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Conflicting Loyalties Facing In-House Counsel: Ethical Care and Feeding of the Ravenous Multi-Headed Client The Fifth Annual Symposium on Legal Malpractice and Professional Responsibility.

William E. Matthews

Robert M. Hoffman

Daniel C. Scott

CONFLICTING LOYALTIES FACING IN-HOUSE COUNSEL: ETHICAL CARE AND FEEDING OF THE RAVENOUS MULTI-HEADED CLIENT

WILLIAM E. MATTHEWS*
ROBERT M. HOFFMAN**
DANIEL C. SCOTT***

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* William E. Matthews, Partner, Gardere Wynne Sewell LLP, Houston, Texas. Mr. Matthews attended undergraduate school at the University of Texas under the Plan II program and received his J.D. from the University of Texas School of Law in 1963.

** Robert M. Hoffman, Partner, Gardere Wynne Sewell LLP, Dallas, Texas. Mr. Hoffman received his B.B.S. with honors from the University of Texas at Austin in 1978 and his J.D. from Southern Methodist University School of Law in 1981.

*** Daniel C. Scott, Associate, Gardere Wynne Sewell LLP, Dallas, Texas. Mr. Scott received his B.A. in 2000 and B.S. in 2002 from Kansas State University and his J.D. with highest honors from the University of Tulsa College of Law in 2005.

I. INTRODUCTION

In the wake of Enron's bankruptcy and other major corporate scandals, Robert Hirshon, as President of the American Bar Association (ABA), assembled the Task Force on Corporate Responsibility (the Task Force) to:

> [E]xamine 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.[1]

One year later, the Task Force recommended revisions to the ABA Model Rules of Professional Conduct 1.6[2] and 1.13.[3] On August

1. *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 BUS. LAW. 145, 145-46 (2003).

2. MODEL RULES OF PROF'L CONDUCT R. 1.6 (2004). Rule 1.6 states:

> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
> (1) to prevent reasonably certain death or substantial bodily harm;
> (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
> (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;
(5) 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
(6) to comply with other law or a court order.

Id.

3. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2004).

(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 that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.
(c) Except as provided in paragraph (d), if
(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and
(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.
(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.
(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.
(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

11-12, 2003, the ABA House of Delegates adopted these revisions *in toto*.[4]

Much of this Article's focus[5] is on ABA Model Rule 1.13—Organization as Client—and in particular, the Rule's idea of "entity theory."[6] The concept of entity theory holds that "only the entity or organization is the lawyer's client, unless the lawyer additionally undertakes representation of individual members, agents, officers, or other 'constituents,' as they are referred to in Rule 1.13. Absent such an undertaking, however, constituents are not clients, and must be treated accordingly."[7]

The effect of entity theory, while necessary, creates significant dangers for in-house counsel who blur what the ABA sees as a clearly delineated line with the organizational client on one side and the unrepresented individual constituents on the other.[8] Under Model Rule 1.13, the in-house counsel who:

> 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 that reasonably might be imputed *to the organization*, and that is likely to result in substan-

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Id.

4. American Bar Association, Recommendation to Amend Rule 1.6, http://www.abanet.org/leadership/2003/journal/119a.pdf (last visited Apr. 17, 2006) (on file with the *St. Mary's Law Journal*); American Bar Association, Recommendation to Amend Rule 1.13, http://www.abanet.org/leadership/2003/journal/119b.pdf (last visited Apr. 17, 2006) (on file with the *St. Mary's Law Journal*).

5. Also of key importance to in-house counsel are the following ethical rules, all of which are applicable to them: ABA Model Rule 1.1 (competent representation); ABA Model Rule 1.2 (prohibition against assisting in fraud); ABA Model Rule 1.6 (confidentially of information with permissive disclosure allowed in very limited circumstances); ABA Model Rule 1.7 (conflicts of interest); ABA Model Rule 2.1 (independent professional judgment); and SEC Rule 205 (mandatory up the ladder reporting and permissive reporting out).

6. 1 Geoffrey C. Hazard, Jr. & W. William Hodes, The Law of Lawyering § 17.2, at 17-5 (3d ed. Supp. 2004).

7. *Id.* at 17-5 to 17-6. Entity theory is to be distinguished from "group theory," which "holds that the lawyer represents several clients jointly; each constituent is a co-client of the other. This means that the lawyer must manage the conflicts of interest inherent in concurrent representation of multiple clients in conformity with [ABA] Model Rule 1.7 and other provisions of the law of lawyering." *Id.* at 17-6.

8. *See* Katherine S. Yates, *An In-House Lawyer's Perspective on Ethics*, 68 Tex. B.J. 920, 921 (2005) ("The lines of ethical behavior become blurred when there is tension between the lawful ethical behavior of employees and the business goals and objectives set by senior management.").

> tial injury *to the organization*, then the [in-house] lawyer *shall* proceed as is reasonably necessary in *the best interest of the organization.*[9]

Furthermore, Model Rule 1.13 requires the in-house counsel to "explain the identity of the client [as the organization] 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*."[10]

As recognized in the Rule, in-house counsel necessarily must work with the organization's constituents, who act as agents on the organization's behalf. Likewise, in-house counsel are employees of the organization and they communicate with their same constituents, often on a daily basis for many years. Thus, it is easy to see how difficult situations will arise in which in-house counsel may be required to report violations committed by their co-workers, some of whom may have hired the in-house counsel and continue to sign their paychecks.

In the aftermath of relatively recent corporate scandals—Enron, WorldCom, and Tyco to name a few—and with the passage of the Sarbanes-Oxley Act of 2002 (SOX), lawmakers, government agencies, ethical committees, and the general public are now demanding that in-house counsel make these difficult differentiations.[11] With

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9. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2004) (emphasis added).

10. *Id.* (emphasis added).

11. The Conference Board Commission on Public Trust and Private Enterprise addressed this concern in the first paragraph of its reported findings and recommendations regarding executive compensation. COMM'N ON PUB. TRUST AND PRIVATE ENTER., THE CONFERENCE BD., FINDINGS AND RECOMMENDATIONS, PART 1: EXECUTIVE COMPENSATION 5 (2002). It stated:

> The Commission shares the public's anger at the misconduct leading to the breakdown of public trust which grew out of the scandals at Enron, WorldCom and other companies. These egregious failures evidence a clear breach of the basic compact that underlies corporate capitalism—which is that investors entrust their assets to management while boards of directors oversee management so that the potential for conflict of interest between owners and managers is policed. Furthermore, various professional advisors of companies, such as public auditors, compensation consultants, and, in some cases, *law firms failed to provide truly independent advice and professional judgment as they came to view management as the "client" instead of the corporation.*

Id. (emphasis added). "The Conference Board creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society." *Id.* at 2. "The Conference Board Commission on Public Trust and Private Enterprise was convened to address the circumstances which led to the recent corthis backdrop in mind, this Article examines how much the ethical road upon which in-house counsel tread has changed over the past few years, specifically focusing on (1) executive compensation, (2) in-house counsel wearing multiple hats, (3) imposition of the SOX laws, and (4) charges of obstruction of justice during corporate investigations.

