important goal of minimizing harm resulting from the misconduct. Likewise, the Comments to Rule 1.13 state that "[c]lear justification should exist for seeking review over the head of the constituent normally responsible for it." This wording discourages a lawyer from seeking review by higher corporate authority.

The Task Force accepts that it is the appropriate role of corporate officers and employees to make business decisions involving substantial degrees of risk, such as entering into a largely untested new line of business or building new facilities in

[23] Disclosure of client confidences to higher authority *within* the corporation is not prohibited by Rule 1.6, and Rule 1.13 should make this clear.

anticipation of projected business growth, and certainly the lawyer is not expected to go over the head of the individual with whom the lawyer is dealing unless he or she has reason to believe that the officer or employee is acting illegally or fraudulently, or in breach of a duty to the corporation. When the lawyer knows or reasonably should know of such misconduct, however, the lawyer should be encouraged to act promptly to protect the interests of the corporation.

The Task Force therefore recommends that Rule 1.13 be amended to make clear that it requires the lawyer to pursue the measures outlined in Rule 1.13(c)(1) through (3) (including referring the matter to higher corporate authority), in a matter either related to the lawyer's representation (as currently provided) *or* that has come to the lawyer's attention through the representation, where the misconduct by a corporate officer, employee or agent involves crime or fraud, including violations of federal securities laws and regulations.[24] Rule 1.13(b) could also be amended to emphasize in the text of the Rule itself that the list of potential remedial measures need not be pursued in sequential order, and that in circumstances involving potentially serious misconduct with significant risk to the corporation, an effort to seek reconsideration by a particular officer or employee that is unlikely to succeed should be bypassed in favor of referral to a higher

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[24] Where the misconduct is unrelated to the lawyer's representation, however, the requirement to pursue the measures outlined in Rule 1.13(c)(1) should apply only where the lawyer knows of the misconduct, since there should be no obligation on the part of the lawyer to inquire into matters unrelated to the lawyer's representation. *See* discussion below, text at note 34, proposing to amend Rule 1.13, among others, to reach matters of which the lawyer "reasonably should know."

authority in the corporation.[25] Finally, the Task Force recommends that both the text of and comments to Rule 1.13 should be revised to avoid unduly discouraging action by counsel to prevent or rectify corporate misconduct, and to encourage lawyers to take the action required by the rule.

**Model Rule 1.6.** Rule 1.6 prohibits (with limited exceptions) a lawyer from disclosing information relating to the representation of a client except with the client's informed consent. The protections of Rule 1.6 apply to communications to the lawyer by a corporate officer when acting in that capacity. It is not clear, however, what the Rules permit the lawyer to disclose upon learning of corporate misconduct through confidential consultation with a corporate officer. The Comments to Rule 1.13 state that even if the lawyer is unable through other courses of action to protect the corporation and its shareholders, the lawyer's duty to safeguard confidential communications under Rule 1.6 remains in force.

The ABA Commission on Evaluation of the Rules of Professional Conduct ("Ethics 2000") proposed in February of this year, consistent with the Restatement (Third) of the Law Governing Lawyers, that three exceptions be added to Model Rule

[25] The existing commentary to Rule 1.13(b) correctly notes that referral to a higher corporate authority may occur without prior presentation to the officer or employee whose conduct is in question: "If that [presentation to the officer or employee] 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." Rule 1.13, Comment [3] (emphasis added).

1.6 to permit the lawyer to disclose client confidences to third parties.[26] The ABA House of Delegates approved one of those exceptions, permitting disclosure when necessary to prevent reasonably certain death or substantial bodily harm. It rejected the other two Ethics 2000 proposals to expand permissive disclosure under Rule 1.6. Those proposals would have permitted disclosure to prevent or rectify the consequences of a crime or fraud in which the client had used or was using the lawyer's services and that was reasonably certain to result, or had resulted, in substantial injury to the financial interests or property of another.[27]

The Task Force recommends that the House of Delegates reconsider and adopt these Ethics 2000 proposals. We endorse the following articulation in the Ethics 2000 report of the rationale for those proposals:

