Executive Summary

REPORT

NEW YORK CITY BAR ASSOCIATION

TASK FORCE ON THE LAWYER'S ROLE IN CORPORATE GOVERNANCE

In March 2005, Bettina Plevan, then President of the New York City Bar Association (the "Association"), appointed this Task Force with the following charge:

> The Task Force will examine the role of counsel, both in-house and outside, with respect to counseling about corporate conduct. The Task Force will examine all aspects of the role of individual lawyers and law firms by examining recent failures to perform that role effectively as alleged by government agencies, Congress and the courts. The Task Force will also consider the interplay between ethical rules, privileges and the evolving enforcement climate. It will include within its focus an examination of decision-making within law firms, and the possible need for enhanced procedures to strengthen the oversight by law firms of the conduct of their attorneys.

The full 190 page report of the Task Force (hereafter the "Report") is posted elsewhere on this website. What follows is an Executive Summary of the Report.

Recommendations

A lawyer's legal duties: confidential advisor to clients

The subject of the lawyers' role in advising public companies has been an active subject of debate for many decades (see Report pp. 30-40). It has received heightened focus as a result of the spate of recent major corporate scandals, which have again raised the oft-asked

question, "where were the lawyers"?, i.e., why were such scandals not averted by either inside or outside lawyers? The Task Force reviewed the available public record concerning nine recent scandals in an attempt to answer this question on an empirical basis.

Our conclusion, necessarily a tentative one absent definitive fact-finding, is that lawyers, either in-house or outside, appear to have been strategically positioned with respect to a significant number of these scandals. Though not necessarily culpable in any actual wrongdoing, a matter for determination by courts or other tribunals, lawyers often were sufficiently familiar with aspects of client conduct later alleged to have been fraudulent to have asked questions about that conduct. They appear to have done so in certain instances. Where questions were not asked or pressed, it is reasonable to believe that more assertive action might have avoided or mitigated wrongdoing in some of these situations. (see Report pp. 21-30, and Appendix D).

This conclusion suggests that lawyers are potential "whistleblowers" or "gatekeepers" with respect to incipient or past client wrongdoing, thus posing the question of whether they should be duty-bound to play that role for the protection of the investing public. The Task Force does not recommend that lawyers be required to play such a role. (See Report pp. 57-64). To the contrary, we believe that to impose general whistle-blowing or gatekeeping duties on lawyers, so contrary to their traditional role as confidential advisors to their clients, would be counterproductive. It probably would result in a chilling of client-lawyer communications, the exclusion of lawyers from some strategic meetings, and generally degrade the ability of lawyers to

render well-informed advice to their corporate clients.[1] It might also lead to a defensive advising on the part of lawyers concerned about the possibility of their own liability.

The traditional limitation of the lawyer's duties of loyalty to his or her client, and the correlative obligation to preserve client confidences, is in the public interest as facilitating the rendition of well-informed legal advice to public companies. By rendering well-informed legal advice, even in the face of client or employer pressures to the contrary, lawyers can play their most productive role in avoiding future corporate scandals. The forthright rendition of such advice is every lawyer's duty. The professional courage necessary to press such advice, sometimes at the risk of losing a client or a job, is indispensable to a lawyer's ability to play an effective role in corporate governance (see Report pp. 95-96).

Thus we do not recommend a fundamental change in a lawyer's responsibilities, such as by recognizing a general legal (or ethical) duty to the investing public.[2] However, because the lawyer's public company client has clear legal duties to the investing public, including its shareholders, the effect of corporate action on the investing public must be a matter of active concern for the lawyer in advising the client (see Report pp. 65-67).

Nor should a lawyer restrict his or her advice to narrow questions of legal compliance. Much conduct that may not violate the law nonetheless may harm the client, or appear to

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[1] We recognize that the SEC's mandatory reporting up rules under SOX, and permissive reporting out rules, which we support, also may produce these impacts to some degree. See Report n. 68 and pp. 70-72, 86-91).

