*Ethics of Internal Investigation*s

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I. Defining the scope of the investigation.

A. In conducting internal corporate investigations, lawyers generally have two goals – to uncover the facts and to advise management and/or the board of directors regarding the corporation's potential liability and recommended courses of action.

B. Knowledge of all the facts will allow the corporation to develop an appropriate response to possible charges of wrongdoing, both civilly and criminally. The corporation may then anticipate and argue against prosecution, avoid being blindsided by unknown facts, and undertake appropriate remedial measures. The investigation itself may also be seen as a positive indication of the responsible conduct of the corporation. Early action by a corporation once it believes a problem may exist will contribute to an effective defense against the allegations of corporate wrongdoing.

1. Particularly in today's national climate of curbing "corporate greed," internal investigations have come to be expected at first signs of trouble.

a. Hundreds of internal investigations of alleged stock options backdating after the Wall Street Journal's "Perfect Payday" article in March 2006.

b. Note the ever-increasing number of internal investigations being performed as a result of the subprime mortgage crisis.

2. Corporate directors have a fiduciary duty to establish a monitoring system to prevent (and if necessary) correct criminal misconduct. "Relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

a. Internal investigation can be a way of ensuring that this fiduciary obligation is satisfied.

b. Lesson learned from Hewlett Packard investigation is that responsibility may fall on the lawyers: "Where were the lawyers? There were red flags waving all over the place," but "none of the lawyers stepped up to their responsibilities." *Hewlett Packard's Pretexting Scandal Before the H. Subcomm. On Oversight and Investigation,* 109th Cong. (2006) (statement of Rep. John D. Dingell).

C. Events from this remarkable decade have highlighted the importance of conducting thorough and independent internal investigations.

1. At the Arthur Andersen federal criminal trial in Houston, the now-(in)famous Vinson & Elkins report on the Sherron Watkins allegations at Enron was termed a "whitewash."

2. Coudert Bros., as part of its independent investigation of accounting issues at Global Crossing, found that the manner in which Simpson, Thacher & Bartlett conducted its internal investigation of the company breached its professional obligations to the company.

3. Hewlett Packard's initial reliance on its long-time counsel, Wilson Sonsini, to conduct the internal investigation to identify a press leak within the company's board of directors was unsuccessful, in part, because of Wilson Sonsini's preexisting relationship with the very same people it was investigating.

4. Numerous companies engaged in the now all-too-familiar audit committee investigation as part of an accounting restatement have had to redo internal investigations because of insufficient independence, scope, or rigor.

5. A thorough internal investigation followed by cooperation with the government can spell the difference between an indictment of the company and either non-prosecution or a deferred prosecution. *E.g.*, Computer Associates, Symbol Technologies (two recent examples of deferred prosecution agreements from the E.D.N.Y.), KPMG (recent deferred prosecution agreement from the S.D.N.Y.) and Boeing (recent non-prosecution agreement from the C.D.Cal. and E.D.Va.).

6. Similarly, cooperation with the SEC can mean the difference between an enforcement action and a pass.

a. In April 2002, the SEC announced settlement with Xerox Corp. imposing a then unprecedented penalty of $10 million against the company for securities fraud violations. The SEC publicly announced that the penalty reflected "in part, a sanction for the company's lack of full cooperation in the investigation." *See Xerox Settles SEC Enforcement Action Charging Company With Fraud*, Release No. 2002-52 (April 11, 2002).

b. Companies such as Homestore, Electro Scientific Industries, and Putnam Fiduciary Trust Company avoided enforcement actions "because of [their] swift, extensive, and extraordinary cooperation in the Commission's investigation. . . ." even when individual officers and directors were found to have committed fraud. *See, e.g.*, *SEC Charges Six Former Officers of Putnam Fiduciary Trust Company with Defrauding Clients of $4 million*, Release No. 2006-2 (Jan. 3, 2006).

D. Lawyers conducting internal investigations should understand that their actions and conclusions may be closely scrutinized.

1. A finding of no misconduct is likely to be viewed skeptically by regulators, prosecutors, and the press.

2. Findings of misconduct, particularly by persons at the highest levels of the company, will have to be amply supported in order to garner approval from within the corporation, including at the board level.

II. How should an in-house counsel react to learning of possible impropriety at the company, such as by receiving a whistleblower letter like the Sherron Watkins letter to Enron that accuses a company of accounting fraud?

A. Be guided by the following factors:

1. the level of seriousness of the alleged wrongdoing;

2. the level of detail and substantiality of the allegation; and

3. the background and credibility of the employee making the allegation.

4. <u>But</u> be careful about discounting too much the word of a complainer or crackpot. Some of the best and most famous whistleblowers have been real misfits.

B. Begin by talking with the whistleblower, if the person is identified.

C. If the charge is made anonymously but appears to be serious and significant, begin an informal inquiry.

1. Talk to people who may know what is going on.

2. Look at company materials and records that are relevant to the allegation.

D. Decide if you should continue looking into it, close the file, or hire outside investigators.

E. If the allegations seem serious and substantial, or are from someone at the level of seniority and authority of Ms. Watkins, show the letter to the inside auditor, the outside auditor, the CEO and the audit committee. It is important to let the facts of the allegations be known to the relevant parties, and to let them know that you are following up. This is true even if you initially think that the claims are not legitimate.

F. Remind the audit committee members that they have the authority to retain their own counsel. (Sarbanes-Oxley § 301)

G. Try to evaluate the claim before beginning an investigation. Balance the inquiry that must be made against the possible disruption to the operation of the company during an investigation (disruption from people being brought in to be interviewed, etc.).

H. The aftermath of the recent Hewlett Packard investigation taught us that if the company determines that an internal investigation is necessary, the company must be sure that:

1. Investigation is being done for a valid purpose (*i.e.* not driven by corporate politics);

2. A valid process for accomplishing the investigation must be established;

3. If the purpose or process of the investigation is compromised, the consequences for a corporation and counsel may be worse than doing nothing at all.

I. Remember that the general counsel's primary duty is to make a reasonable inquiry to determine whether there is a credible basis for the allegation.

III. Once it is determined that an investigation is warranted, the company will need to determine whether to use in-house or outside counsel as investigators.

A. In-house counsel have advantages:

1. In-house counsel are better acquainted with the company.

2. Employees may be more open in discussing sensitive matters if they know the investigator. Maybe not.

3. In-house counsel cost a lot less.

B. Other factors favor outside counsel conducting the investigation.

1. Outside counsel will likely provide a more objective analysis.

a. Outside counsel likely to have no relationship with the subjects of the investigation.

b. Hewlett Packard investigation demonstrates pitfalls of internal General Counsel overseeing investigation over same people ordinarily counseled.

2. The judgment of outside counsel, who are experienced in similar cases, may be valuable to the corporation.

3. In-house counsel may not appear as independent or as credible to prosecutors or the SEC.

4. The attorney-client privilege may be more easily maintained by outside counsel. In-house counsel are often required to provide business as well as legal advice, and to share information for matters under investigation with other corporate officers and employees, resulting in waiver of the privilege. The government may be more alert to the potential for waiver when in-house counsel conducts the investigation.

5. In-house counsel may be too close to many problems to see them.

a. In the stock options backdating cases, we have seen the growing trend of the government aggressively going after in-house counsel for participation in alleged wrongdoing. *E.g.* Apple, McAfee, Monster, Comverse, Take-Two Interactive.

b. In-house counsel may be valuable witnesses into issues of alleged wrongdoing.

6. By using outside counsel who work closely with in-house counsel, the corporation may take advantage of both the benefits of retaining outside counsel and the familiarity with a knowledge of the corporation by in-house counsel.

IV. Thoroughly investigating conflicts—beyond the standard conflicts check.

A. Sometimes, a too-close relationship of outside counsel and the client removes many of the benefits of having outside counsel conduct an internal investigation. This is conventional wisdom after Enron and Global Crossing.

B. Global Crossing / Simpson Thacher & Bartlett

1. Global Crossing's acting general counsel, also an active Simpson Thacher partner, responded to an employee whistleblower complaint by retaining the company's primary outside counsel, Simpson Thacher, to conduct the investigation.

2. Coudert's subsequent report concluded that the general counsel's simultaneous service as Global Crossing's acting general counsel and as a Simpson Thacher partner "compromised the Company's relationship with ST&B; led to misunderstandings; and ultimately gave rise to a conflict of interest upon the failure of ST&B to adequately investigate [the whistleblower's] allegations."