> The Commission recommends that a lawyer be permitted to reveal information relating to the representation to the extent necessary to prevent the client from committing a crime or fraud reasonably certain to result in substantial economic loss, but only when the lawyer's services have been or are being used in furtherance of the crime or fraud. Use of the lawyer's services for such improper ends constitutes a serious abuse of the client-lawyer relationship. The client's entitlement to the protection of the Rule must be balanced against the prevention of the injury that would otherwise be suffered and the interest of the lawyer in being able to prevent the misuse of the lawyer's services.
>
> Moreover, with respect to future conduct, the client can easily prevent the harm of disclosure by refraining from the wrongful conduct. …
>
> The rationale for [permitting disclosure to prevent, mitigate or rectify substantial economic loss resulting from client crime or fraud in which client has used

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[26] American Bar Association, Commission on Evaluation of the Rules of Professional Conduct, Report with Recommendation to the House of Delegates (August 2001), *available at* http://www.abanet.org/cpr/e2k-report_home.html.

[27] *See* http://www.abanet.org/cpr/e2k-rule16.html.

> lawyer's services] is the same …, the only difference being that the client no longer can prevent disclosure by refraining from the crime or fraud. See also Comment [8]. The Commission believes that the interests of the affected persons in mitigating or recouping their substantial losses and the interest of the lawyer in undoing a wrong in which the lawyer's services were unwittingly used outweigh the interests of a client who has so abused the client-lawyer relationship.

The Task Force further recommends amendment of Rule 1.6 to make disclosure mandatory, rather than permissive, 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.

Forty-one states either permit or require disclosure to prevent a client from perpetrating a fraud that constitutes a crime,[28] and eighteen states permit or require disclosure to rectify substantial loss resulting from client crime or fraud in which the client used the lawyer's services.[29] If existing Rule 1.6 was "out of step with public policy" a year ago, as Ethics 2000 concluded,[30] it is even more out of step today, when

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[28] Alaska, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Massachusetts, Maryland, Maine, Michigan, Minnesota, Mississippi, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, West Virginia and Wyoming (permit); Florida, New Jersey, Virginia and Wisconsin (require).

[29] Connecticut, Hawaii, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Texas, Utah, Virginia and Wisconsin (permit); Hawaii and Ohio (require).

[30] *See* Reporter's Explanation of Changes to Rule 1.6, *available at* http://www.abanet.org/cpr/e2k-rule16rem.html

public demand that lawyers play a greater role in promoting corporate responsibility is almost certainly much stronger. The Ethics 2000 proposals are an important part of an effective response to the problems that have provoked public criticism of the bar.

**Model Rules 1.2 and 4.1.** Rules 1.2 and 4.1 prohibit active participation in a client's criminal or fraudulent conduct. 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." 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." Rule 4.1 also provides 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."

Both of these Rules refer to "knowing" conduct. Similarly, the mandate of Rule 1.13 applies only if the lawyer "knows" that a person associated with an organization is engaging in or intends to engage in misconduct. The Model Rules define "knows" as "actual knowledge of the fact in question." While a person's knowledge "may be inferred from the circumstances," this term presumably does not reach conduct covered by the term "reasonably should know," which is also defined in the Model Rules.

In recent corporate failures, some legal advisers have been criticized for accepting management's instructions and limiting their advice and/or services to a narrowly defined scope, ignoring the context or implications of the advice they are

giving.[31] This criticism is similar to that generally directed at lawyers giving tax opinions on hypothetical facts in circumstances in which the opinions served to facilitate fraudulent transactions.[32] The ABA has long advised that lawyers providing transactional opinions that may be relied upon by third parties cannot blindly accept facts posited by the client; they must question and investigate the factual predicate for their advice, at least to some extent and in some circumstances.[33]

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[31] *See, e.g.,* 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, at 25-26, available at http://news.findlaw.com/hdocs/docs/enron/sicreport/.

[32] *See* ABA Standing Committee on Ethics and Professional Responsibility, Formal Opinion No. 346, "Tax Law Opinions in Tax Shelter Investment Offerings," 68 A.B.A.J. 471 (1982).

