Bloomberg BNA

Corporate Law & Accountability Report™

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OFFICER LIABILITY

SEC Broadens Corporate Officer Liability Exposure By Adding Teeth to Internal Controls Certification and Disclosure Requirements

BY DANIEL O'CONNOR, MARKO S. ZATYLNY AND KAIT MICHAUD

The Securities and Exchange Commission's increased focus on identifying and penalizing misstatements in public company financials is no secret. In April of this year, Chairman Mary Jo White highlighted in prepared testimony before the U.S. House Financial Services Committee the SEC's new Financial Fraud Task Force and the strides it was taking to identify ''both traditional and emerging financial fraud issues.''[1] Likewise, at the March 2014 ''SEC Speaks'' conference, an annual event where the agency provides an overview of recent initiatives, SEC representatives explained that they would be analyzing patterns of internal control problems even absent a restatement and holding ''gatekeepers''—such as auditors and corporate officers—accountable for corporate misstatements.[2]

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The SEC's disclosure on July 30 of an enforcement action against two corporate executives of a small, Florida-based computer equipment company exemplifies the type of emerging theory the SEC staff is apt to pursue.[3] In a departure from past practice, the SEC pursued theories of fraud against both the chief executive officer and chief financial officer of Quality Services Group Inc. solely for alleged misrepresentations in public disclosures about the company's internal controls environment, which are required by the Sarbanes-Oxley Act of 2002.

What makes QSGI a unique case is that it did not arise from a restatement of the company's prior financial statements; indeed, there does not appear to have

[1] Mary Jo White, Chairman, U.S. SEC. & EXCH. COMM'N, Testimony before U.S. House Fin. Servs. Comm. (Apr. 29, 2014), *available at* http://www.sec.gov/News/Testimony/Detail/Testimony/1370541674457#_ftn1.

[2] *See generally* http://www.sec.gov/News/Page/List/Page/1356125649549 (speeches dated Mar. 12, 2014).

[3] (12 CARE 887, 8/1/14).

been any material mistakes in the company's reported financials. Here the SEC hinged its fraud claims on alleged unreported deficiencies in QSGI's internal controls over its accounting function.

Taking the SEC's theory to its furthest extension, this case may sound an end to the days where corporate officers may simply adopt a ''no harm, no foul'' approach to disclosure when a company identifies an immaterial accounting issue or otherwise fails to follow its accounting policies and practices.

The SEC's theory in the QSGI matter also appears to reflect a continuation of the SEC's ''Broken Windows'' strategy, a reference to a New York Police Department strategy that pursued small infractions on the theory that chasing minor violations may lead to preventing larger ones. This theory was originally adopted by a former director of the SEC Enforcement Division, Robert Khuzami, and rearticulated by Chairman White.

As Chairman White explained in her October 2013 remarks at the Securities Enforcement Forum: ''The [Broken Windows] theory can be applied to our securities markets—minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions.''[4]

The SEC's focus on ''small'' internal controls misstatements that are unaccompanied by restatements of public company financials should serve as a reminder to corporate officers that Sarbanes-Oxley certifications can form the basis of personal liability for minor, known problems. While it may be debatable whether the SEC's resources are best spent pursing such cases, the environment today at the agency is such that we may see more of these types of cases. Commissioner Aguilar's August 28, 2014 Dissenting Statement In the Matter of Lynn R. Blodgett and Kevin R. Kyser reinforces that certain voices within the SEC are committed to deter fraud with the imposition of suspensions for individuals involved regardless of whether those individuals acted with any intent.[5] Commissioner Aguilar emphatically noted that ''the Commission *must* be willing to charge fraud and *must* not hesitate to suspend [individuals] from appearing or practicing before the Commission. This is true regardless of whether the fraudulent misconduct involves *scienter*'' (emphasis in original).

Therefore, companies that identify internal control problems, large or small, should quickly address the issues and consider the need to report such issues to their auditors and, after evaluating the potential risks posed by the issue, the investing public.

The SEC's Allegations Against QSGI's Corporate Officers

The SEC alleged that QSGI's CEO (Marc Sherman) and former CFO (Edward Cummings) knew of significant internal controls issues in the company's inventory practices that they failed to disclose to auditors and investors. Central to the SEC's theory of fraud is that Sherman and Cummings (1) signed Form 10-Ks with management reports on internal controls (required by Sarbanes-Oxley Act § 404) that falsely omitted issues; and (2) signed certifications (required by Sarbanes-Oxley Act § 302) in which they falsely represented that they had evaluated the management report on internal controls and disclosed all significant deficiencies to auditors.

At bottom, the SEC's theory is reducible to two internal controls ''deficiencies.'' First, the SEC viewed inventory controls at one of QSGI's facilities as insufficient, principally because inaccurate inventory counts occurred when product was routinely moved into and out of the facility without appropriate entries in the company's books and records. The SEC explained that the inaccurate inventory counts were a product of multiple issues at the facility, including (1) a general practice of removing component parts from products in inventory without documenting it, (2) belated and insufficient efforts to introduce new controls, and (3) failure to hire experienced accounting personnel and granting autonomy to unqualified individuals.

Second, the SEC asserted that QSGI took advantage of the internal control weaknesses to accelerate revenue recognition by a matter of days, up to approximately a week, to maximize QSGI's borrowing potential based on the terms of a private working capital loan agreement.

The SEC's enforcement action did not allege, however, that the revenue acceleration materially altered QSGI's financial statements. (One has to wonder if this ''early recognition'' issue is what first drew the attention of the SEC enforcement staff.)

The company's internal controls ''deficiencies'' translated to misstatements in public disclosures in two ways. First, QSGI's management reports on internal controls over financial reporting were ''false'' because they stated that Sherman had evaluated QSGI's management controls using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control. In the SEC's view, however, Sherman did not participate in any such evaluation and, in fact, was unaware of the referenced evaluation framework.

Likewise, QSGI's § 302 certifications were ''false'' because they certified that the signatories (Sherman and Cummings) had evaluated the management report on internal controls and disclosed all significant deficiencies to auditors when, in the SEC's view, both men were aware of and failed to disclose to auditors the aforementioned inventory and revenue recognition controls issues when they signed the certifications.