II. EXECUTIVE COMPENSATION

Executive compensation falls on the shoulders of the board of directors as one of its many fiduciary duties.[12] Commonly, directors delegate this task to compensation committees and independent directors whose responsibility it is "to oversee and properly incent and reward management."[13] In fact, the Conference Board Commission on Public Trust and Private Enterprise (the Commission) states that "[a] diligent and independent Compensation Committee of the Board is critical to avoid abuses."[14] Unfortunately, many boards and compensation committees have fallen victim to what Alan L. Beller, the Securities and Exchange Commission's (SEC) Director of the Division of Corporation Finance,[15] terms the "Lake Wobegon effect"[16]—"[t]he tendency to treat all members of a group as above average, particularly with respect to numerical values such as . . . executive salaries . . . ."[17]

porate scandals and the subsequent decline of confidence in American capital markets." *Id.* at 4.

12. Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 20, *available at* 18 NO. 12 Insights 20 (Westlaw).

13. *Id.*

14. COMM'N ON PUB. TRUST AND PRIVATE ENTER., THE CONFERENCE BD., FINDINGS AND RECOMMENDATIONS, PART 1: EXECUTIVE COMPENSATION 6 (2002).

15. Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 20 n.a1, *available at* 18 NO. 12 Insights 20 (Westlaw).

16. *Id.* at 20.

17. *See* Word Spy, http://www.wordspy.com/words/LakeWobegoneffect.asp (last visited Feb. 12, 2006) (defining the Lake Wobegon effect) (on file with the *St. Mary's Law Journal*). As a result, boards feel they must compensate their executives in the top half, or even top quarter, of some benchmark group (often not specified) in order to be competitive. *See* Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 20, *available at* 18

As a result, the SEC has focused its direct regulatory interest in the area of executive compensation on four specific areas. The first is a general implementation of the proxy provisions of the Securities Exchange Act of 1934.[18] The remaining three areas focus more specifically on the SEC's own proxy rules, executive compensation disclosure requirements,[19] and oversight of the listing standards of its markets pertaining to compensation committees and independent directors.[20] Congress also has enacted section 409 of the Internal Revenue Code[21] "to address the long-standing frustration of the Internal Revenue Service's (IRS) efforts to i) contain the proliferation of deferred compensation; ii) regulate how compensation may and may not be deferred; and iii) dictate what was 'good'

NO. 12 Insights 20 (Westlaw) (describing the apparent principles motivating boards of directors in compensating their officers).

18. *See* Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 21, *available at* 18 NO. 12 Insights 20 (Westlaw) (discussing the manner in which the SEC handles executive compensation disclosure).

19. The pertinent provision of Item 402 of Regulation S-K states:

> *All compensation covered.* This item requires clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers designated under paragraph (a)(3) of this item, and directors covered by paragraph (g) of this item by any person for all services rendered in all capacities to the registrant and its subsidiaries, unless otherwise specified in this item. Except as provided by paragraph (a)(5) of this item, all such compensation shall be reported pursuant to this item, even if also called for by another requirement, including transactions between the registrant and a third party where the primary purpose of the transaction is to furnish compensation to any such named executive officer or director. No item reported as compensation for one fiscal year need be reported as compensation for a subsequent fiscal year.

17 C.F.R. § 229.402(a)(2) (2005).

20. Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 20-21, *available at* 18 NO. 12 Insights 20 (Westlaw). The Conference Board Commission also "applauds the tough measures taken . . . that are embodied in the Sarbanes-Oxley Act, stock exchange listing rule revisions, and Securities and Exchange Commission (SEC) orders and regulations," noting that "these recent reforms constitute the most wide-spread new business regulations since the 1930's." COMM'N ON PUB. TRUST AND PRIVATE ENTER., THE CONFERENCE BD., FINDINGS AND RECOMMENDATIONS, PART 1: EXECUTIVE COMPENSATION 5 (2002).

21. 26 U.S.C. § 409 (2000).

deferred compensation."[22] In short, executive compensation has become a "hot topic" in the area of corporate governance.[23] As Beller made clear in his presentation on executive compensation, "non-transparent, obfuscated, poorly detailed and 'buried' disclosure should not be tolerated and may well be getting more and more attention from the SEC and the investor community, both specifically and generally."[24]

What does this mean for in-house counsel? First, in-house counsel will face special difficulties in this area due to executives' tendencies to prefer less disclosure.[25] For obvious reasons, executives are personally interested in the description of their compensation, which often results in tension between what *should* be disclosed and what *management wants* disclosed.[26] Here again, entity theory rears its head, for, as Beller states, "[i]n such a case, inside . . . counsel must remember that their client is the company and not its management."[27]

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22. Stephen W. Skonieczny, *Executive Compensation: Are You in Compliance? How the SEC and Congress Are Confronting the Disguised and the Deferred*, CORP. COUNS., Mar. 2005, at 1, *available at* 19 NO. 10 Corp. Couns. 1 (Westlaw).

23. Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 21, *available at* 18 NO. 12 Insights 20 (Westlaw).

24. Stephen W. Skonieczny, *Executive Compensation: Are You in Compliance? How the SEC and Congress Are Confronting the Disguised and the Deferred*, CORP. COUNS., Mar. 2005, at 2, *available at* 19 NO. 10 Corp. Couns. 1 (Westlaw). The Conference Board Commission feels the same way:

> Shareholders and markets need accurate and timely information to make informed decisions—this is, after all, the foundation of our capital markets.
>
> Companies should make conspicuous disclosure of the size, costs and effects of stock options on both earnings per share after dilution and the proportion of future shareholder value that such equity compensation plans would provide to executives and employees.
>
> In sum, the Commission believes that this material information should not only be in plain English, but in plain sight as well.

COMM'N ON PUB. TRUST AND PRIVATE ENTER., THE CONFERENCE BD., FINDINGS AND RECOMMENDATIONS, PART 1: EXECUTIVE COMPENSATION 8 (2002).

25. *See* Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 22, *available at* 18 NO. 12 Insights 20 (Westlaw) (noting the interest of executives in "how their compensation is described").

26. *Id.*

27. *Id.*

Second, it means that in-house counsel should ensure that the entity's current policies and practices are in accordance with executive compensation disclosure requirements to avoid enforcement action and embarrassing media coverage as the SEC begins to renew its focus on this issue.[28] Transfering this potentially "hot potato" to outside counsel will not automatically solve the concern:

> Most companies rely heavily on outside legal counsel to prepare or at least review the executive compensation disclosure required for Proxy Statements. The outside lawyer is frequently positioned and used as a buffer between in-house counsel and both executive management and the Board of Directors, and the inevitable tension created by deciding what to disclose and how to disclose it. *In-house counsel needs to remember, however, that the client is the registrant and not the board members or the individual executives.* Moreover, outside counsel are perceived as too frequently trying to be "creative" with disclosure and placing disclosure in sections of the Proxy Statement where it is less likely to be located or understood in context. These practices are coming under more and closer scrutiny and in-house counsel is well advised to consider upgrading their client's practices and disclosure attitude.[29]

The ethical rules are not concerned with in-house counsel's natural desire to maintain relationships and employment with the constituents who may be adversely affected by such disclosures. Rather, in-house counsel are required—no matter how personally precarious the decision—to fulfill their duties to the organization by requiring proper disclosures.