C. Enron / Vinson & Elkins

1. Vinson & Elkins, Enron's longtime outside counsel, were asked to investigate allegations of wrongdoing – but they were also told not to second-guess the accountants. Was the scope of the investigation too limited?

a. In the memo that spurred the investigation, Sherron Watkins suggested that the accountants were not making appropriate judgments. She raised the possibility of ethical and criminal violations. It was the general counsel's responsibility and obligation to make sure those claims were thoroughly investigated.

b. Ms. Watkins suggested two steps to follow up on her memo: hiring <u>independent counsel</u> to conduct a widespread investigation, and hiring <u>independent accountants</u> to analyze transactions and opine on the accounting treatment employed by Enron and its auditors, Arthur Andersen. The general counsel of Enron and a

Vinson & Elkins partner reviewed her suggestions and concluded (1) that Vinson & Elkins was sufficiently independent and could adequately perform the investigation, and (2) that the hiring of independent forensic accountants was unnecessary at the time. Both of these decisions have since been called into question, to put it mildly.

(i) Vinson & Elkins' independence was not a close call. Enron was Vinson & Elkins' biggest client, and Vinson & Elkins was Enron's primary outside counsel.

(ii) Vinson & Elkins' report concluded that there were "bad cosmetics" and "a serious risk of adverse publicity and litigation," but concluded that further investigation was not warranted.

(iii) Seven weeks after Vinson & Elkins submitted the report to Enron, Enron filed what was at the time the largest bankruptcy in U.S. history. Vinson & Elkins was named in class action lawsuits filed on behalf of Enron shareholders and employees as well as a separate suit filed by Enron's bankruptcy estate.

> (a) Vinson & Elkins was embroiled in lengthy and costly litigation for nearly 4 years.
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> > (1) In June 2006, law firm agreed to pay $30 million to Enron's bankruptcy estate in exchange for the estate agreeing not to pursue claims alleging that Vinson & Elkins aided and abetted Enron's downfall.
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> > > (i) Included in the $30 million was $10.5 million in legal fees returned by Vinson & Elkins to Enron that Enron had paid the firm in the three months before the bankruptcy.
> > >
> > > (ii) Commenting on the settlement, Harry Reasoner, a partner at the firm, noted that "This has been enormously burdensome litigation for everybody involved. Probably more discovery has been taken in this case than any other securities

case in American history." *See* http://www.chron.com/disp/story.mpl/special/enron/3921779.html (last checked April 1, 2008).

(2) Vinson & Elkins' motion to dismiss the shareholder class action complaint was denied, because the district court found that the complaint adequately alleged that Vinson & Elkins had actively participated in fraud. *In re Enron Corporation Securities, Derivative and ERISA Litigation*, 235 F. Supp. 2d 549 (S.D. Tex. Dec. 20, 2002).

(3) Vinson & Elkins was finally dismissed from the lawsuit in January 2007, *only* after lead plaintiff voluntarily dismissed the law firm because lead plaintiff did not want to expend further time and money on "Defendants from which it does not expect to be able to collect substantial funds." *Id.*, 2007 U.S. Dist. LEXIS 5111, at *100-101 (Jan. 24, 2007).

(i) Lead plaintiff agreed with Vinson & Elkins' contention that the law firm's "resources pale in comparison with those of the Financial Institutions, that Vinson & Elkins would be unable to pay a sizeable judgment, and that further pursuit of the law firm would be expensive and risky." *Id.* at *101, n. 9.

(iv) Vinson & Elkins suffered adverse publicity and was dragged before Congress.

(a) Max Hendrick III, a partner at the firm, also suffered embarrassment of having to defend the firm's investigation as a witness in the criminal trial of Jeffrey Skilling and Kenneth Lay.

(v) Such reputational calamities can damage law firms in direct and indirect ways, through departures of clients, missed new business opportunities, loss of morale, distraction of management in defending lawsuits, and depressed recruiting.

2. In defense of the beleaguered: There were valid, rational reasons for the decisions made by Enron and Vinson & Elkins.

   a. Lawyers accept limitations on the scope of their work all the time. They are not experts in all matters, and they often assume the accuracy of an outside expert's conclusion.

   b. A corporation cannot do a full-blown, civil discovery-type internal investigation every time it receives an allegation of wrongdoing.

   c. Speed is often critical. It can be very important to get to the bottom of an allegation very quickly. As Enron's primary outside counsel, Vinson & Elkins already knew all of the necessary background facts. Further, reviewing auditing judgments would have delayed the conclusion of the investigation.

      (i) *See John H. Gutfreund*, Exchange Act Release No. 34-31554, 51 S.E.C. 93 (Dec. 3, 1992) (Salomon Bros. criticized for taking too long with its internal investigation of its Treasury trading scandal).

3. Nevertheless, in this case these decisions turned out very badly, both for the company and for the firm. In light of the lessons learned from Enron, attorneys should take steps to protect themselves and their clients in performing independent investigations.

4. Everyone – shareholders, the board of directors, outside auditors, prosecutors, the Securities and Exchange Commission, Congress – will expect post-Enron internal investigations to be independent, thorough, and robust.

D. How to avoid this quandary?

1. Seek authority sufficient to conduct a credible and competent investigation of the issue troubling the organization.

2. Ideally, the engagement letter will make explicit that the investigation has an unlimited scope, including but not limited to the specific issues that gave rise to the need to investigate. The investigators will of course have to apply the usual investigative

filters to prevent an endless inquiry without focus. But nothing should be placed off limits from the outset.

3. Lawyers should be careful not to accept limits that prevent them from performing the investigation thoroughly and competently.

4. It is now accepted fact that Vinson & Elkins was not sufficiently independent from Enron to enable Vinson & Elkins to give independent advice. The firm was thoroughly familiar with the client and with the client's representatives in the transactions. But, in hindsight, its investigation was not independent or adequate.

E. Risks vs. benefits of retaining long-standing outside counsel for an internal investigation.

1. Granted, an investigation that is conducted by an outside firm that has a long-standing relationship with the organization will likely be quicker and cheaper than one conducted by a comparable firm that is completely outside of the events being investigated.

2. However, in the cold clear light cast by the Enron and Global Crossing debacles, and given the imperatives of the DOJ's "McNulty Memo" and the SEC's *Seaboard* decision, it is in the interest of both the firm and the organization to consider fully the ethical rules and to proceed cautiously if the investigation includes matters on which the firm has provided legal advice.

3. Post-Enron, everyone will expect that the firm that was involved in the underlying conduct is <u>not</u> the appropriate firm to do an internal investigation.

4. Similarly, the company's usual auditors are <u>not</u> the right firm to do the forensic accounting investigation.

5. But: The proof is in the pudding, and if the company's usual outside counsel does a thorough, credible investigation, then many of the usual factors favoring independent counsel should fade. The risk for the company is that its usual outside counsel may be held to a higher standard.

F. Before conducting an investigation, an outside firm must decide if its prior legal work for the organization may be of such concern during the investigation as to materially interfere with the firm's judgment.

1. ABA Model Rule 1.7 ("Conflict of Interest: Current Client") states: A concurrent conflict of interest exists if: … there is a

significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer. Notwithstanding the existence of a concurrent conflict of interest … a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.

2. NY Disciplinary Rule 5-101 [22 N.Y.C.R.R. § 1200.20] ("Conflicts of Interest – Lawyer's Own Interests") states: "A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own financial, business, property, or personal interests, unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby, and the client consents to the representation after full disclosure of the implications of the lawyer's interest."

3. In light of the circumstances giving rise to the investigation, a firm must (1) second-guess its own work and (2) notify the client of the potential conflict. This can be problematic, because a client may interpret notice of a possible conflict of interest as an assertion that the firm's prior work was flawed.

4. While it is hard to do, the ethical rules do require such second-guessing of one's partners and associates. Even if the firm initially concludes that a conflict does not exist, the client should be alerted to the possibility of one and give its consent to the firm performing or continuing the investigation.

5. The firm must continuously reevaluate its own limitations and biases as the investigation proceeds. If facts are discovered that imply that the judgment of an attorney may be materially affected, the ethical rules require termination of the representation.

6. If the investigation leads to a significant number of interviews of law firm partners and employees or substantial issues regarding law firm work product, other counsel should be retained to complete the investigation.

V. Ensuring the firm has the requisite expertise.

1. Lawyers have a duty to act competently for their clients. They may not agree to provide representation when they know that they lack the knowledge to perform adequately the services that are needed. This rule is particularly important in highly regulated industries, such as banking, securities, nuclear power, food and drug safety, or other highly technical fields.

2. Lawyers must also know when and how to seek help in dealing with highly regulated fields. The ability to retain and work with competent, disinterested experts is critical to ethical representation.

3. ABA Model Rule 1.1 ("Competence") states: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation."

4. Disciplinary Rule 6-101 [22 N.Y.C.R.R. § 1200.30] ("Failing to Act Competently") states: "(a) A lawyer shall not: (1) Handle a legal matter which the lawyer knows or should know that he or she is not competent to handle, without associating with a lawyer who is competent to handle it."