[33] *Id.* ("The lawyer who accepts as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue, also gives a false opinion."). Quoting an earlier opinion (A.B.A. Formal Opinion No. 335 (1974), the 1982 ABA opinion explains the lawyer's duty to investigate as follows:

> [T]he lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. The extent of this inquiry will depend in each case upon the circumstances; for example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information.
>
> Where the lawyer concludes that further inquiry of reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion. However, assuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their

There has also been criticism of corporate lawyers for turning a blind eye to the natural consequences of what they observe and claiming that they did not "know" that the corporate officers they were advising were engaged in misconduct. The Task Force believes that, while lawyers should not be subject to discipline for simple negligence, they should not be permitted to ignore the obvious. Instead, lawyers should be held to the "reasonably should know" standard, defined in the Model Rules as denoting "that a lawyer of reasonable prudence and competence would ascertain the matter in question."[34]

In summary, the Task Force believes that the problems and criticisms it has described are legitimate concerns that require a corrective response. Accordingly, the

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> face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate. . . .
>
> The essence of this opinion . . . is that, while a lawyer should make adequate preparation including inquiry into the relevant facts that is consistent with the above guidelines, and while he should not accept as true that which he should not reasonably believe to be true, he does not have the responsibility to 'audit' the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon.

*See also* 31 CFR §10.33(a)(1), which requires tax practitioners who give tax shelter opinions to "make inquiry as to all relevant facts," and precludes such practitioners from

> (ii) ... accept[ing] as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client's statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.

[34] Some members of the Task Force preferred limiting this expansion of Rules 1.2(d), 1.13 and 4.1 to matters that should have been obvious to a lawyer of reasonable prudence and competence given the facts actually known to the lawyer.

Task Force concludes that the Model Rules should be amended so as better to protect the public from criminal or fraudulent conduct using a lawyer's services, better to serve the interests of organizational clients, and better to guide lawyers in complying with their ethical obligations when serving organizational clients.

### C. Reporting by Counsel of Potential Violations of Law and Other Concerns Relating to the Welfare of the Corporate Client

In addition to the foregoing recommendations of amendments to the Model Rules, the Task Force recommends the adoption of two corporate governance policies that would facilitate and encourage independent oversight of potential violations of law and breaches of duty to the corporation. First, the Board of Directors should establish a practice of regular, executive session meetings between the general counsel[35] and the Audit Committee or other appropriate committee of the Board of Directors. Second, all retentions 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 violations or potential violations of law by the corporation or of violations or potential

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[35] Reference to the general counsel includes, where appropriate, the general counsel's staff and, where no office of general counsel has been established, outside counsel performing a similar role with respect to corporate governance, compliance or disclosure. The Task Force recommends that if a public company has no internal corporate general counsel, the Audit Committee (or other committee of independent directors) of the Board of Directors should identify and designate a lawyer or law firm to act as general counsel, or designate an executive officer to have executive responsibility for the legal affairs of the corporation.

violations of duties to the corporation. The reasons for these recommended practices are set forth below.

### *1. 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 officer. Although such interaction is with individual members of management, the general counsel's client is the corporation. That creates a tension whose resolution demands a number of practical steps.

Where the general counsel knows or has reason to know that an officer or employee to whom counsel reports will breach a duty to the corporation or violate a law, counsel may have to confront the issue of going over the head of that individual if the officer or employee cannot be persuaded to alter such conduct. If the relevant officer or employee is a member of senior management or most difficult, the CEO, general counsel must determine whether to go up the corporate ladder to the Board or a Board committee.

The general counsel's consideration, under Model Rule 1.13, of whether to go over the head of the CEO depends upon a number of factors: the basis for and strength of counsel's concerns about the conduct; the severity of possible harm to the corporation as a consequence of the conduct, and the level of disruption within the corporation from raising the issue to the board level. In any event, the general counsel will expect to pay a substantial price for going over the head of the CEO and will be reluctant to do so. At a minimum, such action will disturb the relationship of the CEO

and the general counsel.