Finally, in-house counsel must address all "questionable disclosures."[30] Companies can get into trouble by classifying what essen-

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28. *See* Stephen W. Skonieczny, *Executive Compensation: Are You in Compliance? How the SEC and Congress Are Confronting the Disguised and the Deferred*, CORP. COUNS., Mar. 2005, at 1, *available at* 19 NO. 10 Corp. Couns. 1 (Westlaw) (urging in-house counsel and other legal advisers to evaluate their current practices regarding executive compensation disclosure); *see also* COMM'N ON PUB. TRUST AND PRIVATE ENTER., THE CONFERENCE BD., FINDINGS AND RECOMMENDATIONS, PART 1: EXECUTIVE COMPENSATION 5 (2002) (arguing that "[t]here is a need for procedures and practices within the companies themselves to change their governance policies").

29. Stephen W. Skonieczny, *Executive Compensation: Are You in Compliance? How the SEC and Congress Are Confronting the Disguised and the Deferred*, CORP. COUNS., Mar. 2005, at 2, *available at* 19 NO. 10 Corp. Couns. 1 (Westlaw) (emphasis added).

30. *See* Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 22, *available at* 18

tially is a perk as a business expense in order to avoid disclosure.[31] As Beller notes, "a perk, by any other name, is still a perk, and therefore must be considered for disclosure. When companies review their disclosure, they should give serious consideration to items that have previously been called business expenses (e.g., housing, security systems, cars etc.) but actually are perks."[32] One helpful tip may be to ask whether the expense is applicable to employees in general without discretion, or whether instead it is available only to a select few or on a discretionary basis.[33] In-house counsel should note that it has become vitally important to properly classify and disclose such perks because "[m]aterial deficiencies in disclosure regarding executive compensation expose companies to potential enforcement actions."[34] In order to comply with ethical rules, which require in-house counsel to act in the best interest of the organization,[35] in-house counsel may find them-

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NO. 12 Insights 20 (Westlaw) (detailing the importance of avoiding omissions of "perks" and other incentives in complying with disclosure statements).

31. In addition to perks, Skonieczny states that "in-house counsel should focus on at least four areas: the required Compensation Committee report, perquisites, retirement benefits and deferred compensation," as "[t]hese are likely to be the first areas to receive renewed and focused attention from the SEC." Stephen W. Skonieczny, *Executive Compensation: Are You in Compliance? How the SEC and Congress Are Confronting the Disguised and the Deferred*, CORP. COUNS., Mar. 2005, at 2, *available at* 19 NO. 10 Corp. Couns. 1 (Westlaw); *see also* Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 24-25, *available at* 18 NO. 12 Insights 20 (Westlaw) (identifying the issues on the radar screen of the Division of Corporation Finance as perks, retirement benefits and deferred compensation, total compensation, named executive officers, director compensation, compensation committee reports, and related-party disclosure).

32. Alan L. Beller, Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Executive Compensation Disclosure, Presentation to the Conference of the Corporate Counsel and the Corporate Executive (Oct. 20, 2004), *in* INSIGHTS, Dec. 2004, at 22, *available at* 18 NO. 12 Insights 20 (Westlaw).

33. *Id.* For one example, a taxi ride across town would be a properly labeled expense because it is generally available to all employees on a non-discretionary basis. *See id.* (offering a simple test and the taxi cab example as a basis for determining whether an expense is a perk).

34. *Id.* For two relatively recent cases in which the SEC has brought enforcement actions against companies failing to properly disclose perks, see generally *In re General Electric Co.*, Exchange Act Release No. 50426, 83 SEC Docket 2407 (Sept. 23, 2004) (finding that GE failed to fully describe in its Proxy Statement the retirement benefits given to its chairman and CEO), and *In re W.R. Grace & Co.*, Exchange Act Release No. 39156, 65 SEC Docket 1236 (Sept. 30, 1997) (finding that W.R. Grace failed to fully disclose retirement benefits given to its CEO).

35. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2004).

selves urging the classification of the CEO's personal use of the company jet as a perk requiring disclosure—to avoid embarrassing and public SEC proceedings—when the CEO may insist on classifying such use as a legitimate business expense. This is yet another example of the tough decisions in-house counsel must make daily to ensure compliance with their ethical obligations.

III. In-House Counsel Acting in a Non-Legal Capacity

The ethical rules of the ABA do not expressly prohibit in-house counsel from also serving on their organization's board of directors,[36] as one of its officers,[37] or in some other non-legal capacity.[38] In fact, assuming that in-house counsel may serve on the board of directors, comment thirty-five to Model Rule 1.7 addresses the issue and prescribes how counsel should determine whether their independent professional judgment may be compromised by a conflict resulting from this dual capacity.[39] Rule 1.7's comment,

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36. *See id.* R. 1.7 (stating expressly which situations comprise a conflict of interest).

37. *See* Sally R. Weaver, *Ethical Dilemmas of Corporate Counsel: A Structural and Contextual Analysis*, 46 Emory L.J. 1023, 1035 (1997) (explaining "[m]ost corporate general counsel are officers of the corporation, and many have officer designations in addition to their roles as general counsel"). "The most common designation is probably that of corporate secretary." *Id.*

38. *See* Randolph C. Park, *Ethical Challenges: The Dual Role of Attorney-Employee As Inside Corporate Counsel*, 22 Hamline L. Rev. 783, 792 (1999) (describing the scenario where an employee also functions as an attorney). Park specifically noted:

> Ethics rules do not prohibit an attorney-employee from functioning as a business partner as well as a legal advisor. As long as an attorney-employee can maintain professional independence in the rendering of legal services, there are no restrictions that would prohibit the attorney-employee's participation in daily business operations or strategic business decision making.

Id.

39. Model Rules of Prof'l Conduct R. 1.7 cmt. 35 (2004). The comment states:

> A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privi-

however, only deals with counsel who serve as directors, neglecting the many other non-legal capacities in which in-house counsel may be asked to serve.[40] There is not much in the way of formal guidance to assist in-house counsel who wear multiple hats in this era when they are increasingly asked to do so "because they possess skills that are well suited to management."[41]

In 1998, the ABA issued a formal ethics opinion entitled, "Lawyer Serving as Director of Client Corporation."[42] Two of the key issues raised in the ABA ethics opinion deal with (1) the importance of in-house counsel advising upper-level corporate management beforehand of problems that can arise when counsel serves in a dual role; and (2) the need to protect the attorney-client privilege once such a dual role commences.[43] The importance of these two issues is further expounded in the next section of this Article.

A. *The Vital Importance of In-House Counsel Providing Constituents with Prior Notice and Advice Regarding a Dual Capacity*[44]

When in-house counsel are asked to assume a non-legal role, obvious problems arise—potential conflicts of interest (especially for the in-house counsel who also serve as directors), confusion among constituents as to whether in-house counsel's advice is from either a legal or business judgment perspective, and, of course, the ever-present concern of waiving the attorney-client privilege. To remove or at least lessen the potential for confusion and other problems, it is imperative that in-house counsel, *before* assuming a

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> lege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

Id.

40. *See id.* (omitting any reference to a lawyer who is not a director).

41. Steven N. Machtinger & Dana A. Welch, *In-House Ethical Conflicts*, ACC DOCKET, Feb. 2004, at 30, *available at* 22 NO. 2 ACC Docket 23 (Westlaw).

42. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998) (discussing lawyers who serve as a director of a client corporation).