[2] Of course lawyers, in common with all other participants and advisers involved in the offering of securities by public companies, do have legal duties to the public to the extent prescribed by regulations and statutes, such as the SEC's Rule 10b-5. For example, a lawyer cannot, any more than a corporate officer, make materially misleading representations to the public in connection with a client's offering of securities.

the lawyer to be unfair or unjust. The lawyer's role properly includes advice on such broader questions (see Report pp. 67-70).

Changes in the ethical rules

Notwithstanding the central importance to the lawyer's role of preserving client confidences, limited exceptions to that duty have always existed that recognize other important values. The prevention and mitigation of corporate fraud, particularly in instances where a client has used a lawyer's services in the wrongdoing, is one such value.[3] In this context we recommend that New York's proposed Rules of Professional Conduct, currently under consideration by the House of Delegates of the New York State Bar Association ("NYSBA"), include a series of 2003 amendments to the ABA Model Rules of Professional Conduct ("Model Rules").[4] Specifically, we recommend that New York adopt the 2003 amendments to:

> ABA Model Rule 1.13(b), requiring, presumptively, a lawyer for a corporate client who learns of an ongoing impending violation of law likely to cause substantial injury to the client to report the matter up through the corporate hierarchy, including to the Board of Directors if necessary;
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> ABA Model Rule 1.13(c), permitting a lawyer, if the Board insists upon or fails to address a clear violation of law, to make limited disclosures of client confidences (such as to regulatory bodies) to the extent necessary to prevent substantial injury to the corporate client;

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[3] In this and in several other respects we follow and second the recommendations in the thoughtful report issued in 2003 by the ABA's Task Force on Corporate Responsibility, 59 Bus. Law. 145 (2003).

[4] The proposed New York rules have been put before the NYSBA House of Delegates by the Committee on Standards of Attorney Conduct ("COSAC") in a two volume Report and Recommendations dated September 30, 2005 ("COSAC Report"). Contrary to the views of this Task Force, the COSAC Report does not recommend that New York adopt the "reporting out" features of the ABA 2003 amendments to Model Rules 1.13(c) and 1.6(b)(2) and (3).

ABA Model Rule 1.13(e), requiring a lawyer who believes he has been discharged for reporting up pursuant to Rule 1.13(b), or who withdraws for related reasons, to insure that the Board is informed of this fact;

ABA Model Rules 1.6(b)(2) and (3), permitting a lawyer to make limited disclosures of client confidences (such as to regulatory bodies) to prevent, or to rectify or mitigate, crimes or frauds in which the lawyer's services have been used (see Report pp. 71-95).

Best practices

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

i) the role of General Counsel

The role of the General Counsel of a public company is central to an effective system of corporate governance. We offer a series of suggestions to strengthen and facilitate the General Counsel's role, involving as it does the difficult challenge of reconciling service as a member of a company's senior management with the task of securing management's compliance with the law and the company's articulated ethical standards (see Report pp. 96-112).

To strengthen the General Counsel's ability to discharge her compliance responsibilities, the Board of Directors should review the tenure and terms of compensation of the General Counsel. Specifically, the Board should approve the hiring and compensation of the

General Counsel, articulate its expectations as to General Counsel's role and approve any decision to discharge the General Counsel.

The General Counsel's role should be clearly defined by the Board to include alerting it and other appropriate decision-makers to potential significant law violations and potential damage to the company.

Structures, processes, and procedures should be put into place to emphasize the importance of the General Counsel's function in promoting compliance with the law and ethical standards, and to ensure that the General Counsel has the resources and authority necessary to perform this role.

The General Counsel, to be effective, must be seen as a senior, influential, and respected officer of the corporation and member of the company's senior management, recognized as having strong qualities of independence, judgment and discretion. His or her reporting relationships, access to management and the Board, and compensation all need to be consistent with senior status in the company.

The General Counsel must have sufficient direct access to senior management and to the Board so that problems can be elevated and dealt with at the appropriate level. The General Counsel should report to one of the highest ranked company executives, typically the CEO. He or she should have ready access, as well, to any other executives or directors responsible for compliance, governance or ethics issues, and to any company ombudsman.