Suppose on the other hand that the general counsel, as a matter of routine, periodically meets privately with the Chair of the Audit Committee. Suppose further that the Chair of the Audit Committee had instructed general counsel to use those occasions to report on violations or potential violations of law, breaches of duty to the corporation and other substantial legal concerns relating to the welfare of the corporation that have come to general counsel's attention since their last meeting. The Chair also expects to know what investigation of the facts has been made, what steps have been taken to deal with the violations or breaches, and the steps taken to make sure such violations or breaches do not reoccur. Under such a procedure, the general counsel would not easily be able to avoid reporting to the Chair of the Audit Committee the concerns about the particular conduct. Moreover, the fact that the general counsel would have to make such disclosure probably makes it easier for the general counsel to persuade the CEO to raise the issue with the Chair of the Audit Committee.

If the CEO agrees to raise the issue with the Chair of the Audit Committee, does the general counsel have any duty to see whether the CEO has done so? This possible duty is relatively easy for the general counsel to discharge, by saying: "I understand the CEO has already discussed with you the issue raised by..."

Suppose the Chair of the Audit Committee responds to the general counsel by agreeing with the CEO's position that the corporation must take the business risk of engaging in the conduct worrying the general counsel because if the corporation does not do so it will have enormous problems with its business and lose a substantial

amount of money. Must the general counsel take the issue to the rest of the Board? If the general counsel concludes that there is a reasonable likelihood that this action contravenes the Board adopted Code of Conduct or is illegal, counsel must at a minimum strongly urge that the Board be informed. If the Board is nevertheless prepared in effect to amend the Code to permit a violation of law and the conduct would create substantial risks of physical harm to third parties, it would implicate duties under Model Rule 1.6 to consider disclosure of the conduct, and under Rule 1.16 to consider withdrawal. In addition, under Rule 1.2(d) counsel cannot participate in any act that violates the law.

The Task Force believes that it would facilitate the general counsel's ability to assure that critical issues, including all issues of potential law and fiduciary duty violations, be raised to the Board level if routine, periodic private meetings (designed to elicit specific information) between the general counsel and appropriate independent directors were part of the governance process adopted by the Board. An important virtue of such a process is that it provides leverage for the general counsel to persuade senior management itself to raise those issues with appropriate members of the Board and thus allows the general counsel to avoid the painful and possibly disruptive process of having to go over the head of senior management.

*2. Communication Between Outside Counsel and General Counsel*

The corporation is commonly served by a number of outside counsel who interact with specific corporate employees. Outside counsel may or may not have regular contact with the corporation's senior management (including the CEO) and typically do

not interact with the Board of Directors or independent members of the Board. In the absence of such contact, outside counsel who becomes concerned that a duty to the corporation has been breached or that the corporation may be violating or potentially violating the law is unlikely to have either the mandate or access to the corporation's resources to permit an appropriate investigation to be made.

In these circumstances, present Model Rule 1.13 probably does not require the outside counsel to take any action. There are frequently significant practical obstacles, moreover, to outside counsel bringing potential misconduct to the attention of appropriate corporate authorities. In many situations operational personnel will hire outside counsel and be responsible for future hires of counsel. Consequently, a pattern can easily develop where outside counsel does not fully appreciate that counsel's responsibility is to the corporation, not to the employee or department who retains counsel.

In many well run corporations, however, the general counsel will have made clear to outside counsel that in circumstances where outside counsel believes that an officer or employee is violating the law or a duty to the company, outside counsel should communicate that belief to the general counsel. General counsel may have additional information and, if needed, typically has the resources to make appropriate investigations and is charged with responsibility to pursue such inquiries in appropriate situations. In those corporations, outside counsel will have an invitation to make known his or her concerns at a place in the corporate structure where appropriate action can be taken.

Particularly in circumstances where operational personnel select (or are perceived as selecting) counsel, general counsel should take an early opportunity to meet with outside counsel and stress that outside counsel represents the corporation and that general counsel wants to be informed of situations where outside counsel is concerned that the law is being violated or there is a breach of duty that adversely affects the interests of the corporation.[36] General counsel will also follow up by periodically meeting with outside counsel to talk about the representation.