43. *Id.*

44. It should be noted that considerable ethical challenges arise solely from an attorney's employment by an organization without in-house formally taking on a dual role. *See* Randolph C. Park, *Ethical Challenges: The Dual Role of Attorney-Employee As Inside Corporate Counsel*, 22 HAMLINE L. REV. 783, 784 (1999) (discussing generally the challenges in-house counsel face simply by accepting employment with an organization).

non-legal role, have "full, free and frank discussions" with the board of directors and organizational executives to ensure that they clearly "understand the ethical and practical pitfalls that lie along the way."[45] To go a step further, one writer wisely advocates, that before being hired, in-house counsel should "seek a written agreement with [their] employer-client that explicitly details [their] role with the organization and clearly notes [their] professional independence as a lawyer."[46] Clearly, the key is for in-house counsel to explain to management and the board the inherent dangers of in-house counsel putting on yet another hat.

B. *In-House Counsel Must Be Acutely Aware of the Ease with Which the Attorney-Client Privilege Can Be Waived When They Act in a Dual Capacity*

One of the biggest concerns organizations and in-house counsel face when in-house counsel take on a non-legal function is the possibility of inadvertently waiving the attorney-client privilege, thus making what was thought and intended to be confidential communications susceptible to discovery. In theory, confidential communications between in-house counsel and organizational employees are privileged to the same extent as communications between those employees and outside-counsel.[47] However, because the attorney-client privilege acts as an absolute bar to what is otherwise likely to

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45. ABA, Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998). *See* Randolph C. Park, *Ethical Challenges: The Dual Role of Attorney-Employee As Inside Corporate Counsel*, 22 HAMLINE L. REV. 783, 784 (1999) (explaining the attorney-employee's responsibility to communicate).

> As in any attorney-client relationship, the burden of explaining the attorney-employee's dual role falls to the attorney. An attorney employed for a significant period of time by a corporation must persistently and consistently remind the corporation of what the attorney *can* and *cannot* do. It is as important for a corporate attorney-employee to frame the scope of representation as it is for the store-front solo practitioner who is hired by an individual client for a one-time legal service. In the end, a violation of an attorney's ethical duties, even in pursuit of the corporation's goals, can result in an attorney losing her license to practice law and her professional livelihood.

Id.

46. *Id.* at 794.

47. F. Joseph Warin, Michael F. Flanagan & Jason C. Schwartz, *The Multiple Hats Dilemma: Application of the Attorney-Client Privilege to In-House Counsel*, INSIGHTS, Apr. 1999, at 12, *available at* 13 NO. 4 Insights 12 (Westlaw); *see also* Boca Investerings P'ship v. United States, 31 F. Supp. 2d 9, 11 (D.D.C. 1998) (referencing Upjohn Co. v. United States, 449 U.S. 383, 389-97 (1981) for the proposition that communications concerning legal advice by and to in-house counsel are protected by attorney-client privilege).

be relevant and discoverable information,[48] "a trend has developed whereby courts appear to be treating in-house counsel differently in making determinations regarding the protections afforded by the attorney-client privilege."[49]

In-house counsel and their constituents must realize and constantly be aware that the protection afforded by the attorney-client privilege applies only to *legal advice*.[50] No such privilege exists when in-house counsel is, or is later seen to have been, providing business advice.[51] The already tumultuous ethical road traveled by in-house counsel here becomes an even more slippery slope. Even experienced in-house counsel, wise in the ways of the law, "may have difficulty deciding when [they] are serving as an attorney and when [they] are serving as a business person."[52] Needless to say, confusion in the minds of the legally untrained constituent is even greater.[53]

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48. *See* FED. R. EVID. 501 (defining the rules of privilege).

49. F. Joseph Warin, Michael F. Flanagan & Jason C. Schwartz, *The Multiple Hats Dilemma: Application of the Attorney-Client Privilege to In-House Counsel*, INSIGHTS, Apr. 1999, at 12, *available at* 13 NO. 4 Insights 12 (Westlaw).

50. *Id.*; *see also* Upjohn Co. v. United States, 449 U.S. 383, 389-97 (1981) (finding communications concerning legal advice by and to in-house counsel to be protected by attorney-client privilege).

51. *See* F. Joseph Warin, Michael F. Flanagan & Jason C. Schwartz, *The Multiple Hats Dilemma: Application of the Attorney-Client Privilege to In-House Counsel*, INSIGHTS, Apr. 1999, at 12, *available at* 13 NO. 4 Insights 12 (Westlaw) (noting "[t]he near-absolute protection of the attorney-client privilege only applies to the provision of legal advice; the shield does not extend to business advice"); *see also* E.I. du Pont de Nemours & Co. v. Forma-Pak, Inc., 718 A.2d 1129, 1142 (1998) (explaining "[c]ommunications [with in-house counsel] with regard to business advice are unprotected").

52. Steven N. Machtinger & Dana A. Welch, *In-House Ethical Conflicts*, ACC DOCKET, Feb. 2004, at 31, *available at* 22 NO. 2 ACC Docket 23 (Westlaw).

53. *See id.* at 31-32 (describing the confusion shared by both in-house counsel and the client). Machtinger and Welch commented:

> To make matters worse, [in-house counsel are] not the only one[s] having difficulty sorting out when [they] are performing in which capacity: the client will probably be more confused than [counsel]. Do [in house] introduce [themselves] by saying, "Hello, I'm Sally Springer, and I'll be your chief administrative officer today" or "Hello, I'm Sally Springer, and I'll be your general counsel today," to properly inform [their] client which hat [they] are wearing? No matter what [in-house counsel] do, there is bound to be more than one instance of confusion and even potential disaster if [the] client, for example, discusses legal matters with [in-house counsel] when [they were] wearing [their] business hat.

Id.

In addition to difficulties arising when in-house counsel serves as either an officer or other managerial committee member, the problem is exacerbated when an in-house counsel serves on the board of directors.[54] Once in-house counsel dons the hat of director, it becomes that much more difficult for the organization to prove that advice given was "legal rather than business related."[55] Thus, "[b]ecause the lawyer-director provides the management and board with business advice as well as legal assistance, the lawyer, management and board members could find themselves forced to testify about conversations that would not be involuntarily disclosed if the lawyer-director had been acting only as a lawyer."[56] This becomes more likely when the organization receives legal advice from the in-house counsel/director who fails to recognize it as confidential and shares it as *business* advice with other organizational employees who are beyond the "need to know."[57] For this reason, it is essential that in-house counsel/directors at all times make absolutely clear whether the advice they are providing is business or legal. If it is legal advice, "[t]he lawyer should avoid the temptation of [also] providing business or financial advice, except insofar as it affects legal considerations such as the application of the business judgment rule."[58]

Finally, an additional issue for lawyers serving both as in-house counsel and director to keep in mind is that they themselves are capable of waiving the entity's attorney-client privilege. In-house

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54. *See, e.g., id.* at 32 (noting "[t]he problem becomes even more acute when the in-house lawyer also serves as a member of the board of directors, the governing body of the corporation"); F. Joseph Warin, Michael F. Flanagan & Jason C. Schwartz, *The Multiple Hats Dilemma: Application of the Attorney-Client Privilege to In-House Counsel*, INSIGHTS, Apr. 1999, at 13, *available at* 13 NO. 4 Insights 12 (Westlaw) (stating "[a]nother layer of complication is introduced when a company's lawyer (in-house or outside) serves on its board of directors"); *see also* Fed. Sav. & Loan Ins. Corp. v. Fielding, 343 F. Supp. 537, 546 (D. Nev. 1972) (holding "[w]hen the attorney and the client get in bed together as business partners, their relationship is a business relationship, not a professional one, and their confidences are business confidences unprotected by a professional privilege").