The General Counsel should have opportunities to meet with the independent (non-management) members of the Board separately from management, on a regular basis, as distinguished from only ad hoc meetings initiated by the General Counsel when a special need for

consultation arises. The regularity of such meetings would facilitate the raising and discussion of important issues.

In most if not all companies, the General Counsel should regularly attend meetings of the full Board, the Audit Committee, and any legal compliance committee.

When internal lawyers are assigned to subsidiaries or discrete business units, and have their direct reporting relationship to a business manager, they should have at least a "dotted line" reporting relationship to the General Counsel, who should have a significant voice in their hiring, firing and compensation.

Processes and procedures should be put into place to ensure that internal lawyers of appropriate seniority are involved in decisions on matters involving disclosure or other legal risk. For example, a company should insure that internal lawyers are present at appropriate meetings or are members of relevant committees.

A company should clearly inform employees to whom within the internal legal department they can bring concerns. It should also establish employee hotlines, and ensure that lawyers are involved in resolving any legal issues presented through that medium.

Junior lawyers should have training specific to their position and have access to sufficiently senior and experienced internal lawyers – if necessary including the General Counsel – to obtain support and to discuss and elevate issues where required.

The compensation of internal lawyers should not be determined in a manner that undermines the independence of their legal advice, and deters them from raising and appropriately dealing with issues. Such a situation might be presented, for example, were the compensation of a lawyer to be determined solely by a business manager to whom she reported. The Board, as stated

above, should review the compensation of the General Counsel, and the General Counsel should have a substantial role in reviewing the compensation of other internal lawyers.

The General Counsel should have ultimate authority with respect to the selection of the principal external lawyers retained by the company and should clearly define their roles. The General Counsel's expectations of outside counsel, including to "report up" any apparent wrongdoing by corporate agents, must be clearly understood by outside firms.

The General Counsel (or his/her designee) should consider meeting regularly, at least once a year if not more often, with any outside firm performing substantial ongoing work for the company.

ii) the role of outside counsel

The role of outside counsel has evolved in recent decades from a general counseling role to one more focused on specific transactions and on projects that require special expertise. This narrowing of the role of each outside counsel creates the risk that such counsel may render certain services without a full understanding of the context in which the services are requested or to be used.

Another change in the profession over this period has been its evolution toward a more competitive, bottom line orientation, with client relationships often in play and critical to the compensation of partners. This environment creates pressures on law firms and lawyers to acquiesce in questionable client conduct rather than place the client relationship at risk by pressing unwelcome advice. Consequently, it is important for the profession to adhere to professional standards that support the rendition of forthright advice and the rejection of clearly improper client conduct (see pp. Report 112-18).

Outside counsel, through dialogue with the company's General Counsel or management, should endeavor to be aware of the context in which and the purpose for which her services are being requested and used. Counsel cannot guarantee that her services will not be put to some improper purpose, but she can reduce this risk through appropriate inquiries when circumstances suggest some reason for concern.

When in the course of the representation outside counsel becomes seriously concerned about the legality of the company's actual or intended conduct, counsel should make reasonable inquiry of the company, regardless of whether the concern rises to the level of requiring a report under the SEC's lawyer conduct rules (17 C.F.R. § 205) promulgated under Section 307 of the Sarbanes-Oxley Act ("SOX"), Public Law 107-204, 15 U.S.C. § 7245, or comparable state ethical rules. If such inquiries and subsequent counseling do not allay the concern, counsel should seriously consider withdrawing from the representation.

In the rare situation when a company's Board of Directors declines to consider or take action in response to counsel's report of a threatened or ongoing clear and material violation of law by the company, counsel should seriously consider reporting such violation to the appropriate regulatory or governmental authorities (as permitted, under specified circumstances, by the SEC's lawyer conduct rules, ABA Model Rules 1.6(b) and 1.13(c) and the ethics rules of most states). The case for reporting out will be especially compelling if a substantial reason exists to doubt the independence of the company's directors.