The SEC's Fraud Theory

Rather than pursue a theory of negligence on the basis of this fact pattern, the SEC has advanced fraud charges against Sherman and Cummings under § 10(b) of the Securities and Exchange Act of 1934. In addition, the SEC has asserted claims against both for violating § 13(b)(5) of the Exchange Act, which prohibits knowingly falsifying books and records and circumventing a company's internal controls, and causing QSGI to violate § 13(b)(2) of the Exchange Act, which requires

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[4] Speech, Mary Jo White, Chair, U.S. SEC. & EXCH. COMM'N (Oct. 9, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.U_31GXPD-Uk.

[5] Luis A. Aguilar, Comm'r, U.S. SEC. & EXCH. COMM'N, *Dissenting Statement In the Matter of Lynn R. Blodgett and Kevin R. Kyser, CPA, Respondents* (Aug. 28, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542787855.

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companies to "make and keep accurate books and to devise and maintain effective internal accounting controls." The SEC also charged them with making false statements to the company's auditors under Exchange Act Rule 13(b)(2), by omitting to disclose the internal controls significant deficiency and the inventory recognition scheme.

The § 10(b) fraud claim carries a high burden of proof with respect to intent. Section 10(b) prohibits the "a) use of any device, scheme, or artifice to defraud; b) the making of material misrepresentations or omissions; and c) any act, practice or course of business which operates or would operate as a fraud or deceit upon any person" in connection with the purchase or sale of a security. Section 13(b)(5) forbids "knowing falsification" of a public company's books and records or "knowing circumvention" of a public company's internal controls. In the § 10(b) context, the SEC must establish that the defendant acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud."[6] This requires "proof that the defendant acted knowingly or recklessly,"[7] where "[r]eckless conduct . . . represents an extreme departure from the standards of ordinary care such that the defendant must have been aware of it."[8]

The weight of the SEC's evidence may yet be tested. At the time the SEC announced its theory of liability, it disclosed that Cummings entered into a settlement without admitting or denying the SEC's claims.[9] Cummings' settlement carried with it a $23,000 civil monetary penalty, a minimum five year bar from appearing in front of the SEC as an accountant, and a five year bar from acting as an officer or director of a public company. Unlike Cummings, however, Sherman has not settled his claims and will be required to appear at an evidentiary hearing before an Administrative Law Judge to contest the SEC's allegations.[10]

Corporate Officers' Obligations to Attest To a Corporation's Internal Controls

Congress' enactment of Sarbanes-Oxley in 2002 is well acknowledged as a bellwether moment in the general movement to heighten corporate executive accountability. Specifically, §§ 302 and 404 were intended to place more responsibility on corporate officers to establish and monitor internal control systems. Some have argued that these certification requirements were born of former Enron CEO Jeffrey Skilling's testimony in front of the U.S. Senate Banking and Commerce Committee in 2002, in which he claimed ignorance of and denied responsibility for the details of Enron's accounting. Regardless, the congressional record regarding Sarbanes-Oxley acknowledged a dual purpose to the executive certification requirements: prevention of fraud and accountability. Specifically, representatives in favor of the bill noted it would "improve the ethical standards of top corporate officers" and ensure they would be liable in the event of fraud.[11]

Taken together, §§ 302 and 404 require corporate officers to (1) certify that they have evaluated and maintained internal controls, (2) identify the framework used to make such an evaluation, and (3) certify that they have reported significant deficiencies in the design of internal controls to auditors. Section 302 and 404 certifications are formalized, requiring the following elements:

- Section 302's certification asserts:
  - that the financial statements and related disclosures fairly present the company's operations and financial condition in all material respects;
  - that the CEO and CFO have designed disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting;
  - that the CEO and CFO have evaluated the effectiveness of the company's internal controls in a management statement on internal controls over financial reporting; and
  - that the CEO and CFO have disclosed to the auditor and audit committee all significant deficiencies or material weaknesses in the design or operation of internal controls and any fraud, whether or not material, that involved management or other employees with a significant role in internal controls.
- Section 404's report on internal controls requires:
  - a statement asserting management's responsibility for establishing and maintaining adequate internal control over financial reporting;
  - a statement identifying the framework used by management to evaluate the company's internal controls; and
  - management's assessment of the effectiveness of the company's internal controls and disclosure of any material weaknesses in the internal controls.

Prior to the QSGI decision, perhaps given the ambiguity inherent in determining whether internal controls are adequate or effective, SEC enforcement actions premised on "false" §§ 302 and 404 certifications were almost always accompanied by other alleged misstatements, such as an accounting misstatement. Even in the civil securities fraud arena, courts routinely held that false certifications are insufficient on their own to enable a securities fraud action to survive a motion to dismiss.

This principle was affirmed as recently as this year by the U.S. District Court for the Southern District of New York in its analysis of *In re Magnum Hunter Resources Corp. Sec. Litig.*, 2014 BL 173951 (S.D.N.Y. June 23, 2014). In granting a motion to dismiss a § 10(b) fraud action, Judge Forrest stated that " 'failure [of corporate executives] to identify problems with the defendant-company's internal controls and accounting practices does not constitute reckless conduct sufficient for Sec-

[6] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

[7] Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc).

[8] SEC v. Rubera, 350 F.3d 1084, 1094 (9th Cir. 2003).

[9] U.S. Sec. & Exch. Comm'n, Release No. 2014-152, *SEC Charges Company CEO and Former CFO with Hiding Internal Controls Deficiencies and Violating Sarbanes-Oxley Requirements* (July 30, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542561150#.U_34N6MXOA0.

[10] *Id.*

[11] House Consideration and Agreement to the Conference Report to Accompany H.R. 3763, Sarbanes-Oxley Act of 2002 (July 25, 2002).

tion 10(b) liability.' '' Therefore, even though the court found that there may have been misstatements in the company's public statements, and that as a result management certifications may have been false, such allegations did not sufficiently plead the scienter requirement of § 10(b).

Now, however, the SEC is signaling an intent to enforce §§ 302 and 404 certification requirements even absent material misstatements in a company's financial statements.

Key Takeaways

In its press release announcing the charges, the SEC took the opportunity to state that corporate executives have ''an obligation to take the Sarbanes-Oxley disclosure and certification requirements very seriously.''[12] Corporate officers should remember three key takeaways:

1. Where appropriate, be open with the company's external auditors about perceived internal controls setbacks. Transparency with the company's audit committee and with external auditors regarding evaluations of the company's internal controls will protect the company, its investors and its officers. Possible steps to achieve this end may include: taking additional ownership over the internal audit function, hiring adequate personnel with accounting background to place in appropriate management positions and ensuring that accounting practices are consistent throughout the company. Although it is no silver bullet, it is much more difficult for the SEC's enforcement staff to bring a fraud case against an officer when an issue has been fully vetted with the company's auditor.