55. F. Joseph Warin, Michael F. Flanagan & Jason C. Schwartz, *The Multiple Hats Dilemma: Application of the Attorney-Client Privilege to In-House Counsel*, INSIGHTS, Apr. 1999, at 13, *available at* 13 NO. 4 Insights 12 (Westlaw) (internal quotations omitted).

56. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998).

57. F. Joseph Warin, Michael F. Flanagan & Jason C. Schwartz, *The Multiple Hats Dilemma: Application of the Attorney-Client Privilege to In-House Counsel*, INSIGHTS, Apr. 1999, at 13, *available at* 13 NO. 4 Insights 12 (Westlaw).

58. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998).

counsel *acting as a director* "may be found to have waived the privilege on behalf of the corporation without need of any further client consent."[59]

Despite all of the drawbacks and potential problems associated with in-house counsel wearing multiple hats, there is certainly a place—if done properly—for an in-house lawyer's "business" role in an organization. However, as two experienced corporate attorneys[60] warn, those wishing to serve in this dual capacity need to take precautionary steps:

> [B]efore you step into a business role, make sure that it will not impair your ability to fully serve your client as a lawyer. Make sure that you have great outside counsel who fully understand you and your company and who can provide both a sanity check and independent legal advice when you feel that you are or might be compromised. Make sure that the business-people know when you are giving them legal advice and when you are giving them your business judgment. If you serve in a dual capacity, you may have to clearly (but gracefully) announce in which capacity you are serving at the moment, in order to protect the [attorney-client] privilege, among other things. And don't ever be afraid to admit that you may have a conflict. Better to err on the side of providing your client the best and sometimes hard legal advice than to be asked, "Where were the lawyers (read, "You") when . . . ?"[61]

IV. The Ethical Effect of Sarbanes-Oxley

With the adoption of SOX on January 23, 2003, the One Hundred Seventh Congress, for the first time, placed specific professional responsibilities on attorneys who appear before the SEC.[62]

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59. *Id.*; *see also* United States v. Vehicular Parking Ltd., 52 F. Supp. 751, 753 (D. Del. 1943) (finding no attorney-client privilege when voluntary disclosure was made by lawyer-director in role as a business manager and not as an attorney).

60. *See* Steven N. Machtinger & Dana A. Welch, *In-House Ethical Conflicts*, ACC Docket, Feb. 2004, at 23 n.a1, *available at* 22 NO. 2 ACC Docket 23 (Westlaw) (noting that "Steven N. Machtinger is senior vice president and associate general counsel for J.P. Morgan Chase & Co. in San Francisco"). Prior to his position with J.P. Morgan Chase, Mr. Machtinger was general counsel at Hambrecht & Quist. *Id.* Additionally, "Dana Welch practices in the San Francisco office of Ropes & Gray LLP . . . specializing in securities and corporate compliance and securities enforcement defense." *Id.* at 23 n.a2.

61. *Id.* at 33.

62. 15 U.S.C. § 7245 (Supp. II 2002). Pursuant to the rule making power granted to it by § 7245, the SEC established the following definition:

> Appearing and practicing before the Commission:

Congress also required the SEC to issue its own rules of professional conduct covering the activities of all such attorneys.[63] This

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(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

17 CFR § 205.2(a) (2005).

Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

Id. § 205.2(h).

63. 15 U.S.C. § 7245 (Supp. II 2002). The provision states:

Not later than 180 days after July 30, 2002, the Commission shall issue 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 issuers, including a rule—

(1) 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

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

provision of SOX, section 307, "immediately provoked significant debate because of its first-time-ever statutory federal regulation of attorneys and because many believe it imposed new and stronger obligations on attorneys representing the organization as client. Section 307 is a departure from the traditional method of regulating attorneys' professional responsibility through state authorities."[64]

Despite the uproar, the SEC promulgated Rule 205 in compliance with its Congressional mandate.[65] The crux of Rule 205 is its "reporting up" and "reporting out" provisions: "Rule 205 requires lawyers practicing before the SEC to report material evidence of wrongdoing up the chain of command within a company and permits, although it does not require, outside disclosure of wrongdoing."[66] More precisely, the attorney must initially report, absent special circumstances,[67] evidence of any material violation to the

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Id.

64. Cullen M. Godfrey, *The Revised Role of Lawyers After Sarbanes-Oxley*, 68 TEX. B.J. 932, 932 (2005).

65. 17 C.F.R. § 205 (2005).

66. Steven N. Machtinger & Dana A. Welch, *In-House Ethical Conflicts*, ACC DOCKET, Feb. 2004, at 28, *available at* 22 NO. 2 ACC Docket 23 (Westlaw). The permissible "reporting out" provision of Rule 205 states:

> An attorney appearing and practicing before the Commission in the representation of an issuer *may* reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
>
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
>
> (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or
>
> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

17 CFR § 205.3(d)(2) (2005) (emphasis added).

67. 17 CFR § 205.3(b)(3) (2005). Rule 205 provides that if the reporting attorney feels that the CLO or CEO has not "provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to" the following entities:

> (i) The audit committee of the issuer's board of directors;
>
> (ii) Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of

chief legal officer (CLO) or to both the CLO and the chief executive officer (CEO).[68] Rule 205 states:

> If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney *shall* report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.[69]

As mentioned at the beginning of this Article, the ABA revised its Model Rule 1.13 in response to these actions by Congress and the SEC. The new Model Rule 1.13 now includes both mandatory and permissive disclosure provisions.[70] The unfortunate result is that attorneys are left with SEC and ABA disclosure provisions

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> the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)) (if the issuer's board of directors has no audit committee); or
> (iii) The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19))).

Id. However, if the reporting attorney feels that reporting to the CLO or CEO would be futile, the attorney may initially report as provided under paragraph (b)(3). *Id.* § 205.3(b)(4). Finally, the attorney may alternatively report directly to the issuer's qualified legal compliance committee if one has been so established by the issuer. *Id.* § 205.3(c).

68. *Id.* § 205.3(b)(1).

69. *Id.* (emphasis added).

70. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13 (2004) (indicating that if the lawyer for an organization knows that an officer or employee with the organization is engaged or intends to act in a manner that violates a legal obligation of the organization the lawyer shall "proceed as is reasonably necessary in the best interest of the organization").

> Between the original promulgation of the Model Rules of Professional Conduct in 1983 and August 2003, "reporting out" was forbidden, if the highest authority that could act declined to do so after having received a "report-up" under Rule 1.13(b). The lawyer was required to treat the situation as one in which the client (speaking through its highest authority) had rejected her advice and insisted upon its own course of conduct. According to former Rule 1.13(c), the lawyer could remain at her station and try to help the client weather the coming storm, or she could resign, as permitted by Rule 1.16(b).

1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 17.12, at 17-47 (3d ed. Supp. 2004).

that "contrast[ ] and conflict[ ] starkly with many state bar ethics rules . . . which strictly prohibit any breach of lawyer-client confidentiality."[71] To the extent any state professional responsibility rules conflict with Rule 205, however, they are preempted for those attorneys governed by the SEC's rules:

> This part sets forth minimum standards of professional conduct *for attorneys appearing and practicing before the Commission* in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.[72]

As shown below, in spite of disclosure similarities in Rule 205 and Model Rule 1.13, the objectives of the two are entirely different.