Creation of this routine path of communication helps outside counsel to take appropriate steps where counsel knows or has reason to believe that officers or employees are engaging in conduct which will cause the corporation to violate the law or otherwise suffer serious harm. These steps tend to put the problem in the hands of the general counsel who usually has better tools to get the problem properly resolved within the corporate governance process.

This procedure will not solve the problem 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 outside counsel is remitted to the guidance in Model Rule 1.13, discussed above, dealing with presenting concerns about corporate misconduct to higher levels of authority within the corporation.

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[36] Since outside counsel does not want the raising of this information to prejudice unnecessarily an ongoing working relationship with the employee, general counsel must be sensitive in dealing with the information communicated by outside counsel.

Many public corporations have no internal corporate general counsel with whom outside counsel can communicate. If an outside law firm serves as the corporate general counsel, the Chair of the Audit Committee or Corporate Governance Committee of the Board of Directors will want to meet regularly and privately with the appropriate member or members of such outside law firm. In addition, the Chair may want to arrange for that firm to perform the general counsel role described above with respect to other outside firms retained to represent the corporation. In some cases that process would not be appropriate and outside counsel would be remitted to the guidance in Model Rule 1.13, discussed above. In general, however, the Task Force believes that the Audit Committee (or other committee of independent directors) should identify and designate a single lawyer or law firm to perform the general counsel role.

### D. Issues for Further Study

The foregoing recommendations, if adopted and implemented, should by no means represent the last word in the development of standards of conduct for corporate lawyers in the interest of promoting corporate responsibility. There have been enormous changes in the legal profession in recent years, including the growth of very large law firms, whose offices are widely scattered, not only in the United States but also abroad. This development heightens the need for thoughtful evaluation of how the rules of professional conduct and best practices can be effectively implemented.

Growth in size, geographical dispersion and increasing emphasis on economic results compel law firms to focus attention on internal quality and risk management controls. These controls should assure that difficult issues of client relations are

surfaced at appropriate levels of the firm, are thoroughly examined in discussions, which include partners who are not intimately involved with the client, and decided by the firm. In addition, senior management of law firms and corporate law departments should make special efforts to educate all their colleagues about their responsibilities to their corporate clients and their other professional responsibilities.

The Task Force recommends that the appropriate committee of the Business Law Section of the ABA, and such other groups as the ABA considers appropriate, promptly take up these important issues of internal law firm and law department governance.

Finally, the Task Force notes that the corporate lawyer should be sensitive to the potential conflicts of interest arising out of business and investment relationships with his or her client. While ethically permitted under current principles, accepting securities in a client company in exchange for legal services, serving on the board of directors of a client for which legal services are performed by the firm, and entering into business arrangements with the client raise potential conflicts of interest with the client and may adversely affect the attorney's independence and judgment.[37] The Task Force has not had the time fully to consider these difficult issues. It expects to do so prior to the issuance of its final report following comments and testimony on these issues.

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[37] *See* Model Rule 1.8(a); American Law Institute, Restatement (Third) of the Law Governing Lawyers §126; ABA Standing Committee on Ethics and Professional Responsibility Formal Opinion No. 00-418, Acquiring Ownership in a Client in Connection with Performing Legal Services (July 7, 2000); The Lawyer-Director:

EXHIBIT A

## SUMMARY OF RECOMMENDATIONS[38]

### Recommendations Relating to Internal Corporate Governance

*Recommended Standards for Public Companies*

1. A Board of Directors should include a substantial majority of independent directors, with independence being defined in a manner consistent with recent listing standard proposals for the New York Stock Exchange.

2. A corporate governance (or equivalent) committee composed entirely of independent directors should be responsible for identifying and contacting potential independent directors.

3. The audit committee should consist entirely of independent directors, and should have authority to recommend or take action with respect to engaging and removing the outside auditor, engaging independent accounting and legal advisers when deemed necessary or appropriate, and establishing policies relating to non-audit services by the outside auditor and other matters that may affect the outside auditor's independence.