2. It may be appropriate for officers to revisit their company's internal controls review framework, as well as their individual involvement in the same. The Sarbanes-Oxley § 404 certification places ultimate responsibility for an operational and effective internal controls environment at officers' feet. Accurate descriptions of the scope of each corporate officer's involvement in internal controls development and monitoring will head off a theory of fraud premised on over-selling an officer's involvement in internal controls.

3. The SEC's ''Broken Windows'' strategy might extend to issues that many consider to be immaterial. Although the SEC has shown with recent cases that it will pursue non-restatement accounting issues against companies (for example, PACCAR's $225,000 payment to the SEC in 2013 to settle charges that the company misinformed investors through ''various accounting deficiencies that clouded their financial reporting''), it appears to be extending this approach to individuals. The SEC may take the view that a corporate officer's obligations extend beyond responding to problems as they develop, and encapsulate ''rooting out'' systemic issues before they turn into larger problems and keeping auditors informed as the company identifies and addresses problems.

[12] U.S. Sec. & Exch. Comm'n, Release No. 2014-152, *SEC Charges Company CEO and Former CFO with Hiding Internal Controls Deficiencies and Violating Sarbanes-Oxley Requirements* (July 30, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542561150#.U_34N6MXOA0.

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ISSN 2330-6300

Remediation Assessment Framework

The Government stresses the importance of remedial measures and other procedures to prevent further recurrence of misconduct in determining whether to file criminal charges or enforcement proceedings, impose a monitor, and seek fines and other penalties. The Government, however, provides no detailed guidance for prosecutors, regulators, compliance officers and counsel on the criteria they should consider and the procedures they should perform to assess the effectiveness of the remediation and other corrective measures.

StoneTurn Group's assessment sets forth key criteria, which we draw from the DOJ, *Principles of Federal Prosecution of Business Organizations* (2008); SEC, Enforcement Division, *Enforcement Manual* (2012); DOJ and SEC, *Resource Guide to the U.S. Foreign Corrupt Practices Act* (2012); *U.S. Sentencing Guidelines, Chapter 8* (2012); FINRA, *Sanction Guidelines* (2011); Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control – Integrated Framework* (2013); and DOJ and SEC settlement agreements.

For detailed procedures and guidance on conducting these assessments, please contact:

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TIMELINESS	TEAM COMPETENCE	INDEPENDENCE	ROOT CAUSE ANALYSIS	OTHER MISCONDUCT
Did the organization…				
Commence remediation promptly after discovery of misconduct?	Include experts in risks, controls, forensic analytics and audit on its remediation team?	Engage an outside professional adviser as recommended by the U.S. Sentencing Guidelines?	Employ a structured process to conduct an analysis of why and how the misconduct occurred?	Conduct audit procedures to detect other misconduct by the perpetrator(s)?
Actually implement steps to prevent recurrence or just state that it will take future steps to implement?	Seek experts in prevention and detection, and not just investigation?	Independently assess and audit the remediation program?	Use a risk assessment to identify risks? How did flawed incentives and corporate culture contribute?	Conduct audit procedures to detect similar misconduct by others in the organization?

DISCIPLINARY MEASURES	PROCESSES & CONTROLS	RESTITUTION	SELF-REPORTING	ASSESSMENT & AUDIT
Did the organization…				
Employ a fair and consistent disciplinary process? (e.g., Did high producers or senior personnel receive special dispensation?)	Implement new or enhanced processes and controls to prevent and timely detect recurrence of similar misconduct?	Take appropriate steps to quantify the loss, and identify, notify and make full restitution to the victims?	Consider (on the advice of counsel) whether to self-report misconduct to the authorities?	Engage an independent, third party to assess the remediation process and implementation of corrective measures?
Take appropriate disciplinary measures for failing to prevent, detect and report misconduct?	Consider the use of forensic analytics and other technology tools to prevent recurrence?	Make restitution voluntarily or was it court-ordered?	Self-report voluntarily or was it required to do so by rules or regulations?	Periodically audit the new and enhanced processes and controls?

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"Pre-Existing" Compliance Program Assessment Framework

Prosecutors and regulators must assess the effectiveness of an organization's "pre-existing" compliance program to determine whether to file criminal charges or enforcement proceedings, impose a monitor, and seek fines and other penalties. The Government, however, provides no detailed guidance for prosecutors, regulators, compliance officers and counsel on the criteria they should consider and the procedures they should conduct to a ssess the effectiveness of the compliance program at the time of the violation.

StoneTurn Group's assessment of the existing compliance program will draw key criteria from a variety of relevant authoritative literature including but not limited to the DOJ, *Principles of Federal Prosecution of Business Organizations* (2008); SEC, Enforcement Division, *Enforcement Manual* (2012); DOJ and SEC, *Resource Guide to the U.S. Foreign Corrupt Practices Act* (2012); *U.S. Sentencing Guidelines*, Chapter 8 (2012); FINRA, *Sanction Guidelines* (2011); Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control – Integrated Framework* (2013), and DOJ and SEC settlement agreements.

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CONTROL ENVIRONMENT	RISK ASSESSMENT	CONTROL ACTIVITIES	INFORMATION & COMMUNICATION	AUDIT & MONITORING
Did the organization…				
Promote a culture that encourages ethics and compliance with the law? Did it demonstrate a commitment to a culture of compliance?	Use a risk assessment as a fundamental component of the compliance program, and periodically assess and document risk of misconduct?	Promulgate visible and clear policies, standards and procedures?	Communicate policies effectively to directors, employees, joint venture partners, agents, suppliers, and other relevant third parties?	Review its ethics and compliance standards and procedures no less than annually?
Assign effective oversight and day-to-day responsibility over the compliance program? Did it provide adequate resources and direct Board access?	Implement an ongoing risk assessment, and update the assessment with company and industry developments?	Have controls to ensure fair and accurate books, records and accounts?	Provide adequate training, including annual certifications, and a resource to provide advice?	Equip audit and operational personnel with adequate detection tools and training?
Have an incident response process? Did the process provide for taking steps to remedy harm and avoid future misconduct? Did the organization take those steps?	Identify the violation as a risk? If not, why?	Have controls to ensure that assets could not be acquired, used or disposed to commit or conceal misconduct?	Make adequate use of technology including forensic data analytics and security systems?	Conduct forensic audit procedures to detect misconduct, including the identified misconduct?
Assess how the corporate culture and control environment impacted the occurrence and detection of the misconduct?	Look at how the risk process impacted the occurrence and detection of the misconduct?	Examine how the policies, procedures and controls impacted the occurrence and detection of the misconduct?	Evaluate how information and communication issues impacted the occurrence and detection of the misconduct?	Look at how the audit and monitoring impacted the occurrence and detection of the misconduct?