When a company asks a law firm or lawyer to succeed other counsel in connection with corporate advice or a transaction, and the circumstances suggest that the predecessor firm's withdrawal or discharge may have involved an issue concerning the client's conduct, before accepting the engagement successor counsel should request that the company permit it to discuss

with prior counsel the reasons for its withdrawal or discharge. A refusal by the company so to permit should usually disincline successor counsel from accepting the engagement.

iii) the role of law firms

The responsibility of law firms as institutions has recently received increased attention in discussions of the ethical responsibilities of the profession. The SEC's lawyer conduct "reporting up" rules appear to have stimulated a heightened focus by firms on their responsibilities to provide ethical guidance to their attorneys in the rendition of legal services. We offer several suggestions for law firms in this area (see Report pp. 121-27).

Every firm with significant public company representations should adopt written procedures for implementing the "up-the-ladder" obligations imposed by applicable ethical rules and the SEC's lawyer conduct rules.

Firm procedures should include, among other things: mechanisms within the firm to report possible violations; clear assurance that lawyers – especially junior attorneys – will be protected against any retaliatory action by reason of reporting up a perceived problem; education and training sessions; and the establishment of designated senior lawyers or committees to facilitate compliance. (One example of such procedures is set forth in Appendix F to the Report).

Because a law firm's culture has a significant impact on how ethics rules are interpreted and enforced within a firm, firms should also adopt for the guidance of their attorneys a statement of best practices in advising public companies. (One example of such a statement is set forth in Appendix G to the Report).

Firms are encouraged to designate a partner (or other senior lawyer), committee or outside counsel as an ethics adviser available to consult with all firm attorneys and otherwise to advance the firm's promotion of high ethical standards.

The attorney-client privilege should be applied to protect consultations between lawyers and their law firm's in-house ethics counsel (or specially retained outside counsel) on matters of professional conduct, including issues pertaining to clients. This protection will facilitate compliance with applicable rules and statutes, and enable the firm to enforce its ethical standards internally, thereby strengthening the lawyer's role in corporate governance. We recommend that the courts review such privilege issues in light of this strong public interest.

iv) the lawyer-auditor relationship and financial disclosures

Almost all of the recent high-profile corporate scandals have involved financial frauds, typically focused on accounting manipulations. This lends urgency to the need to examine the role of lawyers with respect to client financial disclosures, including the manner in which lawyers and auditors work together, or fail to do so, as they render their respective services to a common client (see Report pp. 127-35).

The distinctly different roles of auditors and lawyers, the former independent of the client and owing direct duties to the investing public, and the latter confidential advisors owing their sole duties to their clients, precludes any facile notion of collaboration between the two. Each relationship necessarily must be controlled by the client. The present climate surrounding the auditing of public companies, with the risk of litigation or regulatory action ever present, likely means, regrettably, a continuation of the traditional arm's-length relationship between auditors and lawyers.

Nonetheless, lawyers do have a role to play in connection with a client's financial disclosures. Because accounting concepts are so frequently central to disclosure issues and other matters on which companies require legal advice, a basic familiarity with the relevant accounting concepts is essential for a lawyer advising a public company on financial disclosure and financial

structuring. Law firms (and companies) should provide adequate training programs for their attorneys in these areas.

Lawyers should be actively consulted on matters of financial disclosure, as many accounting issues have taken on legal overtones. Processes and procedures should be set up (for example, the now frequently utilized "disclosure committee" format) to insure that disclosure issues are properly vetted among all who have relevant input, including lawyers.

In designing internal controls and procedures, pursuant to Section 404 of SOX, companies should require that the relevant internal and/or external counsel be consulted in connection with preparation of the company's financial statements to insure that information possessed by counsel relevant to the accuracy of those statements is adequately communicated to the financial personnel responsible for their preparation.

The process a company develops to support the CEO and CFO certifications of financial statements mandated by SOX Section 302 also should include input from the company's lawyers as to matters on which they have been engaged that are material to the financial statements.

The 1975 ABA-AICPA "Treaty," providing guidance as to how lawyers should respond to auditors' inquiries concerning asserted and unasserted claims (loss contingencies), need not be modified in light of such recent developments as adoption of the SEC's lawyer conduct rules and the 2003 amendments to the ABA Model Rules. Those new rules, however, can impact lawyer conduct consistent with the Treaty, such as by requiring a report up if management resists the lawyer's advice that a clearly material unasserted claim be disclosed to its auditors and in its financial statements.