A. *SEC Rule 205 Is Aimed at Protecting the Investor*

As has been mentioned throughout this Article, SOX and the SEC's resulting Rule 205 were the direct result of the corporate scandals that shook the business world—and the general public for that matter—shortly after the turn of this century. Legislative, corporate, and public fingers alike were immediately pointed at corporate attorneys for allowing such egregious conduct to occur, thereby destroying the jobs, retirement plans, and investments of thousands of employees and shareholders. As a consequence, the SEC designed the resulting reporting provisions to protect stakeholders' interests before those of the organization. The SEC noted a preference for protecting investors in its final release on Rule 205 regarding the effect of its disclosure provisions:

> [C]oncerns about impacting the attorney-client relationship must yield to the public interest where an issuer seeks to commit a material violation that will materially damage investors, seek to perpe-

71. Steven N. Machtinger & Dana A. Welch, *In-House Ethical Conflicts*, ACC DOCKET, Feb. 2004, at 28, *available at* 22 NO. 2 ACC Docket 23 (Westlaw).

72. 17 C.F.R. § 205.1 (2005) (emphasis added).

> trate a fraud upon the Commission in enforcement proceedings, or has used the attorney's services to commit a material violation.[73]

The SEC further explained:

> Part 205 is designed to protect investors and increase their confidence in public companies by ensuring that attorneys who represent issuers report up the corporate ladder evidence of material violations by their officers and employees.[74]

The result is that Rule 205 has made corporate attorneys into "gatekeepers."[75] Rule 205's permissive disclosure provision acts essentially as a whistleblower license for attorneys to use in a last-ditch effort to protect *third parties* when the highest authorities within the organization fail to take appropriate remedial measures.

B. *The Reporting Provisions of Model Rule 1.13 Are Designed to Protect the Organizational Client*

In contrast, Model Rule 1.13 and its 2003 revisions were designed specifically to promote entity theory, with the ultimate goal to protect the organizational client. Unlike its Rule 205 counterpart, Model Rule 1.13 remains nearly entirely "inward-looking."

> Rule 1.13 actually has little substantive effect of its own, *especially* with respect to "outsiders"—including governmental regulatory agencies—who are neither the entity client itself nor agents or other affiliates of the client. Moreover, notwithstanding the Enron, Worldcom, and other scandals that gave rise to the important

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73. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, Investment Company Act Release No. 25,919, 68 Fed. Reg. 6296, at 6311 (Jan. 29, 2003), *available at* http://www.sec.gov/rules/final/33-8185.htm (last visited Mar. 22, 2006).

74. *Id.* at 63.

75. Cullen M. Godfrey, *The Revised Role of Lawyers After Sarbanes-Oxley*, 68 TEX. B.J. 932, 932 (2005) ("[Rule 205 has] not proven to be as draconian as was first feared, but recent events have confirmed that the SEC still sees a major role for lawyers as 'gatekeepers.'").

> The perhaps unintended consequence of a rule that turns a lawyer into a gatekeeper/deputy regulator is that we now must be concerned about more than advising and protecting our clients; we must be concerned with protecting ourselves. It is not necessarily the case that the best interests of the client follow in this scenario. Any time that a lawyer must worry about protecting his or her license and livelihood first, the interests of the client inevitably suffer.

Steven N. Machtinger & Dana A. Welch, *In-House Ethical Conflicts*, ACC DOCKET, Feb. 2004, at 29-30, *available at* 22 NO. 2 ACC Docket 23 (Westlaw).

amendments to Rules 1.6 and 1.13 that were approved as a package by the ABA House of Delegates in 2003, Rule 1.13 is *still* almost entirely an "inward-looking" rule. It continues to focus on the problems of identifying those with authority to speak and act for the entity, and of protecting the entity from false servants within.[76]

To the extent that Model Rule 1.13 looks beyond the organization via its reporting out provision, it does so solely for the protection of the organization. For this reason, external disclosures under Model Rule 1.13 have been labeled by some as "loyal disclosures."[77] The assumption is:

> If outside influence is brought to bear, a change of course may yet be possible, avoiding the looming harm to the company or other organization. . . . [T]he Rule conditions disclosure, as well as the extent of the disclosure, on the lawyer's reasonable belief that it is "necessary to prevent substantial injury *to the organization*." This is consistent with the thematic concern of Rule 1.13 with maximizing the ability of entity lawyers to protect the interests of entity clients.[78]

Model Rule 1.13 only provides for permissive outside disclosure *after* reporting up the chain has been exhausted and proven unsuccessful.[79] To the contrary, Rule 205 indicates that, in limited circumstances, "an attorney . . . may reveal to the [SEC], without the issuer's consent, confidential information" without any prerequisite that the attorney first exhaust all available internal remedies.[80] This contrast illustrates that Model Rule 1.13 places ethical duties on corporate attorneys to further the entity theory approach, protecting the organizational client, while the SEC, via Rule 205, has

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76. 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 17.2, at 17-5 (3d ed. Supp. 2004) (citation omitted).

77. *See id.* at 17-46 (explaining that reporting out is referred to as a "loyal disclosure" on the basis that the attorney is protecting the entity from the bad behavior of disloyal servants within).

78. *Id.* at 17-45 (quoting MODEL RULES OF PROF'L CONDUCT R. 1.13 (undated)).

79. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2004) (providing scenarios when a lawyer may reveal information). Professors Hazard and Hodes have argued that:

> If ameliorative measures taken by the lawyer—including 'reporting up' pursuant to Rule 1.13(b)—have been insufficient, and if even the highest authority within the entity client will not take action to avoid substantial injury *to the entity*, [then] the lawyer may make limited disclosure under Rule 1.13(c) of client information *outside* the organization in a last-ditch rescue effort.

1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 17.2, at 17-45 (3d ed. Supp. 2004).

80. 17 C.F.R. § 205.3(d) (2005).

placed additional professional responsibilities on corporate counsel for publicly traded companies to protect third parties.[81]

Under either set of Rules, the likelihood of implementing the reporting out scenario remains somewhat equal:

> In everyday practice, a requirement for "*reporting up*," whether under the SEC rules in securities matters or under Model Rule 1.13(b) more generally, is likely to provide the most reliable protection for entity clients. . . . "*[R]eporting out*" situations are likely to be rare. Most matters serious enough to require reporting up all the way to the highest authority in the entity are likely to be resolved internally at that point, obviating the need for extramural resort. Most often, in other words, directors of major corporations are not only honest and conscientious, but also have a marked aversion to lawsuits and other legal trouble that put the company at risk.[82]

Given the vast potential for injury to the organization from a reporting out, such a decision should be made advisedly, with input from experienced and independent outside counsel.

C. *Other Ethical Concerns Facing In-House Counsel Post-SOX*

Beyond the effect that mandatory reporting up and permissive reporting out provisions have had—and will continue to have—on corporate attorneys, in-house counsel must pay close attention to other matters. One is the effect that SOX has had on subordinate in-house counsel for publicly traded companies; another is the effect SOX will have on *all* in-house counsel regardless of whether their client may be considered an "issuer" as defined under Rule 205.