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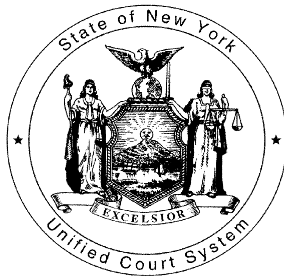
NEW YORK STATE UNIFIED COURT SYSTEM

PART 1200

RULES OF PROFESSIONAL CONDUCT



Dated: May 1, 2013

These Rules of Professional Conduct were promulgated as Joint Rules of the Appellate Divisions of the Supreme Court, effective April 1, 2009. They supersede the former part 1200 (Disciplinary Rules of the Code of Professional Responsibility).

The New York State Bar Association has issued a Preamble, Scope and Comments to accompany these Rules. They are not enacted with this Part, and where a conflict exists between a Rule and the Preamble, Scope or a Comment, the Rule controls.

This unofficial compilation of the Rules provided for informational purposes only. The official version of Part 1200 is published by the New York State Department of State. An unofficial on-line version is available at www.dos.ny.gov/info/nycrr.html (Title 22 [Judiciary]; Subtitle B Courts; Chapter IV Supreme Court; Subchapter E All Departments; Part 1200 Rules of Professional Conduct; § 1200.0 Rules of Professional Conduct).

RULE 1.1.

Competence

(a) A lawyer should provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

(b) A lawyer shall not handle a legal matter that the lawyer knows or should know that the lawyer is not competent to handle, without associating with a lawyer who is competent to handle it.

(c) lawyer shall not intentionally:

(1) fail to seek the objectives of the client through reasonably available means permitted by law and these Rules; or

(2) prejudice or damage the client during the course of the representation except as permitted or required by these Rules.

RULE 1.13.

Organization As Client

(a) When a lawyer employed or retained by an organization is dealing with the organization's directors, officers, employees, members, shareholders or other constituents, and it appears that the organization's interests may differ from those of the constituents with whom the lawyer is dealing, the lawyer shall explain that the lawyer is the lawyer for the organization and not for any of the constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action or intends to act or refuses to act in a matter related to the representation that (i) is a violation of a legal obligation to the organization or a violation of law that reasonably might be imputed to the organization, and (ii) 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. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and

the risk of revealing information relating to the representation to persons outside the organization. Such measures may include, among others:

(1) asking reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to an appropriate authority in the organization; and

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

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly in violation of law and is likely to result in a substantial injury to the organization, the lawyer may reveal confidential information only if permitted by Rule 1.6, and may resign in accordance with Rule 1.16.

(d) 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 concurrent 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.

RULE 4.2.

Communication With Person Represented By Counsel

(a) In representing a client, a lawyer shall not communicate or cause another to communicate about the subject of the representation with a party the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the prior consent of the other lawyer or is authorized to do so by law.

(b) Notwithstanding the prohibitions of paragraph (a), and unless otherwise prohibited by law, a lawyer may cause a client to communicate with a represented person unless the represented person is not legally competent, and may counsel the client with respect to those communications, provided the lawyer gives reasonable advance notice to the represented person's counsel that such communications will be taking place.

(c) A lawyer who is acting *pro se* or is represented by counsel in a matter is subject to paragraph (a), but may communicate with a represented person, unless otherwise prohibited by law and unless the represented person is not legally competent, provided the lawyer or the lawyer's counsel gives reasonable advance notice to the represented person's counsel that such communications will be taking place.

RULE 4.3.

Communicating With Unrepresented Persons

In communicating on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person other than the advice to secure counsel if the lawyer knows or reasonably should know that the interests of such person are or have a reasonable possibility of being in conflict with the interests of the client.

RULE 4.4.

Respect for Rights of Third Persons

(a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass or harm a third person or use methods of obtaining evidence that violate the legal rights of such a person.

(b) A lawyer who receives a document relating to the representation of the lawyer's client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender.

RULE 8.3.

<u>*Reporting Professional Misconduct*</u>

(a) A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer shall report such knowledge to a tribunal or other authority empowered to investigate or act upon such violation.

(b) A lawyer who possesses knowledge or evidence concerning another lawyer or a judge shall not fail to respond to a lawful demand for information from a tribunal or other authority empowered to investigate or act upon such conduct.

(c) This Rule does not require disclosure of:

(1) information otherwise protected by Rule 1.6; or

(2) information gained by a lawyer or judge while participating in a bona fide lawyer assistance program.

The Association of the Bar of the City of New York Committee on Professional and Judicial Ethics

Formal Opinion 2004-02: Representing Corporations and Their Constituents in the Context of Governmental Investigations

Topic: Multiple Representations; Corporations and Corporate Constituents

Digest: Multiple representations of a corporation and one or more of its constituents are ethically complex, and are particularly so in the context of governmental investigations. If the interests of the corporation and its constituent actually or potentially differ, counsel for a corporation will be ethically permitted to undertake such a multiple representation, provided the representation satisfies the requirements of DR 5-105(C) of the New York Code of Professional Responsibility: (i) corporate counsel concludes that in the view of a disinterested lawyer, the representation would serve the interests of both the corporation and the constituent; and (ii) both clients give knowledgeable and informed consent, after full disclosure of the potential conflicts that might arise. In determining whether these requirements are satisfied, counsel for the corporation must ensure that he or she has sufficient information to apply DR 5-105(C)'s disinterested lawyer test in light of the particular facts and circumstances at hand, and that in obtaining the information necessary to do so, he or she does not prejudice the interests of the current client, the corporation. Even if the lawyer concludes that the requirements of DR 5-105(C) are met at the outset of a multiple representation, the lawyer must be mindful of any changes in circumstances over the course of the representation to ensure that the disinterested lawyer test continues to be met at all times. Finally, the lawyer should consider structuring his or her relationships with both clients by adopting measures to minimize the adverse effects of an actual conflict, should one develop. These may include prospective waivers that would permit the attorney to continue representing the corporation in the event that the attorney must withdraw from the multiple representation, contractual limitations on the scope of the representation, explicit agreements as to the scope of the attorney-client privilege and the permissible use of any privileged information obtained in the course of the representations, and/or the use of co-counsel or shadow counsel to assist in the representation of the constituent client.