As recommended in the Treaty, outside counsel confirm in their responses to auditors' letters that their practice is to consult with clients when they learn of unasserted claims

that may require financial statement disclosure. These consultations typically occur only with company management. This practice should be modified in one respect, consistent with the spirit if not the literal requirements of the SEC's lawyer conduct rules: counsel should insure that the Audit Committee is also made aware of such unasserted claims, and of any advice, if rendered to management, that such claims should be disclosed.

Due diligence with respect to financial (and other) disclosures, including in public offerings of securities, is also an important concern that may not be receiving sufficient attention from issuers, underwriters, their respective lawyers and the SEC (see Report pp. 135-42). Lawyers play an essential role in due diligence programs for both issuers and underwriters. Law firms should review the adequacy of their due diligence training programs and practices, including the need to assign qualified personnel to lead due diligence teams. Issuer's inside counsel and (where involved) outside counsel should advise the client's Board or Audit Committee and management on the extent of due diligence work done in connection with the client's public disclosure documents and its material corporate transactions. Oversight of issuer due diligence practices by Audit Committees and other independent directors is part of sound corporate governance.

The SEC's accelerated securities offering procedures, available since the early 1980s for many frequent (or "well seasoned") issuers, leave little time for traditional due diligence by underwriters. This creates a risk that whatever diligence is performed with respect to such issuers, even if sufficient to sustain the underwriters' due diligence defense to claims under § 11 of the Securities Act of 1933, may not adequately protect the issuers from absolute liability, or purchasers in the offering from harm, as a result of inaccurate or incomplete disclosure. The SEC has provided no meaningful guidance on this subject since adoption of its Rule 176, promulgated 24 years ago.

When the SEC authorized these accelerated procedures, it expected that many eligible issuers, in collaboration with their chosen underwriters and their lawyers, would adopt "continuous" due diligence programs. However, the number of companies today using such continuous due diligence programs appears not to be extensive, and opinions vary on their effectiveness.

Lawyers and their public company and underwriter clients should focus on the development of new techniques, better suited than traditional due diligence to the current realities of the marketplace, which could serve as a sound basis for SEC rulemaking in the future.

v) the role of lawyers conducting internal investigations

The frequency with which inside counsel and law firms are called on to conduct internal investigations for public companies, either at the company's initiative or the initiative of the SEC, some other regulatory agency, or the company's auditors, has sharply increased in recent years. The ethical parameters of such investigative assignments have not yet been clearly delineated. However, the perceived failure of a number of such investigations has highlighted some important basic ground rules (see Report pp. 143-79).

Before undertaking any investigation, outside counsel should consider, and discuss with the company, the following:

> Any prior or current relationships of counsel (or counsel's firm) with the company, or with any of its officers, directors, or principal employees, and whether those relationships, including any role of counsel or counsel's firm as the company's regular outside counsel, will undermine the fact or appearance of counsel's independence and thus adversely affect how the investigation will be viewed by regulators and others;

To whom counsel should report in connection with the investigation, and whether the reporting relationship will undermine the fact or appearance of counsel's independence or otherwise affect the investigation;

The scope of the investigation, including any limitations on the scope;

To whom and the manner in which the results of the investigation will be disclosed.

While the scope of an investigation is a client decision, and can be limited by a number of valid considerations, counsel must be alert to any restriction motivated by factors contrary to law or the company's interest, such as an attempt to cover up apparent wrongdoing. Any such concerns need to be elevated within the company.

Counsel should be authorized to communicate to regulators the scope of the investigation, whether any limitations have been placed on the scope, and to whom counsel is reporting in the company.

Counsel should continually reassess whether the company has a reporting obligation to the regulators, or the markets, or others, and discuss with the company the pros and cons of voluntary self-reporting.

Counsel should exercise independent judgment in determining whether improper conduct has occurred and should be cognizant of pressures that might cause counsel to "under charge" (i.e., be too lenient in judging corporate conduct) or "over charge" (i.e., be too quick to find a violation).