5. In a cross-border investigation, the need for ensuring competence will often call for local counsel, experts, and accountants, not to mention translators. Take special care to obtain local law advice on privacy laws that may restrict access to and use of employee emails.

VI. Who is the client?

A. A basic fact of any representation of a corporate client is obvious on paper but can be tough in reality: the organization itself is the client. The executives and officers, board members, shareholders and other stakeholders are part of the corporation, but they do not embody it. Attorneys for entities must be careful to recognize and remember this fact, and to explain it to constituents of the corporate client.

B. See New York Disciplinary Rule 5-109 [22 N.Y.C.R.R. § 1200.28] ("Organization as Client"), ABA Model Rule 1.13 ("Organization as a Client"):

1. New York Disciplinary Rule 5-109(a) requires a lawyer retained by an organization to explain to officers, directors, employees, members, shareholders, or other constituents of the organization that the attorney represents the corporation, not any of the constituents.

2. ABA Model Rule 1.13(d) requires a lawyer, in dealing with an organization's directors, officers, employees, members, shareholders or other constituents, to 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.

    a. A lawyer must be clear that his loyalty and responsibility are to the organization and not to any individual shareholder, director, officer or employee.

    b. The lawyer representing the entity must not be persuaded by the personal interests of the company's directors, officers or employees, and must always consider the best interest of the organization above any individual interest.

3. New York Disciplinary Rule 5-109(b) and ABA Model Rule 1.13(b) lay out the circumstances under which an attorney must proceed in the best interest of the corporation, as opposed to the best interest of an individual constituent of the organization. This is the closest that the rules come to a "whistleblower" provision for in-house counsel. Two threshold conditions must exist:

    a. the attorney knows that an officer, employee, or other person associated with the organization is engaged in an action that is either:

        (i) illegal (i.e., a violation of the securities laws), or

        (ii) a violation of a legal obligation to the organization (such as a breach of fiduciary duty or usurpation of a corporate opportunity); and

    b. this action is likely to result in substantial injury to the organization.

    c. The obligation on the lawyer is imposed only when the lawyer has "actual knowledge" that the illegal activity is occurring or will occur (a subjective standard).

4. The general guidance is not all that helpful: in such situations, the lawyer "shall proceed as is reasonably necessary in the best interest of the organization."

5. New York Disciplinary Rule 5-109(b) [ABA Model Rule 1.13 (b)] does give some additional guidance, stating that in determining how to proceed, a lawyer may consider the following factors:

   a. the seriousness of the violation and its consequences;

   b. the scope and nature of the lawyer's representation;

   c. the responsibility in the organization and the apparent motivation of the person involved;

   d. the policies of the organization concerning such matters; and

   e. any other relevant considerations.

6. The rule – far from favoring disclosure to authorities – limits disclosure outside the organization. Under New York Disciplinary Rule 5-109(b) [ABA Model Rule 1.13 (b)], the lawyer must take measures designed to minimize disruption to the organization and the risk of revealing information relating to the representation to persons outside the organization. ABA Model Rule 1.13(b) suggests the following measures:

   a. asking reconsideration of the matter;

   b. advising that a separate legal opinion on the matter be sought for presentation to the appropriate authority in the organization; and

   c. referring the matter to a higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law (usually the board).

7. New York Disciplinary Rule 5-109(c) [ABA Model Rule 1.13 (c)] permits an attorney to resign if, despite the lawyer's efforts in accordance with the rule generally, the highest authority that can act on behalf of the organization insists upon an action, or a refusal to act, that is <u>clearly</u> a violation of law and is likely to result in a <u>substantial</u> injury to the organization.

8. To a significant extent, Sarbanes-Oxley § 307 and the SEC's implementing rules have superseded the state rules of professional responsibility in this areas. *See* 17 C.F.R. § 205.3(a) (SEC's

Attorney Conduct Rules): An attorney for an issuer "owes his or her professional and ethical duties to the issuer as an organization."

a. "That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients." *Id*. This may of course become especially difficult when an individual or family plays a dominant role in a public company. E.g.:

(i) Hank Greenberg and AIG.

(ii) The Rigases and Adelphia.

b. The SEC's Attorney Conduct Rules trump state disciplinary codes and provide a road map for responding to certain types of illegality within the corporation.

VII. Defining from the outset who is the client is important to establish independent reporting lines.

A. Investigations are typically supervised by independent directors—either the audit committee or a special litigation committee.

1. Especially when conduct of senior management or board members is under investigation, special care must be taken in identifying to whom counsel reports and from whom counsel takes directions.

2. Must identify conflict-free individuals who can serve as corporate client (*i.e.* in stock options backdating investigation, Compensation Committee member not right person to oversee investigation).

B. The client is the board committee, not management.

C. Management is usually <u>not</u> included in the reporting line regarding progress of the investigation.

D. This is a thorny problem for non-U.S. corporations, many of which have strong management control and/or a supervisory board of outside directors without the authority that a U.S. audit committee possesses. *See* Section 301 of Sarbanes Oxley (giving audit committees the authority to hire their own counsel).

E. Where a foreign corporation has a U.S. investigative problem – e.g., Royal Ahold, Vivendi, Royal Dutch/Shell, Parmalat, etc.– it should adapt to U.S. expectations, like it or not.

F. If a foreign issuer wishes to tap U.S. capital markets or operate a U.S. banking branch, such American "legal imperialism" will become a fact of life, like it or not.

VIII. Multiple Representations: Corporations and Corporate Constituents.

A. Lawyers are sometimes called on simultaneously to represent both a corporation and one or more of its officers, directors, employees or other constituents in the context of a governmental investigation.

B. The ABA Model Rules of Professional Conduct allow a lawyer representing a corporation to represent any of its directors, officers, employees, members, shareholders or other constituents, subject to limitations (1.13 (e)).

1. According to the ABA Model Rules, in dual representations where two parties have no reasonable likelihood of becoming adverse, client consent is not needed. A lawyer may represent a constituent whose representation will be directly adverse to the corporation or whose representation presents a significant risk that one or more clients will be materially limited by the lawyer's responsibility if: (i) the lawyer reasonably believes that s/he will be able to provide competent and diligent representation to each client; (ii) the representation is not prohibited by the law; (iii) the representation does not involve the assertion of a claim by one client against another client in the same litigation or other proceeding before a tribunal; and (iv) each affected client gives informed consent, confirmed in writing. (ABA Model Rule 1.7)

2. Informed consent requires that each affected client be aware of the relevant circumstances and the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. (ABA Model Rule 1.0 (e))

C. New York Disciplinary Rule 5-105(C) [22 N.Y.C.R.R. §1200.24] states that counsel for a corporation may undertake such a multiple representation only "if a disinterested lawyer would believe that the lawyer can competently represent the interest of each [client] and if each consents to the representation after full disclosure of the implications of the simultaneous representation and the advantages and risks involved."

D. Even if multiple representation of the company and one or more of its individuals is permissible under the ethics rules, it should be a carefully weighed decision.

1. Recognized advantages of multiple representation include:

a. Avoiding expense of separate counsel;

b. Making a unified defense simpler to implement;

c. Giving the lawyer (and therefore all of the clients) the benefit of detailed and broad knowledge of all relevant facts.

2. *But*: multiple representation of any entity plus individuals in an internal investigation is risky and generally a bad idea.

a. There is always a possibility that a conflict will arise "that will disable corporate counsel from continuing as corporate counsel. If a matter is time sensitive, or if corporate counsel has invested considerable time in the representation, the prejudice to the corporation from such a development could be quite significant." Association of the Bar of the City of New York ("ABCNY") Formal Op. 2004-02.

b. "Potential loss of credibility with the investigating agency." *Id.* Prosecutors and SEC staff attorneys often state a preference that employee-witnesses be represented by counsel other than counsel for the corporation.

c. Multiple representation may also complicate the ability of (i) the lawyer to report to the corporation or (ii) the corporation to report to the authorities, the findings of the investigation, because such information may implicate the attorney-client privilege of the employee-client.

(i) The case *In re Grand Jury Subpoena: Under Seal*, 415 F.3d 333 (4th Cir. 2005), highlights the conflict of interest that may arise in representing both the company and individual employees.

(a) The Fourth Circuit concluded that, in response to a grand jury subpoena, three corporate employees—regardless of their assertions that they were represented by their former employer's counsel—were required to disclose documents related to an internal investigation conducted by their former company.

(b) While the Court concluded that the employees had not entered into an attorney-client relationship with the company's counsel regardless of the investigating attorneys' statements during the employees' interviews that they "*could*" or "*can*" represent them as long as no conflict of interest became present, the court found that even contemplation of such multiple representation created a "potential legal and ethical mine field."