Code: DR 2-110; DR 4-101; DR 5-105; DR 5-107; DR 5-108; DR 5-109; DR 7-104

Question

Under what circumstances may a lawyer simultaneously represent a corporation and one or more of its officers, directors, employees or other constituents in the context of a governmental investigation? What disclosures must the lawyer make to her current and prospective clients and what consents must she obtain prior to undertaking such a representation? How may the lawyer structure her relationship with her clients so as to minimize adverse consequences if conflicts between their interests arise?

Opinion

In an era in which each day's edition of The Wall Street Journal brings fresh reports of companies under investigation, it has become increasingly common for lawyers to be asked to undertake simultaneous representation of a corporation and one or more of its officers, directors, employees or other constituents (sometimes collectively referred to as "constituents") in the context of a governmental investigation. In addition, in an era in which corporations are under increasing pressure to demonstrate that they are "good corporate citizens" by cooperating fully with governmental investigations, it has become increasingly likely that simultaneous representation of a corporation and its constituents may involve the representation of differing interests.

At the same time, there is relatively little guidance available to attorneys on the ethical issues implicated by a request for simultaneous representation of a corporation and an officer or employee of that corporation in the context of a governmental investigation. We have found no ethics opinions addressing the topic.*1* In addition, reported case law on multiple representation – which tends to be limited to issues such as when conflicts will require the disqualification of counsel or the reversal of a conviction – is of only limited assistance.*2*

As a result, we believe it would be helpful and timely to outline the ethical issues implicated by multiple representation of a corporate client and one or more officers, directors, employees or other constituents in the context of a governmental investigation. In particular, this Opinion focuses on: (1) the circumstances under which a lawyer for the corporation may ethically undertake simultaneous representation of one or more employees of the corporation; (2) the disclosures that must be made and the consents that must be obtained in order to render such multiple representation ethically permissible; and (3) the steps that can or should be considered to minimize potential harm to the corporate and employee clients if conflicts between their interests arise.*3* Although this Opinion deals specifically with multiple representations in the context of governmental investigations, we believe that most, if not all, of the concepts discussed in this opinion would apply to any multiple representation of a corporation and one or more of its constituents.

While there is no per se bar to simultaneous representation of corporate and employee clients in the context of governmental investigations, the Code of Professional Responsibility imposes three important restrictions on the permissibility of such representations. First, the lawyer must be able to conclude that a disinterested lawyer would, given the facts at hand, regard multiple representation as in the interest of both the corporate client and the employee client. Second, the lawyer must obtain the consent of both clients after full disclosure of the advantages and risks involved in multiple representation. Third, the lawyer must be alert to changes in circumstances that would render continuation of multiple representation impermissible.

In addition, the lawyer contemplating multiple representation should consider whether steps might be taken to structure his relationship with each client so as to minimize adverse consequences in the event that a conflict between them arises. For example, it may be appropriate or even necessary for the lawyer to seek a prospective waiver from his clients permitting him to continue his representation of the corporate client in the event that a conflict arises between the corporate client and the employee client. Additionally, or alternatively, the lawyer may conclude that the disinterested lawyer test is more clearly satisfied if he jointly represents one or both clients with co-counsel or shadow counsel.

The Standard Articulated in DR 5-105

DR 5-105 articulates the ethical standard governing the permissibility of representing multiple clients in a matter. Subject only to the exception contained in DR 5-105(C), the provisions of DR 5-105(A) and (B) prohibit undertaking or continuing in multiple representation "if the exercise of independent professional judgment in behalf of a client will be or is likely to be adversely affected" or "if it would be likely to involve the lawyer in representing differing interests."

As defined by the Code, differing interests "include every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be conflicting, inconsistent, diverse, or other interest." 22 N.Y.C.R.R. § 1200.1(a); see also NYSBA Comm. on Prof'l Ethics Op. 674 (n.d.). Accordingly, a finding of "adverse" or "differing" interests does not require "actual detriment" or any actual conflict; rather, a broad prophylactic rule is appropriate because it "not only preserves the client's expectation of loyalty but also promotes public confidence in the integrity of the bar." Tekni-Plex, Inc. v. Meyner & Landis, 89 N.Y.2d 123, 131, 674 N.E.2d 663, 667 (1996) (discussing, on motion to disqualify, similar standard under DR 5-108 regarding conflicts with former clients).

Under DR 5-105, a lawyer may undertake or continue multiple representation of clients with potentially differing interests only if:

> a disinterested lawyer would believe that the lawyer can competently represent the interests 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.

DR 5-105(C).

The Disinterested Lawyer Test

Thus, under DR 5-105, the first determination that must be made before undertaking simultaneous representation of a corporate client and an employee client is that a disinterested lawyer would believe that a single lawyer could competently represent the interests of each client. In addition, since DR 5-105 also speaks to continuing a multiple

representation, it requires the attorney to remain alert to potential conflicts and to reassess, as circumstances change, whether the disinterested lawyer test is still satisfied.

A "disinterested lawyer" is an objective, hypothetical lawyer "whose only aim would be to give the client the best advice possible about whether the client should consent to a conflict" or potential conflict. Simon's New York Code of Prof'l Responsibility Ann. 554-55 (2003). If the lawyer believes that such a disinterested lawyer "would conclude that any of the affected clients should not agree to the representation under the circumstances, the lawyer involved should not ask for" consent to multiple representation. EC 5-16.
In some instances, it will be obvious that the disinterested lawyer test cannot be satisfied with respect to the simultaneous representation of a corporate client and an employee client. For example, if the government is investigating securities law violations relating to the filing of false or misleading financial statements, a disinterested lawyer could not reasonably conclude that a single lawyer could competently represent both the corporation and an employee who has admitted wrongdoing in connection with the financial statements under investigation.

In such a scenario, the corporation would have a strong interest in avoiding or limiting criminal or civil liability by, among other things, cooperating fully with the government and providing any information sought by the government regarding the preparation of the financial statements.*4*The individual employee would, by contrast, have to consider a variety of factors before deciding whether it was in his interest to cooperate with the government, and he would need counsel able and willing to negotiate the best possible resolution of the matter for him.

In other scenarios, it would be clear that the disinterested lawyer test is easily satisfied. For example, in our same hypothetical investigation of securities law violations, an employee in the corporation's maintenance department who merely overheard comments regarding the need to alter the corporation's financial statements would have no reason for concern about personal liability. Such an employee would have no need for counsel to negotiate independently with the government on his behalf, and a disinterested lawyer would easily conclude that a single lawyer could competently represent the interests of both the corporation and the maintenance worker.