In giving its advice, counsel should always consider the fiduciary duties of the company's officers and directors to safeguard the best interests of the company and should offer advice consistent with those interests, as opposed to any differing interests of individual officers and directors, or counsel's own interest in his or her reputation or career.

The extent of the General Counsel's involvement in internal investigations must depend upon the facts (including the existence of conflicts) and the capabilities of the relevant in-house department. The General Counsel and/or internal lawyers can and often should be involved in many internal investigations. However, the Board might well decide that certain investigations, such as those involving a material allegation concerning the CEO or other senior management, should be conducted by independent external counsel engaged by the Board, given the position of General Counsel and the inherent conflicts such an investigation would present. The advantages and disadvantages of involving the General Counsel in such investigations should be discussed with the Board.

The corporation should also take into account conflicts (or the appearance of conflicts) in determining whether an internal lawyer should be in charge of an investigation of a peer, or of another officer with whom counsel conducts significant business, or of a matter on which the internal lawyer rendered significant legal advice. Where an apparent conflict could compromise an investigation, the investigation should be handled by an outside counsel or another internal lawyer who would not be similarly conflicted.

Other issues

We have reviewed a number of other suggestions that have been made with respect to the lawyer's role in corporate governance, but for various reasons do not recommend them. In this category are proposals that lawyers should be required to certify the accuracy of their clients' SEC filings or other public disclosures, a concept that we think would not be cost-effective and would be inconsistent with the traditional and valued role of lawyers as counselors (see Report pp. 118-19).

We also considered whether New York should enact a statute protecting lawyers (and others) from retaliatory discharge as a result of the reporting of client wrongdoing. This is an issue we recommend be further considered by this Association, including by reviewing of the experience of other states that do provide such protections (see Report pp. 180-83).

Finally, we reflected on whether aiding and abetting liability in civil litigation under the securities laws should be reestablished by Congress, reversing the impact of the Supreme Court's decision eliminating such liability in Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A., 511 U.S. 164 (1994). We believe that consideration of such legislation at this time would be premature (see Report pp. 183-88). It is important, first, to assess the impact on lawyer conduct of the SEC's interpretation and enforcement of its lawyer conduct rules. In addition, the courts need to resolve the present uncertainty concerning the extent to which lawyers (and other "secondary actors") may be held as primary violators of the securities laws for conduct previously thought to constitute aiding and abetting (see Report pp. 42-45).

Conclusion

The subject of the lawyer's role in corporate governance is a complex matter. The "right answers" are not susceptible to empirical proof. No one can speak with confidence, at any level of generality, concerning the involvement (or non-involvement) of lawyers with the recent prominent corporate frauds. The shroud surrounding attorney-client dealings, a product of the attorney-client privilege and confidentiality, obscures such facts with respect to many alleged frauds. Nor is it possible to muster empirical proof to demonstrate that preserving confidentiality is essential to the optimal functioning of the attorney-client relationship.

Relying as we must on our own experience, the observations of practitioners, regulators and commentators we respect, and common sense, we do believe that any "reform"

undermining the confidential nature of a lawyer's relationship with his or her client would represent an overreaction to the recent scandals and a cure worse than the disease.

Nonetheless, there ought to be a new determination by the corporate bar to play its proper role as confidential advisor counseling compliance with the law -- and conduct exceeding its minimum requirements -- in a clear and forthright manner. We believe our recommendations of best practices should be helpful in facilitating the effective performance of this role. Clear advice, including escalating a problem up the corporate hierarchy when necessary, should obviate almost all serious potential violations of law coming to a lawyer's attention.

No lawyer should knowingly acquiesce in client conduct clearly violating the securities laws, whether or not the lawyer's services are directly implicated in the wrongdoing. Reporting up often will be obligatory in such an instance under the SEC lawyer conduct rules and the ABA's Model Rules. Those rules also permit withdrawal and, depending on the circumstances, may also permit reporting out if reporting up fails to end the wrongdoing. A lawyer should not shrink from those actions, if confronted with the rare circumstances that warrant them.

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