(1) As the court explained, "[h]ad the investigating attorneys, in fact, entered into an attorney-client relationship with appellants, as their statements to the appellants professed they could, they would not have been free to waive the [employees'] privilege when the conflict arose. It should have seemed obvious that they could not have jettisoned one client in favor of another."

(2) The court further added that the only solution "would have [been] to withdraw from all representation and to maintain all confidences. Indeed, the court would be hard-pressed to identify how an investigating counsel could robustly investigate and report to management or the board of directors of a publicly-traded corporation with the necessary candor if counsel were constrained by the ethical obligations to individual employees."

(ii) The countervailing options of the employee's Fifth Amendment rights and the corporation's ability to cooperate fully with the authorities will often make multiple representation inadvisable if not unethical.

(iii) Potential or actual conflicts may also arise in the context of indemnification, advancement of fees and expenses, insurance coverage, and other employment-related issues.

3. After assessing the facts and determining that a lawyer can undertake the multiple representation, an attorney should consider the ways in which s/he can structure the attorney-client relationship so as to "minimize potential drawbacks to multiple representation." ABCNY Formal Op. 2004-02.

   a. Prospective waivers of conflict. There is no ethical bar to seeking a waiver of future conflicts. *Id*. (*citing* ABA Comm. On Ethics and Prof'l Responsibility, Formal Op. 372 (1993)); NYCLA Ethics Op. 724 (1988).

      (i) Prospective waiver should be set forth in writing.

      (ii) Prospective waiver should meet all of the requirements for contemporaneous waivers (including full disclosure by attorney of what conflicts could potentially arise).

      (iii) In context of internal investigation, prospective waiver may be "sought in such cases from an employee client regarding the ability of corporate counsel to continue representing corporate client in the event an actual or potential conflict develops." ABCNY Formal Op. 2004-02.

         (a) Particularly in cases where investigation could lead to litigation, "consideration should be given to obtaining a waiver of the employee client's right to object to being cross-examined by his former attorney." *Id*.

         (b) Prospective waiver may also be useful in situations where the corporate client has mandatory reporting requirements (e.g. banks and broker-dealer firms), so that if attorney learns of reportable information from employee client, attorney will be able to divulge required information.

         (c) Independent of the prospective waiver, when the actual conflict develops, the attorney is obligated to revisit the issues if an actual or potential conflict arises. If actual or potential conflicts turns out to be materially different from those the client waived, the lawyer will not be permitted to rely on the prospective waivers, and will have to obtain new, contemporaneous waivers. *Id*. (*citing* ABA Formal Op. 372; NYCLA Ethics Op. 724).

b. Contractual limits on representation

(i) An attorney may ethically limit by contract her/his representation, so long as "the representation still comports with the requirements of the N.Y. Code of Professional Responsibility. . . [T]his means that the representation may not be so limited as to be inadequate." ABCNY Formal Op. 2004-02.

(ii) For the limitations to be proper, the attorney must give the client full disclosure of the terms of the engagement and obtain the client's consent.

(a) Contractual limitations may be appropriate in cases where corporate counsel can represent the employee client only during the investigation phase (but not at the trial) or even narrower representation limited to a discrete stage of the investigation, a single interview, or a particular topic.

(b) *But:* it will rarely be in the interest of the employee to have an attorney subject to such contractual limitations.

(iii) Shadow counsel

(a) Potential conflicts of interest may be avoided or mitigated if corporate counsel takes on the representation of an employee client along with "a separate counsel who serves as additional counsel for the corporate employee, and thus is available to offer independent advice to the employee, and if necessary, to take over as sole counsel for the employee." *Id.*

(b) Having shadow counsel may be advantageous in that it can alleviate concern from the government investigators that the employee client is not receiving independent legal advice. Also, in case there is a conflict and corporate counsel has to withdraw, at least co-counsel or shadow counsel should be "apprised of facts and developments" so as to avoid any delays or prejudice to the employee client. *Id.*

(c) Of course, hiring a co-counsel or shadow counsel diminishes cost-saving incentive of multiple representation.

(d) It may sometimes be in the mutual interest of the corporation and the employee that shadow counsel remain in the shadows, i.e., not be present for an interview with the government.

c. In summary, if an attorney determines that multiple representation is appropriate, s/he must be sure to have a clear understanding with both clients as to:

(i) Whether and what kind of confidential information will be shared;

(ii) Who will control the privilege with respect to such information;

(iii) How the attorney-client privilege will operate in the event a dispute arises between the clients concerning the matter; and

(iv) Whether the lawyer will continue to represent the corporation even if a conflict develops between the corporation and the constituent. ABCNY Formal Op. 2004-02.

(v) The parties should reduce to writing the understanding they reach. *Id.*

IX. Interviewing employees.

A. Interviews are best handled by at least two people.

1. The second person should serve as note taker, and may serve as a witness at some later time.

2. All attorneys conducting the interview should review any resulting memorandum for accuracy.

3. All notes of the interview should be preserved.

B. Employees should be informed of the purpose of the interview. This includes:

1. the fact that the government is conducting an investigation (if such is the case);

2. the nature of the problem(s) being investigated;

3. the fact that counsel has been retained to provide advice to the company, the audit committee, or special committee of the board; and

4. the fact that the interview is necessary for counsel to obtain the information needed to provide appropriate advice to its client.

C. Employees should be told of expectation of cooperation.

1. Employee has right to refuse to be interviewed—but does so at risk of losing job.

2. Employee could face *criminal* consequences for lying or misleading lawyers during course of internal investigation.

a. On April 9, 2004, three former executives of Computer Associates entered pleas of guilty to obstruction of justice charges tied to lies they told during the internal investigation being conducted by Wachtell, Lipton, Rosen & Katz.

(i) At the time it was a novel theory of criminal liability because, as one commentator explained, "[t]he Computer Associates executives were never accused of lying directly to federal investigators or a grand jury. Their guilty pleas were based on the theory that in lying to Wachtell they had misled federal officials, because Wachtell passed their lies to the government." Alex Berenson, *Case Expands Type of Lies Prosecutors Will Pursue*, N.Y. Times, May 17, 2004.

(ii) Almost two year later, on April 24, 2006, Computer Associates' former CEO, Sanjay Kumar, also entered a plea of guilty to charges including a count for obstruction of justice for lying to Wachtell's lawyers during the internal investigation and of instructing the company's general counsel to coach witnesses to misinform investigators.

b. On March 8, 2006, the U.S. Attorney's Office for the Southern District of Texas charged a natural gas trader with, among other things, obstruction of justice for failing to "disclose, falsely den[ying], and otherwise conceal[ing] that he had provided false information to trade publications." *United States v. Singleton*, S.D. Texas, No. H-04-514-SS, 3/8/06.

(i) The indictment alleges in effect that Singleton provided false information to the outside lawyers used to create a report submitted to federal agencies, including the U.S. Attorney's Office.

(ii) Charges stem from one interview Singleton had with outside lawyers conducting an internal investigation.

(iii) The obstruction charge alone could result in a sentence of up to twenty years in prison.

(iv) Singleton's motion to dismiss count on basis that count did not "allege an offense recognized by law" was denied. *See United States v. Singleton*, No. H-06-080, 2006 WL 1984467 (S.D. Tex. July 14, 2006).

> (a) The fact that the information provided by Singleton to the outside lawyers was used in creation of a report was sufficient for the court to find that there was "some nexus to a document or other tangible evidence" required for the obstruction charge. *See id.* at *4.
>
> (b) The court also found that the outside counsel were "acting as an arm of the investigating agencies" and that Singleton knew, by virtue of being told that his statements may be given to "other third parties, including government agencies," that the outside lawyers' investigation was an "official proceeding." *See id.* at *6.

(v) Singleton successfully moved for judgment of acquittal on the obstruction count on the 15th day of trial. *See* Hearing Minutes and Order, 4:06-cr-00080 (S.D. Tex. July 31, 2006).

> (a) In his motion, Singleton relied upon the testimony during the trial of the outside lawyer responsible for the internal investigation. *See* Motion for Judgment of Acquittal as to Count Ten by Greg Singleton, 4:06-cr-00080 (S.D. Tex. July 31, 2006).

(1) Specifically, the attorney testified that:

(i) In the course of the investigation, he and members of his firm represented themselves as attorneys for the company.

(ii) The employees interviewed (including Mr. Singleton) were told that the information learned from the interviews would be shared with the company's upper management and that the company may decide to share the information with third-parties, possibly including the government.

(iii) At the time of the internal investigation, the company had not made any decision whether it was going to share the findings of its internal investigation with the government.

(iv) Mr. Singleton was not told that his law firm would be preparing a memo of its findings.

(v) Mr. Singleton did not have a chance to review the memo which was ultimately provided to the government.