Many situations, however, are likely to be far less clear than the two scenarios described above. What if, for example, instead of working in the corporation's maintenance department, the employee was the head of one of the corporation's accounting divisions, albeit not the one involved in the financial statements under investigation? What if the employee worked in the accounting division under investigation, and had some, but not full, discretion to decide how to account for the transactions giving rise to the investigation? What if the employee had no decision-making authority, but nonetheless participated in booking the transactions? What if the employee is the corporation's CEO, who is not an accountant but who certified the accuracy of the corporation's financial statements?

In all such scenarios, the question of whether multiple representation would pass the disinterested lawyer test is much closer and likely would turn on the specific knowledge possessed by the employee, the specific laws or regulations implicated by the conduct, and the perceived scope of the government's investigation. As a result, in all such scenarios, the lawyer must take particular care to ensure that he has a sufficiently detailed grasp of the relevant facts to be able to make the assessment required by DR 5-105(C).

Obtaining the Facts Needed to Apply the Disinterested Lawyer Test

The need for facts sufficient to apply the disinterested lawyer test raises the issue of what, if any, precautions a lawyer must take in his fact-gathering to avoid potential harm to his existing or prospective clients. In the typical case, an attorney's first encounter with a corporate employee will occur in the context of an interview in which the attorney is representing only the corporation and is engaged in fact-gathering on behalf of the corporation. In such interviews, it is typical for the attorney to advise the employee that: (1) the attorney represents the corporation, not the employee; (2) any information imparted to the attorney is privileged, but the privilege is held by the corporation, not the employee; and (3) it will be up to the corporation to decide whether to waive the privilege and share any information imparted by the employee with third parties.

In all cases where the interests of the constituent and the interests of the corporation may differ, attorneys are affirmatively required to give at least part of the advice described above. The Code requires an attorney to advise a corporation's employees that she is "the lawyer for the organization and not for any of the constituents" in any

situation in which "it appears that the organization's interests may differ from those of the constituents." DR 5-109(A). Given the ease with which the "differing interests" test is satisfied, we believe an attorney should usually advise a corporate employee that she represents the corporation rather than the employee. Furthermore, given the increased solicitude that courts and other authorities have shown for the reasonable expectations of a party in determining whether an attorney-client relationship has been formed,*5* an attorney also acts at the peril of his corporate client if the attorney fails to make clear whom she does and does not represent.

If, in an initial interview, a corporate employee asks the corporation's attorney whether he should consult with counsel, it is typical for the attorney to reiterate that he represents the corporation and therefore cannot advise the employee. Here, too, the Committee regards that practice as a prudent precaution. While DR 7-104(a)(2) allows an attorney to advise an unrepresented party to secure counsel,*6* the attorney also must bear in mind that as corporate counsel, "he owes allegiance to the entity and not to a shareholder, director, officer, employee, representative, or other person connected with the entity." EC 5-18. Because 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.*7*

If a constituent requests, prior to an initial interview by corporate counsel, to be represented by corporate counsel, it is typical for corporate counsel to decline at that point to undertake multiple representation. The Committee regards that practice as a prudent precaution. While it is, in theory, possible that corporate counsel will already have facts sufficient to enable her to apply the disinterested lawyer test prior to an initial interview with the employee, it seems likely that in most instances she will not have sufficient facts. Thus, we regard it as likely to be an exceptional case in which corporate counsel could properly agree to represent one of the corporation's employees prior to an initial interview of that employee.

If an employee who has already been interviewed subsequently requests representation by corporate counsel – a request that typically is triggered by a request from the government to interview or take testimony from the employee – the corporate attorney will then need to determine whether he has sufficient facts to enable him to apply the disinterested lawyer test. If he does not, he must then determine how best to obtain those additional facts.

In this regard, the corporate attorney should take care to avoid proceeding in a manner that could work against the interests of his existing client, the corporation. Thus, for example, if the corporate attorney were simply to agree to meet again with the corporate employee for the purpose of determining whether he could represent the employee, without first discussing whether the attorney may not be free to share with the corporation any additional information that was imparted, then the attorney may not in fact be able to share that information with the corporation, see, e.g., United States v. Dennis, 843 F.2d 652, 656-57 (2d Cir. 1988) (statements made by prospective client are privileged even if attorney ultimately declines the engagement), and might even in some cases be unable to continue to represent the corporation. See Restatement (Third) of the Law Governing Lawyers § 15 (2000) (addressing a lawyer's duty to protect information relating to the representation of a prospective client and how to protect against adverse consequences to an existing client). As a consequence, to protect the interests of the existing client, the corporation, it is important that the lawyer make clear to the employee that information shared in the interview will be disclosed to the corporation and that the corporation will control the decision as to whether to disclose such information further.

Consent After Full Disclosure

If the attorney concludes that the disinterested lawyer test has been satisfied, the lawyer may undertake multiple representation only with the consent of each client after "full disclosure of the implications of the simultaneous representation and the advantages and risks involved." DR 5-105(C).

" Full disclosure" means the provision of "information reasonably sufficient, giving due regard to the sophistication of the client, to permit the client to appreciate the significance of the potential conflict . . . ." EC 5-16; cf. People v. Gomberg, 38 N.Y.2d 307, 314, 342 N.E.2d 550, 554 (1975) ("Attorneys are under an ethical obligation to disclose to their clients, at the earliest possible time, any conflicting interests that might cloud their representation.").

Full disclosure also includes "disclosure of any and all defenses and arguments that a client will forgo because of the joint representation, together with the lawyer's fair and reasoned evaluation of such defenses and arguments, and the

possible consequences to the client of failing to raise them." NYCLA Ethics Op. 707 (1995).

This Opinion cannot, and does not attempt to, catalogue all possible advantages and risks attendant to simultaneous representation of a corporation and one or more of its employees. Instead, the Opinion attempts to provide general guidance in this area by noting some of the more common advantages and risks, with the caveat that in each case in which multiple representation is contemplated, the attorney must give careful, fact-specific consideration to the potential risks and advantages of the representation so that there can be full disclosure to the clients within the meaning of DR 5-105(C).