4. The compensation committee should consist entirely of independent directors, and should have authority to recommend or take action with respect to determining senior executive officer compensation and engaging independent executive compensation and legal advisers when deemed necessary or appropriate.

5. The corporate governance committee should recommend a corporate code of ethics and conduct including establishing a mechanism for communication to independent directors of information about material violations of law and breaches of duty to the corporation.

6. A committee of independent directors should approve all material transactions with a director or executive officer, upon specific

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Implications for Independence, ABA Section of Litigation Task Force on the Independent Lawyer (April 1998).

[38] This summary is solely intended to facilitate comment, and is in all respects qualified by the full text of the recommendations in the body of the report.

determinations of fairness, rationale for dealing with a related party rather than a third party, and appropriate public disclosure.

7. The Board should adopt procedures for routine held, executive session meetings between the corporate governance and/or audit committees and the corporate officers (*e.g.*, general counsel, chief internal auditor, chief compliance officer) responsible for implementing internal controls.

*Recommended Governance Enhancements for Boards of Directors of Public Companies*

1. Consider use of "lead" independent director or independent Board chair, and adoption of processes for agenda setting and information distribution.

2. Consider policies establishing term limits or rotating chair/membership of corporate governance, audit and compensation committees, and the number of board and committee memberships.

3. Maintain a program of director training and education.

4. Adopt procedures for evaluating effectiveness of meetings, information flow, diversity of director experience and contributions of individual directors.

**Recommendations Relating to Lawyer Responsibilities and Conduct**

*Proposals to Amend the Model Rules of Professional Responsibility:*

1. Amend Rule 1.13 to require the lawyer to pursue remedial measures for misconduct whether the problem is related to the representation or learned through the representation and to communicate with higher corporate authority where other efforts fail to prevent or rectify the problem, to make clear that disclosure of confidential client information to higher authority within the corporation does not violate Rule 1.6, and to revise language that discourages lawyers from communicating with higher corporate authorities.

2. Extend permissible disclosure under Rule 1.6 to reach conduct that has resulted or is reasonably certain to result in substantial injury to the financial interests or property of another, and require disclosure under Rule 1.6 to prevent felonies or other serious crimes, including violations of the federal securities laws, where such misconduct is known to the lawyer.

3. Expand Rules 1.2(d), 1.13 and 4.1 to reach beyond actual knowledge to circumstances in which the lawyer reasonably should know of the crime or fraud.

4. Improve the linkage among the Model Rules relating to the obligations of a lawyer faced with illegal conduct or breach of fiduciary duty in representing a corporate client.

*Proposals for Establishing Lines of Communication by General Counsel and Outside Counsel*

1. Corporations should adopt a practice whereby general counsel meets routinely and periodically, privately, with one or more independent directors, to facilitate Board attention to potential violations of law by and breaches of duty to the corporation.

2. All engagements of outside counsel should establish at the outset a direct line of communication with general counsel through which outside counsel should inform the general counsel of violations/potential violations of law and duty to the corporation.

**EXHIBIT B**

## SELECTED MODEL RULES OF PROFESSIONAL CONDUCT

### SCOPE OF REPRESENTATION

RULE 1.2 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) Subject to paragraphs (c) and (d), a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

(b) A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

### 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 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.

## DECLINING OR TERMINATING REPRESENTATION

### RULE 1.16 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the rules of professional conduct or other law;

(2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) the lawyer is discharged.

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if:

(1) withdrawal can be accomplished without material adverse effect on the interests of the client;

(2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;

(3) the client has used the lawyer's services to perpetrate a crime or fraud;

(4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement;

(5) the client fails substantially to fulfill an obligation to the lawyer regarding the

lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled;

(6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or

(7) other good cause for withdrawal exists.

(c) A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

(d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

TRUTHFULNESS IN STATEMENTS TO OTHERS

RULE 4.1 ABA MODEL RULES OF PROFESSIONAL CONDUCT

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.