(b) The Court granted the motion without any explanation for its finding. *See* Hearing Minutes and Order, 4:06-cr-00080 (S.D. Tex. July 31, 2006).

(vi) Interestingly, the press surrounding the *Singleton* case has focused on the Court's initial denial of the motion to dismiss the obstruction charge and not the subsequent judgment of acquittal.

c. Jurisprudence in the area of criminal liability arising from statements made during internal investigations is still forming, but as one commentator remarked, "[a]ll you need is one or two cases to succeed, and then it becomes standard operating procedure." *Obstruction Charge Arises from Failure to Give Information to Internal Investigators*, Law Week (BNA, Inc. March 28, 2006) (*quoting* Peter J. Henning, law professor at Wayne State University).

d. With the increasing privatization of law enforcement – with outside counsel for companies or for their audit committees conducting investigations on behalf of the government – creative defense counsel will begin to make constitutional arguments challenging the conduct of the private attorneys doing the government's work.

(i) Fifth Amendment right against self-incrimination

(ii) Due process

(iii) Fourth Amendment protection against unreasonable search and seizures

D. The employees must be informed that the interviewer is counsel to the corporation (or audit committee or special committee, as appropriate), not to the employee, and that the privilege belongs to the corporation.

1. As Judge Kaplan noted in the KPMG tax shelter case, *United States v. Stein*, 463 F. Supp. 2d 459, 462 (S.D.N.Y. 2006), "Once a government investigation begins, the interests of the employees and of the entity may diverge. . . . Employees are often unaware of the potential personal consequences of cooperating with lawyers hired by their employers. Even more troublesome, they may cooperate with employer-retained counsel in the belief that their communications are protected by a personal privilege, sometimes as a result of misapprehension of the law and occasionally perhaps as a result of deception, inadvertent or otherwise."

2. Investigating counsel must give a clear warning that s/he represents the company and *not* the individual employee.

a. An ambiguous warning may lead to confusion and raise unnecessary questions of who controls the privilege.

b. *In re Grand Jury Subpoena: Under Seal*, discussed *supra*, addressed the question of whether an attorney-client relationship had been formed between investigating counsel and the individual employees where the attorneys stated that they "could" and "can" represent the employees unless a conflict arose with the company.

(i) During one of the interviews, investigating counsel explained to the witness that they represented the company but that they "*could*" represent him as well, "as long as no conflict appeared." 415 F.3d at 335 (emphasis added).

(ii) A second witness was told that company counsel "*can* represent [him] until such time as there appears to be a conflict of interest." Similarly, the third witness was told by investigating counsel that "[w]e represent [the company], and *can* represent [you] too if there is not a conflict." *Id.*

(iii) The court ultimately found that no attorney-client relationship had been formed, in part because "'we *can* represent you' is distinct from 'we *do* represent you.' If there was any evidence that the investigating attorneys had said, 'we *do* represent you,' then the outcome of this appeal might be different." *Id.* at 340 (emphasis in original).

c. While ultimately the Fourth Circuit determined that the "essential touchstones for the formation of an attorney-client relationship . . . were missing," *In re Grand Jury Subpoena: Under Seal* demonstrates the potential ethical and legal pitfalls of investigating counsel failing clearly to inform the individual employee that the attorney currently represents *only* the company.

3. The employee should be advised that the substance of the interview may be disclosed to company management, to the board, and to the government. Such disclosure may occur where the company has a statutory obligation to disclose or the company chooses to make a voluntary disclosure to the government.

a. The investigating attorney should make clear that the privilege belongs solely to the company and can be waived only by the company.

b. In order to protect the company's privilege, the employee should also be reminded to keep the substance of the interview confidential and not to share with anyone, including other employees in the company.

E. Both ABA Model Rule of Professional Conduct 1.13(d) and New York Disciplinary Rule 5-109 [22 N.Y.C.R.R. § 1200.28] require lawyers to explain clearly whom they represent when the interests of the employee are or may become adverse to that of the company.

F. According to ABCNY Formal Op. 2004-02, if the employee asks the lawyer for the company if the employee should consult with separate counsel, the lawyer should reiterate that s/he represents the company and cannot advise the employee.

1. DR 7-104(a)(2) allows (but does not compel) an attorney to recommend to an unrepresented party to secure counsel.

2. A lawyer should be careful in dispensing this advice as "he owes his allegiance to the entity and not to a shareholder, director, officer, employee, representative, or other person connected with the entity." EC 5-18.

3. ABCNY Formal Op. 2004-02 advises that "[b]ecause affirmatively advising a corporate employee to secure counsel may work against the interests of the corporation, we believe it is appropriate for corporate counsel to be reluctant to render that advice – at least in the absence of the consent of his client to do so."

4. But: taking a broader view of the interests of the corporation, the quality of information obtained during the interview may vastly improve if the employee can be prepared in advance by a capable, reputable attorney. Getting the untutored, reflexive reaction of an employee to a potentially incendiary set of facts may often lead to obfuscation and confusion, which only complicate and delay the efforts of the investigating counsel.

a. Question also arises of who should pay for the individual's counsel.

(i) New York's Business Corporation Law governs indemnification of corporate officers and directors of N.Y. corporations. *See* BCL §§ 721-727.

(a) Generally, under BCL § 723(a), an officer or director who has been successful on the merits, or otherwise, in defense or a criminal action or proceeding is entitled to indemnification. However, the individual must have acted in good faith.

(b) Companies can also expand the rights of indemnification and advancement of legal fees through the corporation's certificate of incorporation or bylaws, shareholders' or directors' resolutions, or private agreements.

(ii) Similarly, Delaware has broad, permissive statutes on indemnification and advancement of legal fees. *See* 8 Del. C. § 145 *et seq.*

(a) Delaware law recognizes a strong public policy rationale for giving corporations considerable latitude in deciding to advance expenses, including attorneys' fees.

(b) As one court explained, "No Delaware corporation is required to provide for advancement of expenses. Nevertheless most Delaware corporations do adopt advancement provisions as inducement, which promotes the same salutary public policy that is served by indemnification: attracting the most capable people into corporate service." *Homestore Inc. v. Tafeen*, 888 A.2d 204, 218 (Del. 2005).

(iii) Until December 2006, the DOJ's official policy, as stated by then Deputy Attorney General Larry D. Thompson's January 2003 memorandum on the Principles of Federal Prosecution of Business Organizations (the "Thompson Memo"), permitted prosecutors to weigh "whether the corporation appears to be protecting its culpable employees and agents . . . through the advancing of attorney's fees."

(a) In effect, for companies fearing being perceived as uncooperative, the Thompson Memo's "guidance" served to cut off employees' rights to receive the benefit of advancement and payment of legal fees.

(1) For example, although required by its corporate by laws, Bank of America denied one of its officers advancement of legal fees because it had "decided to cooperate fully with the Office of the Attorney General of the State of New York" in its investigation into trading practices of mutual funds. *See Sihpol v. Bank of America*, Complaint for Advancement, Civ. Action No. 005-N (Del. Ch. 2003).

(b) Similarly, as part of its deferred prosecution agreement, KPMG refused to advance the legal fees of any of its partners during the government's investigation into KPMG's tax shelters unless the individuals cooperated with prosecutors. *See* E. Lawrence Barcella, Jr., "Cooperation with Government is a Growing Trend," National Law Journal (July 19, 2004).

(1) In a harsh rebuke to prosecutors, U.S. District Judge Lewis Kaplan found that the government "let its zeal get in the way of its judgment" and "violated the Constitution it is sworn to defend" by "causing KPMG to cut off legal fees and other defense costs upon indictment." *United States v. Stein,* 440 F. Supp. 2d 315 (S.D.N.Y. 2006).

(2) Judge Kaplan held that, in pressuring KPMG to cut off the legal fees of its partners as part of settling with the government, the prosecutors violated the Constitution's Fifth and Sixth Amendments. *See id.*

(3) According to Judge Kaplan, "KPMG refused to pay because the government held the proverbial gun to its head." *Id.*

(c) On July 16, 2007, Judge Kaplan granted motions to dismiss the indictments of 13 defendants whose defense costs would have been paid by KPMG absent the government's interference. *See United States v. Stein*, 495 F. Supp.2d 390 (S.D.N.Y. 2007).

(1) Judge Kaplan's 2007 ruling went beyond his 2006 decision by finding that the prosecutors' conduct had risen to a level of misconduct that "shocked the conscience." *Id*. at 413.

(d) The government appealed Judge Kaplan's 2007 ruling. The case is currently pending before the Second Circuit Court of Appeals, where the case was argued on March 25, 2008.

(1) During the argument, the government's position was received with apparent skepticism by the three-judge panel: Judges Jacobs, Hall and Feinberg.