1. The Effect of SOX on "Non-Subordinate" In-House Counsel

Rule 205 includes a safe-harbor provision for a subordinate attorney, defined as one "who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (*other than under the direct supervision or direction of the issuer's chief legal officer* (*or*

81. *See* 17 C.F.R. § 205.1 (2005) (noting that Rule 205 applies only to lawyers "appearing and practicing before the Commission in the representation of an issuer").

82. 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 17.12, at 17-46 to 17-47 (3d ed. Supp. 2004) (emphasis added).

the equivalent thereof))."[83] The safe-harbor provision of section 205.5(c) states that "[a] subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission."[84] Thus, an attorney who qualifies for safe-harbor protection fulfills the obligations under Rule 205 simply by reporting the evidence of a material violation to a supervisory attorney. Without more, the subordinate attorney is relieved of his duties to ensure that the CLO or CEO provides an appropriate response to the evidence within a reasonable time as required by section 205.3(b)(3).[85]

One implication of Rule 205's definition for a subordinate attorney is obvious: non-supervisory or low-level in-house counsel, who otherwise would be considered subordinate in the hierarchy of in-house counsel but for Rule 205's definition, are denied safe-harbor protection solely because they happen to be under the direction of the CLO, who is typically the public company's general counsel.[86] The result is that now even potentially inexperienced in-house counsel may be placed in the precarious position of "having to assess the appropriateness of the CLO's response to the report of wrongdoing, as well as the resulting tasks of having to make any further up-the-ladder report if an appropriate response is not obtained" as required by section 205.3(b)(3).[87]

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83. 17 C.F.R. § 205.5(a) (2005) (emphasis added).

84. *Id.* § 205.5(c).

85. *See id.* § 205.3(b)(3) (requiring that, unless an attorney believes that the corporate officers have made a reasonable response to a material violation report, the attorney "shall report the evidence of a material violation" to the issuer's board of directors either directly or through an audit committee).

86. *See* Lisa H. Nicholson, *SARBOX 307's Impact on Subordinate In-House Counsel: Between a Rock and a Hard Place*, 2004 MICH. ST. L. REV. 559, 605 (2004) ("Depriving non-supervisory in-house lawyers of the safe harbor protection of section 205.5(c) simply because they are under the supervision of the chief legal officer is ill-advised, and creates an undue burden for that category of lawyers who may be the first line of defense against corporate wrongdoing.").

87. *Id.*; *see also* 17 C.F.R. § 205.3(b)(3) (2005) (setting the requirements of disclosure that an attorney must go through when there is material evidence of a violation). Furthermore, a more in-depth discussion of the treatment of non-supervisory lawyers is provided in Lisa H. Nicholson, *SARBOX 307's Impact on Subordinate In-House Counsel: Between a Rock and a Hard Place*, 2004 MICH. ST. L. REV. 559, 604-09 (2004).

Thus, in addition to all the other obligations placed on in-house counsel by Rule 205 and Model Rule 1.13, "non-subordinate" in-house counsel—as defined by Rule 205—must be made aware that they are not relieved of their reporting obligations under section 205.3(b) simply because they have reported evidence of a material violation to their supervising attorney. Unlike some of their counterparts, these non-subordinate in-house counsel must follow the reporting process through to completion as required under section 205.3(b)(3).

2. The Potential Effect of SOX on All In-House Counsel

Rule 205 on its face states that only those attorneys who appear or practice before the SEC in the representation of an issuer are governed by its provisions.[88] Rule 205 defaults to the definition of an issuer as used in the Securities Exchange Act of 1934.[89] To be an issuer under Rule 205, an organization must have securities registered under section 12 of the Securities Exchange Act of 1934, be required to file reports under section 15(d) of the Securities Exchange Act of 1934, or have filed a registration statement that is not yet effective under the Securities Act of 1933.[90] The point is that SOX is only applicable to publicly traded companies, which necessarily means that the professional responsibility obligations of Rule 205 are only applicable to in-house counsel (as well as outside counsel in certain instances) for publicly traded companies.

Even so, it is important for counsel at privately held organizations, including limited liability and general partnerships, to pay

88. 17 C.F.R. § 205.1 (2005).

89. *Id.* § 205.2(h) (citing the Securities Exchange Act of 1934 as the source of the definition for the word "issuer"). The Securities Exchange Act of 1934 provides the definition of an issuer as follows:

> The term "issuer" means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.

15 U.S.C. § 78c(a)(8) (2000).

90. 17 C.F.R. § 205.2(h) (2005).

close attention to the ethical landscape and standards framed by SOX. Although SOX and Rule 205 do not specifically apply to the in-house counsel of privately held companies, we foresee the obligations imposed by these laws and rules will likely be used increasingly as a standard for *all* attorneys of organizational clients in ascertaining whether their conduct comported with ethical standards.

V. CORPORATE INVESTIGATIONS: OBSTRUCTION OF JUSTICE

Perhaps no topic is of more concern among today's in-house counsel than that of corporate investigations, whether internal or external. This is because "[c]onducting and/or supervising an internal investigation of potential misconduct can be the most challenging and important function that an in-house counsel performs."[91] Governmental investigations and fines are rapidly increasing in the wake of the previously mentioned corporate debacles of the recent past.[92] The following paragraphs discuss the disturbing trend of prosecutors seeking obstruction of justice charges against in-house counsel, as well as general ethical and legal issues faced by in-house counsel when preparing witnesses for interviews, depositions, and testimony in the face of such an investigation.

In conjunction with the passage of SOX, Congress amended Title 18 of the United States Code by adding two sections that impose criminal liability on any person engaging in obstruction of justice.[93] The government has not hesitated in utilizing these sections:

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91. Deborah J. Edwards, Mark T. Calloway & Brian D. Edwards, *What to Do When the Whistle Blows: Do's and Don'ts of Internal Investigations*, ACC DOCKET, May 2004, at 41, *available at* 22 NO. 5 ACC Docket 41 (Westlaw).

92. *See* Stephen M. Cutler, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, The Themes of Sarbanes-Oxley As Reflected in the Commission's Enforcement Program, Presentation to the UCLA School of Law (Sept. 20, 2004), *in* INSIGHTS, Nov. 2004, at 22, *available at* 18 NO. 11 Insights 18 (Westlaw) (stating that "we have imposed 15 penalties over $50 million in the last year and a half, including many of the highest penalties ever obtained in SEC enforcement actions").

93. One of the changes made by Congress was the addition of a new subsection (c) to section 1512 of Title 18:

> (c) Whoever corruptly—
>
> (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or

> [T]here is nothing that prosecutors like more than to be able to spice up these complex [corporate accounting and securities fraud] cases by tacking on an obstruction of justice charge that is easy for the jury to understand and serves to cast the defendants in a far more negative light than the underlying fraud charges.[94]

In light of the government's zeal in pursuing obstruction of justice charges against in-house counsel it perceives as involved in "covering up" wrongdoing, these attorneys must be circumspect in how they prepare organizational employees for interviews, depositions, and testimony.[95] Obstruction issues frequently arise during the initial phase of a corporate investigation. In-house counsel find themselves involved in the early fact-gathering process, which often includes interviewing relevant employees to ascertain the nature of the problem.[96] In-house counsel also may help prepare employees for interviews or depositions by government regulators or

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> (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.