Risks and Advantages from the Corporate Client's Perspective

In the case of a corporate client, the most common (and most readily apparent) advantage to multiple representation is avoiding the expense of separate counsel. Other common advantages include providing employees with the benefit of counsel who has a detailed and broad knowledge of the relevant facts and avoiding the suggestion that there is any division of interest between the corporation and its employees.*8*

With respect to the risks posed to a corporate client from multiple representation, the most serious potential risk will tend to be the 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.

In this regard, corporate counsel should ensure that the corporation understands that if the interests of the corporation and the employee become materially adverse, corporate counsel will not be able to continue in the matter on behalf of the corporation unless the employee consents to counsel doing so. See DR 5-108(A) (prohibiting, absent consent after full disclosure, representation that is materially adverse to a former client in the same or a substantially related matter). In addition, if there is any reasonable possibility of a divergence of interests, we believe that corporate counsel should seriously consider advising the corporation to obtain a prospective waiver sufficient to satisfy DR 5-108(A) as a condition of consenting to multiple representation. Indeed, in some cases, the absence of such a waiver might well cause the multiple representation to fail the disinterested lawyer test.

Other common disadvantages, from the corporation's perspective, to multiple representation include potential loss of credibility with the investigating agency, complication of corporate counsel's ability to report facts to the corporation, and complication of the corporation's ability to report facts to the government.

With respect to the first of those possible disadvantages, it may well be the case that a government attorney will regard with greater suspicion the testimony of a corporate employee that is favorable to the corporation if the employee is represented by counsel for the corporation. Indeed, a government attorney may even affirmatively object to the multiple representation. In such cases, it is not uncommon for the corporation or its counsel to decide against multiple representation even if it is believed to be permissible.

Multiple representation may also complicate corporate counsel's ability to report to the corporation because, absent consent, she may not be able to pass on the confidences or secrets of his employee client. See DR 4-101(B)(3); DR 4-101(C)(1) (confidences and secrets of a client cannot be disclosed or used for the advantage of a third party without consent of the client after full disclosure); Greene v. Greene, 47 N.Y.2d 447, 453, 391 N.E.2d 1355, 1358 (1979) (prohibition against disclosure of client confidences covers any confidential communication made by the client in the course of the lawyer's representation and continues even after the dissolution of the attorney-client relationship).9 While such a factor is likely to be less significant in cases in which the prospective employee client has already been extensively debriefed, it nonetheless remains a potential complicating factor that ordinarily should be disclosed prior to seeking consent for multiple representation.

Similarly, corporate counsel should ordinarily consider and discuss with the corporation the possibility that multiple representation could complicate the corporation's ability to cooperate with, and report facts to, the government. As noted above, the current state of the law, and the current state of mind of law enforcement officials, operate to place considerable pressure on corporations to be willing to self-report, to waive the attorney-client privilege and effectively to serve as an investigative arm of the government with respect to the conduct of their employees. Allowing corporate

counsel to simultaneously represent a corporate employee may put the corporation or its counsel in the undesirable position of having information that is of interest to the government but that cannot be shared with the government because the employee client has declined to waive his attorney-client privilege.*10*

Risks and Advantages from the Employee's Perspective

From the employee's perspective, many of the common advantages of multiple representation tend to be similar to the advantages that exist from a corporate client's perspective. Those advantages typically include obtaining counsel who has a detailed and broad knowledge of the relevant facts and avoiding the suggestion that there is any division of interest between the corporation and the employee.*11*

The principal risks posed to the employee client from multiple representation typically tend to be that corporate counsel's larger constituency may render it difficult for him (despite his best intentions) to be as vigilant in his protection of the individual client's interests, or that a
divergence of interests will require the attorney to withdraw from representation of the employee client. Any such risks should be discussed with the prospective employee client prior to obtaining his consent to multiple representation. In addition, where the need to withdraw would be likely to work a significant disadvantage to the employee client (because, for example, the matter is time sensitive or especially complex), consideration should be given to the advisability of having co-counsel or shadow counsel.*12*

Structuring the Representation to Minimize Potential Adverse Consequences

As the foregoing discussion indicates, an attorney contemplating multiple representation can, and often should, consider whether the attorney-client relationship can be structured to minimize potential drawbacks to multiple representation. Such structuring may include obtaining prospective waivers of conflict, contractually limiting representation to minimize the possibility of conflicts, having a written understanding with regard to confidential information learned during the representations, and providing for co-counsel or shadow counsel.

Prospective Waivers

There is, as a general matter, no ethical bar to seeking a waiver of future conflicts. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 372 (1993); NYCLA Ethics Op. 724 (1998). In order to best ensure the likelihood that such waivers will be effective, however, it is advisable to put them in writing, see ABA Formal Op. 372, and they should otherwise meet all the requirements for contemporaneous waivers. See id.; NYCLA Ethics Op. 724; see also, e.g., Woolley v. Sweeney, No. 3:01-CV-1331-BF, 2003 U.S. Dist. LEXIS 8110, at *22 (N.D. Tex. May 13, 2003) (rejecting client's prospective waiver of conflicts where client "has never had the benefit of full disclosure"). The nature of these requirements depends on the specific conflicts to be waived, which, in turn, depend on the interests of the various clients. NYCLA Ethics Op. 724 (stating that "adequacy of disclosure and consent will depend . . . upon the circumstances of each individual case") (citation omitted).

In seeking to obtain a prospective waiver from clients, it frequently will be difficult for an attorney to make "full disclosure" to the same extent as in connection with a concurrent waiver. This is because it may not be clear to the attorney at the outset of the representation just what conflicts might later arise. To satisfy his obligation of full disclosure, then, the lawyer seeking a prospective waiver should at least advise the client "of the types of possible future adverse representations that the lawyer envisions, as well as the types of matters that may present such conflicts. The lawyer also should disclose the measures that will be taken to protect the client or prospective client should a conflict arise." NYCLA Ethics Op. 724. "[I]t would be unlikely that a prospective waiver which did not identify either the potential opposing party or at least a class of potentially conflicted clients would survive scrutiny." ABA Formal Op. 372. In other words, the more specific the lawyer can be, the more likely the waiver is to be upheld. *Id*.