(2) At the argument, AUSA Karl Metzner contended that KPMG made its own decision to stop paying the legal fees. Judge Jacobs jumped right in, saying, "So at this point KPMG can still decide to pay the fee, but hasn't the calculus changed? Right now it would seem that the best business deal for KPMG ... the best defense would be to leave these defendants to their enemies."

(3) At another point, Metzner said that the government's earlier policy of taking into consideration the company's willingness to stop paying legal fees for executives under investigation as a sign of cooperation was meant to discourage companies from "protecting culpable employees, by, among other things, advancing their legal fees." He added that, in general, "The government has no legitimate interest in impairing the quality or quantity of a defense." Judge Jacobs responded that he could not "reconcile those two positions."

(e) A decision on the case is pending as of the writing of this outline, but Judge Jacobs' suggested during the argument that short of a "categorical" statement from the government that it will not take into consideration advancement or payment of legal fees in determining cooperation, KPMG was left with no other option. As Judge Jacobs said during the argument, "The government's position has always been it wouldn't have an objection ... but it would evaluate its [KPMG's] actions -- that's exactly the inhibiting mechanism identified by [] [J]udge [Kaplan]."

(iv) On December 12, 2006—in the wake of Judge Kaplan's initial strong criticism—DOJ issued new guidance superseding the Thompson Memo (the McNulty Memo), in which prosecutors were instructed that they "generally should not take into account whether a corporation is advancing attorneys' fees to employees or agents under investigation and indictment." McNulty Memorandum.

(a) The new DOJ policy does permit prosecutors to take note of a company's payment of legal fees in "extremely rare cases" in which the advancement of attorneys' fees is part of a larger scheme to intentionally impede a criminal investigation. *See id*.

(b) To support its reversal of policy, DOJ noted that many state statutes and corporate charters and by-laws affirmatively provide for the advancement of legal fees for corporate employees and agents and concludes that "a corporation's compliance with governing state law and its contractual obligations cannot be considered a failure to cooperate." *Id*.

(c) The McNulty Memo's position leaves the question open of whether in a case where a state statute or corporate charter is silent as to legal fees, would the government still be prohibited from weighing a company's decision to pay attorney fees?

b. In the midst of its impending sale to JP Morgan Chase, Bear Stearns recently reported that it had specifically changed its bylaws to help employees involved in defending an "action, suit or proceeding" pay for their legal expenses. *See* Bear Stearns Form 8-K, filed March 19, 2008.

5. As a practical matter, any individual who refuses to cooperate with the company's own internal investigation will likely be terminated. Taking the Fifth in a government investigation may have the same result at some companies. Once the employee is terminated, company may decide not pay his or her legal fees during the ongoing investigation and/or criminal case following indictment.

G. After the interview, counsel should memorialize the substance of the conversation in writing. This writing should include counsel's standard introductory opening and closing remarks to the employee, and should also include counsel’s mental impressions to preserve work-product protection to the extent possible.

X. What are lawyer’s obligations once they learn of potential impropriety?

A. Counsel must be prepared to address findings from investigation, even if unrelated to initial issue under investigation.

1. Evidence of criminal activity (*i.e.* discovery of narcotics distribution or of pornographic material on employee’s computer).

2. Consider disclosure obligations, both internally within company and externally, if publicly traded company or if material affects business relationships with other third parties.

B. “Up the Ladder” reporting requirements: Implementing § 307 of Sarbanes-Oxley.

1. Attorneys appearing and practicing before the Commission in representation of an issuer must report forthwith evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer. Unless the issuer has established a Qualified Legal Compliance Committee (“QLCC”), the attorney must make the report to the Chief Legal Officer (the “CLO”) of the issuer or to *both* the CLO and the CEO. *See* Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 CFR § 205.1 et seq.

2. The SEC’s Attorney Conduct Rules broadly define a “material violation” to include “a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or similar material violation of any material United States federal or state law.” 17 CFR § 205.2(i).

3. The term “material” is intended to have its well-established meaning under the federal securities laws. *See Basic v. Levinson*, 485 U.S. 224 (1988); *TSC Industries v. Northway, Inc.*, 426 US 438 (1976) (information that would be considered important to a reasonable investor in total mix of available information).

C. “Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." 17 CFR § 205.2(e).

1. How's that again?!?

2. Commentators and practitioners have noted the difficulty of converting into practice the double negative ("it would be unreasonable . . . not to conclude") in this key provision of the rule.

   a. Commentators suggested that the standard should be re-written to read that "a lawyer must report when confronted with information that a prudent and competent lawyer, acting reasonably under the circumstances, would conclude was credible evidence of a material violation." George M. Cohen, Roger C. Cramton and Susan P. Koniak, *The Defective Trigger of the SEC's Rule Implementing SOXA's Duty to Report*, BNA Securities Regulation and Law Report, Analysis & Perspective, vol. 37, no. 3, at 108-09 (Jan. 17, 2005).

   b. Eliminating the double negative would prevent the SEC from having the burden of proving two negatives.

3. The SEC Attorney Conduct Rules require the lawyer to report once the lawyer has "become aware of evidence of a material violation." 17 C.F.R. § 205.3(b).

   a. The term "become aware" is not defined in the rules, and it is unclear if it is limited to the subjective standard of "actual knowledge" of Model Rule 1.13(b) or could be more broadly interpreted to include conscious avoidance or willful blindness or some form of reckless conduct.

      (i) To date, no reported cases were found providing guidance on the interpretation of the term "become aware."

   b. As explained by one group of commentators, "[o]ne of the problems with the subjective 'actual knowledge' trigger in Model Rule 1.13(b), which Congress sought to replace in Section 307, is that it creates an incentive for lawyers not to 'know' that wrongdoing is occurring or may occur." Roger C. Cramton, George M. Cohen and Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 Vill. L. Rev. 725, 755-756 (2004).

c. The SEC rules do not apply specifically to law firms as opposed to individual attorneys, but the "becomes aware" standard raises the question of the extent to which knowledge within firms will be imputed from one lawyer to another.

d. The lonely lawyer is left to ponder what constitutes sufficient "evidence" of a material violation under the rule.

(i) Is the lawyer expected to make credibility determinations in evaluating "the evidence"?

(ii) Does the lawyer have a duty of further inquiry based on facts that raise some suspicion but do not seem to reach the trigger of the rule?

4. Under the final rule, "reasonably likely" has meaning of more "than a mere possibility" but it need not be "more likely than not." *See* SEC Release No. 34-47276.

a. Final Rule takes into consideration that "there is a range of conduct in which an attorney may engage without being unreasonable." The Rule takes into account such things as attorney's skill, background and experience, and familiarity with client.

b. "Reasonably" is based on ABA's Model Rule 1.0(h): "conduct of a reasonably prudent and competent lawyer."

c. The "reasonably likely" standard has come under attack by critics who state that the language is susceptible to multiple interpretations. The commentators suggest that the Commission "amend the rule to add a definition stating that 'reasonably likely' means less than 'more probable than not' but more than a remote possibility." *The Defective Trigger of the SEC's Rule Implementing SOXA's Duty to Report*, Analysis & Perspective, BNA Securities Regulation and Law Report, vol. 37, no. 3, at 109 (Jan. 17, 2005).

5. The Rules have been criticized for having too weak a triggering standard that is "so ambiguous and convoluted that the SEC cannot effectively enforce it." *Id*. The ambiguous triggering standard makes it easy for "lawyers inclined to do so . . . [to] circumvent it." *Id*.

D. If the attorney does not receive a timely and appropriate response from the CLO after reporting evidence of a material violation, the attorney is required to report the evidence of the material violation “up the ladder” to (a) the issuer’s audit committee or, in the absence of an audit committee, (b) to another committee of the board of directors consisting solely of independent directors or, in the absence of such a committee, (c) the full board of directors. 17 CFR § 205.3(b).

1. The attorney can by-pass reporting to the CLO and/or CEO and report directly to company’s audit committee or board of directors if the attorney reasonably believes that reporting to CLO and CEO would be futile. 17 CFR § 205.3(b). Going directly to the audit committee or board is appropriate in circumstances where the CLO or CEO is involved in the violation.

2. The attorney also has the option of reporting to the QLCC, if the company has established such a committee.

a. Under the Final Rule, a QLCC must be comprised of at least one member of the audit committee (or an equivalent committee of independent directors) and 2 more members of the board who are not employed directly or indirectly by the issuer. 17 C.F.R. § 205.2(k).

b. The Rule also requires that the QLCC must have been duly established by issuer’s board, and it must have the authority to investigate and report evidence of material violations.

c. The QLCC is responsible for issuer’s compliance with the rule, thus once the attorney reports the violation to the QLCC, the attorney is no longer responsible for assessing whether the issuer’s response was appropriate.