18 U.S.C. § 1512(c) (Supp. II 2002). The other change was the addition of new section 1519 to Title 18:

> Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

18 U.S.C. § 1519 (Supp. II 2002).

94. Reid H. Weingarten & Brian M. Heberlig, *Representing the General Counsel*, LITIG., Summer 2004, at 32, *available at* 30 NO. 4 Litigation 28 (Westlaw). "The risk of an aggressive prosecutor bringing an obstruction of justice charge is particularly acute if the general counsel was involved in preparing corporate employees for interviews by government regulators, or even for grand jury testimony." *Id.*

95. *See* Ames Davis & Jennifer L. Weaver, *A Litigator's Approach to Interviewing Witnesses in Internal Investigations*, HEALTH LAW., Mar. 2005, at 13, *available at* 17 NO. 1 Health Law 8 (Westlaw) (warning that sections 1512(c) and 1519 expand the scope of obstruction of justice charges by criminalizing acts that might impede investigations). In addition, Davis & Weaver noted:

> To steer clear of such potential [obstruction] liability, the investigating attorney must vigorously instruct employee witnesses to provide complete and truthful answers. The investigating attorney should not suggest answers for the witness, or otherwise mislead the witness as to the facts. The investigating attorney must never instruct an employee not to speak with or cooperate with the government.

Id.

96. *See* Reid H. Weingarten & Brian M. Heberlig, *Representing the General Counsel*, LITIG., Summer 2004, at 32, *available at* 30 NO. 4 Litigation 28 (Westlaw) (warning that

for grand jury testimony.[97] Later, in-house counsel may be involved in post-interview discussions with employees to get a feel for how the investigation is unfolding.[98] It is during these initial meetings that potential obstruction problems can arise:

> During those early sessions, the general counsel may have aggressively coached witnesses to portray events in the light most favorable to the corporation or even to himself. Months later, when the issues in the criminal investigation have crystallized and corporate employees are seeking to cut plea deals to avoid prosecution, what the general counsel performed as "aggressive witness preparation" may be characterized by employees seeking leniency from the prosecutor as "efforts to obstruct justice."[99]

Obviously, in-house counsel need to be extremely cautious regarding witnesses preparation in corporate investigations, whether the investigation is being conducted internally or externally.

One group of attorneys which has tackled the subject in regard to internal investigations suggests two different approaches.[100] The first approach interviews the employee "cold" without any advance notice of the interview or its subject matter and "has the benefit of avoiding the appearance that witnesses have been improperly coached and/or given an opportunity to get their story straight through advance notice from or discussions with the investigative team."[101] The obvious drawback, however, is that without having had the opportunity to refresh his memory before the interview, the employee will likely have to be interviewed again, which can lead to inconsistent and contradictory statements from the wit-

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initial investigations of wrongdoing by in-house counsel may be perceived as covering up or obstructing justice).

97. *Id.* Additionally, it is important to remember, for ethical purposes, that under the entity theory approach of Model Rule 1.13, it is imperative that in-house counsel make absolutely clear to the employee that they are the attorney solely for the organization and therefore are acting only in the best interest of the organization. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2004).

98. *See* Reid H. Weingarten & Brian M. Heberlig, *Representing the General Counsel*, LITIG., Summer 2004, at 32, *available at* 30 NO. 4 Litigation 28 (Westlaw) (noting typical procedure followed by general counsel).

99. *Id.*

100. *See* Deborah J. Edwards, Mark T. Calloway & Brian D. Edwards, *What to Do When the Whistle Blows: Do's and Don'ts of Internal Investigations*, ACC DOCKET, May 2004, at 51-52, *available at* 22 NO. 5 ACC Docket 41 (Westlaw) (espousing two approaches to witness preparation).

101. *Id.*

ness.[102] The second approach seeks to alleviate this problem by providing the employee with relevant information prior to the interview so that the employee may prepare beforehand.[103] Yet this revisits the delicate "coaching versus preparation" issue discussed above. Therefore:

> [C]ounsel must be careful to avoid any conduct that could be described as trying to influence an employee to remember facts in a particular way or that could be characterized as an effort to suggest that witnesses consult with one another prior to being interviewed to ensure that they are all telling the same "story." To minimize these concerns, employees who are given advance notice of the substance of an interview should only be provided with data or documents to review and should be instructed that they are not to discuss the matter with anyone other than the investigative team.[104]

Regardless of the approach in-house counsel take in preparing witnesses for interviews, depositions, and testimony, they must be aware that the government is paying attention. As former SEC Director of the Division of Enforcement, Stephen Cutler, stated in a speech on September 20, 2004, "One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies."[105] Cutler went on to explain, "We are concerned that, in some instances, lawyers may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations."[106]

One potential solution is to retain independent outside counsel to conduct even the earliest internal investigations or at least to respond to external corporate investigations. In doing so, in-house counsel may avoid the appearance of impropriety and obstruction. In any event, in-house counsel must always bear in mind that they can find themselves in violation of the SOX obstruction laws very

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102. *See id.* at 52 (warning that there are risks associated with allowing an employee witness to be interviewed "cold").

103. *See id.* (suggesting that the second school of thought is to help an interviewee to refresh the employee's memory prior to the interview).

104. *Id.* (footnote omitted).

105. Stephen M. Cutler, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, The Themes of Sarbanes-Oxley As Reflected in the Commission's Enforcement Program, Presentation to the UCLA School of Law (Sept. 20, 2004), *in* INSIGHTS, Nov. 2004, at 21, *available at* 18 NO. 11 Insights 18 (Westlaw).

106. *Id.*

early in the investigatory process, perhaps before they even realize the need to refer the matter to an outside entity.

VI. CONCLUSION

The ABA was on the right path over twenty years ago when, in 1983, the Kutak Commission proposed Model Rule 1.13 and promoted the entity theory approach for the lawyer representing the organizational client. The concept is simple: (1) the organization is the in-house counsel's only client; and (2) the in-house counsel's primary duty is to act in the best interest of the organization.[107] Whether the issue is deciding to make an executive compensation disclosure in a proxy statement, taking on a dual role within the organization, acting in compliance with heightened professional responsibility requirements under SOX, or preparing witnesses for corporate investigations, in-house counsel will find themselves unlikely to get into ethical hot water if they consistently act in the best interest of the organization.

Today, however, Rule 205, with its desire to protect stakeholders over the interests of the organization, may provide an exception to this rule. Often when in-house counsel act in the best interests of the organizational client, they necessarily act to the detriment of the individuals who employ them and who work with them on a daily basis. Disregarding the interests of these colleagues can be unimaginably difficult. Nevertheless, due to the corporate fallout of recent years, politicians, state bars, investors, and the general public alike are demanding that in-house counsel—who now are viewed as the first line of defense against corporate irresponsibility—take a stand, in some cases publicly, against corporate impropriety. In short, the SEC and Congress now view in-house counsel as the gatekeepers of corporate integrity. Stephen Cutler summed up the new role of post-Enron in-house counsel when he stated: "What do I mean by 'gatekeepers?' The sentries of the marketplace . . . . [those who are] paramount in ensuring that our markets are clean."[108]

107. *See generally* MODEL RULES OF PROF'L CONDUCT R. 1.13 (2004) (proposing that in-house counsel should use a client-centered approach to rectify violations).

108. Stephen M. Cutler, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, The Themes of Sarbanes-Oxley As Reflected in the Commission's Enforcement Program,

Presentation to the UCLA School of Law (Sept. 20, 2004), *in* INSIGHTS, Nov. 2004, at 18, *available at* 18 NO. 11 Insights 18 (Westlaw).