E. An “appropriate response” is defined as an issuer’s response to an attorney which causes the attorney to reasonably believe that:

1. no material violation has occurred, is occurring or is about to occur;

2. the issuer has adopted appropriate remedial measures or sanctions to stop, prevent or address any past, present or future material violation and minimize the likelihood or its recurrence; or

3. the issuer, with the consent of the board of directors, authorized board committee or QLCC, has retained or directed an attorney to investigate the matter and the issuer (a) has implemented any

remedial measures recommended by the investigating attorney or (b) has been advised by the investigating attorney that a "colorable defense" to an on-going investigation or administrative proceeding can be asserted on behalf of the issuer or its affiliates in connection with the material violation. 17 CFR § 205.2(b).

4. Attorneys are "permit[ted] to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an appropriate response is reasonable." SEC Press Release 33-8185.

F. What must a lawyer do if s/he does not believe that the issuer has "appropriately responded" to evidence of an on-going or likely-to-occur violation?

1. Noisy Withdrawal? Proposed Rule 17 C.F.R. § 205.3(d)(1) would have required an attorney who does not believe that s/he has received an appropriate response to withdraw forthwith from representing the issuer and give notice to the SEC that s/he is withdrawing based on "professional considerations." *See* SEC Press Release 33-8186.

2. This proposed provision faced heavy criticism from the legal community as lawyers feared that noisy withdrawal would impinge on the attorney-client relationship and possibly violate its confidences. Lawyers advocated for a revised rule that would allow for permissive rather than mandatory withdrawal.

3. On January 29, 2003, the SEC proposed an alternative rule that would require the attorney to withdraw, but would put the burden on the issuer (rather than the attorney) to publicly disclose the withdrawal of the attorney. The attorney would have the option but not the duty to inform the Commission that the attorney has withdrawn for professional considerations.

    a. While the comment period for the proposed provision has closed, the SEC has not yet adopted any form of mandatory withdrawal provision.

    b. However, a lawyer who does not believe the issuer has "appropriately responded" may withdraw from representing the issuer, but as of now, is under no obligation to do so.

4. The existing Rules permit, but do not require, the attorney to disclose the material violation to the SEC. 17 C.F.R. § 205.3(d). In so doing, the attorney must take into consideration her/his

ethical obligations to protect the attorney-client confidential relationship.

5. The SEC Attorney Conduct Rules prevent retaliatory dismissal of an attorney who reports evidence of a material violation up-the-ladder. If the attorney reasonably believes that he has been fired by the CLO or CEO because he has reported a violation, he can notify the audit committee or board of directors that he has been fired for complying with the rule. 17 C.F.R. § 205.3(b)(10).

G. Who is covered by the Rule?

1. The Rule broadly defines "appearing and practicing" before the SEC and covers attorneys who communicate in any way with the SEC on behalf of an issuer, including: representing an issuer in a SEC enforcement proceeding, investigation or inquiry; being involved in the preparation of any statement, opinion or other writing incorporated in materials filed or submitted to the SEC; advising a client on the submission of SEC filings or registrations.

   a. "Attorney" is defined broadly by the Rule to mean "any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, who holds himself or herself out as admitted, or otherwise qualified to practice law." 17 C.F.R. § 205.2(c).

   b. Attorney must be providing legal services within context of an attorney-client relationship. That is, an attorney, simply by virtue of being a licensed attorney, is not covered by the rule unless he is providing legal services. *See* 17 C.F.R. § 205.2(a)(2)(i). Also not covered are attorneys who assist in preparing documents (i.e. contracts) that are later submitted to the SEC as an exhibit to a filing, but the lawyer, at the time of drafting the document, did not intend for it or know that the document would be filed with the SEC. *See* SEC Release No. 34-47276.

   c. An attorney retained by an issuer to investigate evidence of a material violation is deemed to be "appearing and practicing" before the SEC.

2. Many, but not all, foreign attorneys are excluded from the Rule's coverage. The Rule does not apply to "non-appearing foreign attorneys", who are defined as attorneys:

   a. who are not licensed to practice law in the US,

b. who do not hold themselves out as practicing or giving advice on U.S. law, and

c. who conduct activities that would constitute appearing and practicing before the SEC only incidentally to his or her foreign practice or appear or practice before the SEC only in consultation with U.S. counsel. 17 CFR § 205.2(j).

3. Supervising attorneys must make reasonable efforts to ensure that a subordinate attorney conforms to the requirements of the Rule and assumes an independent duty under Rule if s/he receives report of a material violation from a subordinate attorney.

a. A subordinate attorney has an independent duty to satisfy Rule's reporting requirements, but s/he can satisfy obligation by reporting evidence to supervisory attorney.

b. CLO is deemed to be a supervisory attorney, but an attorney who practices "under the direct supervision or direction of issuer's chief legal officer," is not treated as a subordinate attorney and retains responsibility for full reporting obligations.

H. If the lawyer has uncovered planned future wrongdoing, what should the attorney do?

1. Under no circumstances may the lawyer assist in the illegal conduct.

2. The in-house counsel should not reveal past wrongdoing to persons outside the company, absent an exception to the confidentiality rules.

a. Again, under no circumstances should a lawyer participate in illegal conduct. The appropriate course of action is to withdraw from representation, or in the case of in-house counsel, leave the company or obtain a transfer to different job responsibilities.

b. The ABA Model Rules do not recognize an exception to confidentiality for fraudulent activity. ABA Model Rule 1.6.

c. New York Disciplinary Rule 4–101(C) states: "A lawyer *may* reveal … (3) The intention of a client to commit a crime and the information necessary to prevent the crime" [emphasis added]. By no means is the lawyer *required* to do so.

d. The Final SEC Rule permits, but does not require, an attorney to reveal an issuer's confidential information to the SEC without issuer's consent to the extent the attorney believes it is reasonably necessary to:

(i) Prevent issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of issuer or investors;

(ii) Prevent issuer, in course of SEC investigation or proceeding from committing perjury or fraud upon agency; or

(iii) Rectify consequences of a material violation by issuer that caused or may cause substantial injury to financial interest of issuer or investors in which attorney contributed to such violation. 17 C.F.R. § 205.3(d)(2).

(iv) Final Rule permits broader revelation of confidential information than do Model Rules 1.6 and 1.13 and NY Disciplinary Rule 4–101(C):

(a) No limitation that the client is using the attorney's services "in furtherance" of the crime or fraud to be committed.

(b) No requirement that that matter which lawyer is revealing must be "related to representation."

(c) Rule permits disclosure if violation affects issuer *or* third party.

(d) The standard is lower under the SEC Rule because it requires only a showing that harm is "likely" as opposed to "reasonably certain."

(e) Rule preempts state standards and ethics rules: "disclosure is permitted under rule whether or not permitted under applicable state law." 17 C.F.R. §§ 205.1, 205.6(c).

I. The SEC's Attorney Conduct Rules permit the lawyer to reveal confidential information to defend charges of that attorney's violation of the Rules. *See* 17 C.F.R. § 205.3(d)(1).

XI. Self-reporting investigation findings to the authorities.

A. DOJ McNulty Memo and SEC *Seaboard* decision place significant pressure on corporations to provide to the government the results of internal investigations. Both place great weight on prompt corporate self-reporting, cooperation, and self-remediation in determining whether the corporation itself should be charged.

1. The *Seaboard* Report explained, "[w]hen businesses seek to self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more directly."

a. "Recently, the SEC's policy has evolved from encouraging self-reporting and cooperation to one that, in addition, affirmatively punishes the failure to cooperate." David Gourevitch, *The Securities and Exchange Commission Raises the Cost of Non-Cooperation*, BNA Securities Regulation and Law Report, Analysis & Perspective, vol. 36, n. 45 (2004).

b. Stephen M. Cutler, former SEC Enforcement Director, has stated that "[a]ny effort to impede an SEC investigation may itself become the subject of an enforcement proceeding." *Id.*

c. Paul Berger, former Associate Director of the SEC, has also been quoted as saying, "[s]tiff sanctions and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interest of investors." *Id.*

2. Prosecutors should weigh a "corporation's timely and voluntary disclosure of wrongdoing and willingness to cooperate in the investigation of its agents." McNulty Memorandum.

a. The Government's favorable view of cooperating companies is evident from the recent non-prosecution agreements entered into with MCI, Inc., KPMG, El Paso Corp., Collins & Aikman Corp., Ahold N.V., AB Volvo, to name just a few.

b. Cooperation, however, does not guarantee leniency.

(i) On March 19, 2007, Chiquita Brands International entered a guilty plea guilty to one count of engaging in transactions with a specially-designated global terrorist. Chiquita agreed to pay the steep penalty of $25 million. *See http://www.usdojgov/opa/pr/2007/March/07_ nsd_161.html* (last checked March 21, 2008).

(ii) The government became aware of Chiquita's payments of $1.7 million to a right-wing Colombian paramilitary group only after Chiquita self-reported the findings from its own internal investigation.

3. Thompson Memo (DOJ's predecessor to McNulty Memo) had profound effect in defining extent of "cooperation" required not only by prosecutors, but also by other regulatory agencies.

a. For example, in its own version of the Thompson Memo, dated September 2005, the NYSE deemed waiver of privilege as "extraordinary cooperation" that would be taken into account as a mitigating factor.

B. Until December 2006, DOJ's official policy was to view waiver of the attorney-client privilege and work product protection as a factor to be considered in the extent of cooperation by the company. *See* Thompson Memorandum.

1. Just how much importance the DOJ placed on a company's willingness to waive the privilege was crystallized in the highly publicized indictment of Milberg Weiss Bershad & Schulman LLP in May 2006. According to the law firm, at that time, negotiations with the DOJ broke down because of the firm's refusal to waive the attorney-client privilege.

2. According to a survey conducted of corporate counsel in 2006, 75% of respondents felt that a "culture of waiver" exists in which governmental agencies expect a company under investigation to broadly wavier attorney-client privilege. *See* http://www.judiciary. house.gov/OversightTestimony.aspx?ID=568 (last checked March 21, 2008).

3. Testifying in front of the Judiciary Committee, Karen J. Mathis, then President of the American Bar Association, noted that the Thompson Memo's privilege waiver "policies have led many prosecutors to pressure companies and other entities to waiver their

privileges on a regular basis as a condition for receiving cooperation credit during investigations," adding that most companies have no choice but to comply, lest they be labeled uncooperative and suffer the consequences. *See* http://judiciary.senate.gov/testimony.cfm?id=2054&wit_id=5742 (last checked March 21, 2008).

4. DOJ's policy is to allow each U.S. Attorney's Office to establish its *own* written policy on privilege waivers. *See* Oct. 21, 2005 DOJ Memorandum regarding "Waiver of Corporate Attorney-Client and Work Product Protection."

   a. DOJ endorses a practice of differential treatment of the privilege wavier issue between offices.

   b. DOJ encourages varying practices in order to ensure that each office "retains the prosecutorial discretion necessary, consistent with their circumstances, to seek timely, complete, and accurate information from business organizations."

C. DOJ's forced "retreat" from Thompson Memo's waiver policy.

1. In November 2004, the U.S. Sentencing Commission proposed an amendment encouraging the government to pressure companies, associations, and other organizations to waive their attorney-client privilege and work product protections as a condition for cooperation with the government during investigations.

   a. The ABA criticized the proposed amendment as giving organizations "no choice but to waive [the attorney-client and work product] privileges whenever the government demands it, as the threat to label them as 'uncooperative' in combating corporate crime--even if the charge is unfounded--could have a profound effect on their public image, stock price and credit worthiness." August 15, 2005 Comment Letter, http://www.abanet.org/buslaw/attorney client/materials/046/046.pdf (last checked March 21, 2008).

   b. Because the ABA "believe[d] that the privilege waiver amendment is flawed and uniquely dangerous to our shared goal of protecting the policies that are advanced by the attorney-client relations," the ABA urged the Commission to reconsider the privilege waiver amendment during its 2005-2006 amendment cycle. *Id.*

c. After heavy lobbying from the ABA and various other organizations including the U.S. Chamber of Commerce, the New York State Bar Association and the American Civil Liberties Union, on April 5, 2006, the Sentencing Commission "voted unanimously to *rescind* its policy authorizing and encouraging prosecutors to require corporations and other business entities to waive the attorney-client privilege and constitutional protections in order to receive 'credit' for 'cooperating' in government investigations." http://www.abanet.org/op/greco/memos /sentencingcommission.shtml (last checked March 21, 2008).

2. On December 7, 2006, Senator Arlen Specter, then Chairman of the Judiciary Committee, introduced the Attorney-Client Privilege Protection Act, which, if passed, would forbid prosecutors from considering waiver of attorney-client protections in assessing a corporation's cooperation.

   a. On November 13, 2007, the bill was approved by the House of Representatives.

   b. It took almost a year for the bill to be introduced to the Senate. Since its introduction on January 4, 2007, it has not been voted on.

3. In response to Senator's Specter's introduction of the Act in December 2006, a week later, DOJ issued the McNulty Memo, superseding and replacing the Thompson Memo, including (to some extent) the provision concerning waiver of privileged information.

   a. Wavier of attorney-client privilege and work product protections "is *not* a prerequisite to finding that a company has cooperated in the government's investigation." McNulty Memorandum.

   b. Under new guidelines, prosecutors may request waiver of the attorney-client privilege or work product protections only when there is a "legitimate need" for the privileged information. *See id.*

   (i) Policies set forth factors to assess "legitimacy" of need, including, the likelihood and degree to which privileged information would benefit the government investigation; whether information can be obtained using alternative means; completeness of voluntary disclosure; and collateral consequences of waiver. *See id.*

(ii) Policies also differentiate procedures for obtaining privileged information depending on if the nature of the information sought is factual work product ("Category I") or attorney-client communications and opinion work product ("Category II"). For Category II information, prosecutors should only seek waiver in "rare circumstances." *See id.*

(iii) Prosecutors are allowed to take into account a company's refusal to waiver the privilege for Category I information in assessing cooperation, but a company's decision not to provide Category II information cannot be considered against the company. Prosecutors can consider favorably a corporation's decision to comply with a Category II waiver request.

4. While the McNulty Memo was issued as a response and in a likely attempt to stave off the contemplated federal legislation, the practical effects of the changes compared to the Thompson Memo are likely to be minimal, if any at all.

   a. Those companies that choose to volunteer information (including protected information) will still be rewarded.

   b. Those companies that refuse will still risk serious harm if deemed to be "uncooperative."

   c. As one commentator explained, "the new 'guidelines' governing requests for waiver seem unlikely to have much of an impact on [the] evaluation of just how much a corporate target should cooperate with a federal investigation. Certainly, prosecutors still have the leverage to entice corporations to adhere to the culture of voluntary cooperation, and it seems doubtful that the creation of a structured process for requesting formal waivers will alter significantly a corporation's analysis of whether, and when, to waiver its privileges." Richard J. Morvillo, "The McNulty Memo: What Has Changed (and What Hasn't)," January 8, 2007.

D. While beyond the scope of this outline, companies that waive the privilege in the course of government investigations must consider the ramifications of such a waiver in connection with civil litigation.

1. The Second Circuit has not adopted a per se rule that all voluntary disclosures to the government waives the work product and attorney-client privileges, but the dominant trend is to deem the privilege as waived for purposes of subsequent discovery in civil suits. *See e.g.*, *In re Steinhardt Partners, L.P.*, 9 F.3d 230 (2d Cir. 1993); *Allied Irish Banks v. Bank of America*, No. 03 Civ. 3748, 2007 U.S. Dist. LEXIS 4247 (S.D.N.Y. Jan. 23, 2007).

    a. As recently explained by Judge Scheindlin, "voluntary disclosure of attorney work product, regardless of the existence of a confidentiality agreement, will waive work product privilege absent special circumstances." *In re Initial Public Offering Sec. Litig.*, 2008 U.S. Dist. LEXIS 11058, at *30-31 (S.D.N.Y. Feb. 14, 2008).

        (i) In discussing Credit Suisse's disclosure to the government, Judge Scheindlin concluded that "[w]hat appears to be voluntary disclosure may be, in the context of a threatened prosecution, closer to a compelled disclosure." *Id.* at 31.

        (ii) Judge Scheindlin also made clear that during a government's investigation into potential wrongdoing, the agreement to cooperate to escape or limit liability does not create a "common interest" between the cooperating party and the government. The government remains in an adversarial position. *See id.*

    b. In rejecting the concept of "selective waiver," the Second Circuit joins the majority of other Circuits. *See In re Qwest Commc'ns Int'l Inc.*, 450 F.3d 1179 (10th Cir. 2006) (in denying company's petition for writ of mandamus declaring that company did not waive the attorney-client privilege or work product doctrine with respect to pending civil litigation by producing information to the SEC and DOJ, the court followed the "almost unanimous rejection of selective waiver" by other Circuits).

    c. Only the Eighth Circuit has adopted the concept of selective waiver protecting companies that cooperate with government investigations while facing parallel civil litigation. *See Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (finding that company did not waive attorney-client privilege by voluntarily surrendering material to SEC pursuant to an agency subpoena. "To hold otherwise may have the effect of thwarting the developing procedure of corporations to employ independent outside counsel to investigate and advise them. . . .”).

2. Because the individuals being interviewed in the course of an internal investigation may be defendants in related civil suits, the waiver of privilege by the company may have a significant impact on them.