In the context of governmental investigations, prospective waivers may be useful in dealing with a number of the potential conflicts discussed above. Most commonly, prospective waivers may be sought in such cases from an employee client regarding the ability of corporate counsel to continue representing the corporate client in the event an actual or potential conflict develops. In addition, if there is any realistic likelihood that the governmental investigation

might 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. Such a waiver will satisfy the specificity requirement for advance waivers because the constituent client will understand the nature of the future representation in which the lawyer would cease to represent the individual and continue to represent the entity.*13*

It bears noting that even if the prospective waivers do comport with the requirements for contemporaneous waivers as of the time they are made, the lawyer must still revisit the issues at the time the actual or potential conflicts arise. ABA Formal Op. 372 (stating that securing "'second' waiver" from client at time that actual conflict develops "in many cases . . . will be ethically required"); NYCLA Ethics Op. 724 (stating that "[n]otwithstanding" prospective waiver, "the lawyer must reassess the propriety of the adverse concurrent representation . . . when the conflict actually arises"). If the actual or potential conflicts turn out to be "materially different" from those the clients waived, the lawyer will not be permitted to rely on the prospective waivers, and will have to obtain new, contemporaneous waivers. NYCLA Ethics Op. 724. Likewise, courts will not necessarily accept the validity of prospective waivers, and may have to satisfy themselves that such waivers continue to be appropriate in light of the circumstances that actually develop. Cf. United States v. Alex, 788 F. Supp. 359, 363 (N.D. Ill. 1992) (rejecting waiver of conflicts by former clients as "by no means binding on this court," and recognizing "obligation to independently review the former clients' consents to waive their former counsel's conflict of interest"). Thus, in seeking such prospective waivers, the lawyer should be as specific as possible, in order to ensure that the lawyer has adequately disclosed the risks, and to maximize the likelihood that a reviewing court will conclude that the waiver was knowledgeably made.*14*

Contractual Limits on Representation

A lawyer may likewise ethically limit by contract his representation of a client, provided that the representation still comports with the requirements of the N.Y. Code of Professional Responsibility. NYSBA Comm. on Prof'l Ethics Op. 604 (1989). In effect, this means that the representation may not be so limited as to be inadequate. Ass'n of the Bar of the City on New York Comm. on Prof'l & Judicial Ethics [hereinafter "ABCNY"] Formal Op. 2001-3 (2001). Stated otherwise, the representation "must be sufficient . . . to render practical service to the client," and must not "materially impair the client's rights." NYSBA Ethics Op. 604. Such a limitation on representation is, however, subject to many of the same requirements as valid waivers: there must be full disclosure of the terms of the engagement and the client must consent. ABCNY Formal Op. 2001-3. In addition, such a representation should not be proposed if "a client could not reasonably conclude that the proposed arrangement serves its interests." Id. Finally, any such representation "must cover a discreet matter or a discreet stage of a matter and not terminate before the completion of that stage." NYSBA Ethics Op. 604.

Accordingly, it may be possible for a lawyer to limit his representation of an employee of the corporation to a discreet stage of an investigation in which a conflict with the corporation is unlikely to arise. For example, the lawyer may attempt to limit his representation of the employee to the investigatory stage of the case, thereby eliminating any risk that he would still represent the employee at the time of trial, should he then need to cross-examine the employee. Alternatively, depending on the facts of the particular case, the lawyer may be able to limit the scope of his representation of the employee even more narrowly, perhaps to just a single interview or a handful of interviews with the government about a narrowly circumscribed topic.

Understandings with Respect to Privileged and Confidential Information

Once it is decided that the lawyer will represent the corporation and the constituent, it is important to have a clear understanding with both clients as to (1) whether and what kind of confidential information will be shared; (2) who will control the privilege with respect to such information; (3) how the attorney-client privilege will operate in the event a dispute arises between the clients concerning the matter; and (4) whether the lawyer will continue to represent the corporation even if a conflict develops between the corporation and the constituent. While the New York Code does not require that such understandings be in writing, we strongly recommend that they be in writing.

Co-Counsel or Shadow Counsel

Another potential middle ground that may be appropriate in some cases is the use of co-counsel or shadow counsel – that is, 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. While the use of such counsel diminishes one of the advantages of multiple representation – namely, cost-savings – it can also significantly diminish the potential risks of multiple representation. If the co-counsel's existence is disclosed to the government (as it is in some cases), it can allay any concern on the part of the government that the corporate employee is not receiving independent legal advice. In addition, if the matter is a complex or time-sensitive one, having co-counsel who is kept reasonably well apprised of facts and developments could help prevent prejudice to the employee if it is subsequently determined that corporate counsel cannot continue to represent the employee.

Conclusion

Multiple representations are ethically complex, and the high-stakes nature of a typical governmental investigation only adds to the complexities. Before undertaking simultaneous representation of a corporation and one or more of its employees in the context of a governmental investigation, an attorney must carefully consider whether a disinterested lawyer would conclude that he can competently represent the interests of each client. The attorney must also take care to ensure that she has sufficient information to apply the disinterested lawyer test, and must give careful, fact-specific consideration to the risks and advantages to multiple representation and discuss those factors fully with each client before seeking their consent to multiple representation. In addition, throughout the representation, the attorney must remain alert to changing circumstances that may render continuation of multiple representation impermissible or inadvisable, and the attorney must discuss any such circumstances with his clients. Finally, the attorney should give consideration to whether there are ways in which the multiple representation can be structured so as to minimize adverse consequences to her clients should a conflict between them arise.

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1. Although we have found one ethics opinion in New York relating to multiple representation in a corporate context, that opinion is limited to the relatively narrow issue of an attorney's duties when perjury is committed by a corporate officer and the attorney represents both the officer and the corporation. NYSBA Comm. On Prof'l Ethics, Op. 674 (1995).

2. The issues that might arise at trial are distinct from those implicated at the investigative stage of a matter. In addition, whether counsel should be disqualified and whether counsel should have accepted or continued in multiple representation are separate questions. Thus, while decisions rendered in the context of litigated actions provide some assistance, they do not define the universe of issues relevant to deciding whether it is ethically permissible to undertake multiple representation of a corporate client and one or more employee clients in the context of a government investigation.

3. The guidelines established in this Opinion apply to situations where a lawyer represents or may represent an organization and also one of its constituents, regardless of whether the constituent is an officer, director, or employee, and we use those terms interchangeably throughout the Opinion. However, as with all circumstances in which disclosure and consent is or may be required, the degree of sophistication of the constituent will play a role in how detailed the discussions of those issues need to be.

4. In recent years, both the Department of Justice and the Securities and Exchange Commission, among other law enforcement agencies, have repeatedly cited the willingness of a corporation to cooperate with governmental investigations (which cooperation is sometimes requested to include waiver of the attorney-client privilege) as an important factor in determining whether to hold a corporation civilly or criminally liable for the actions of its officers or employees. See, e.g., United States Attorneys Manual, Criminal Resource Manual 161 (January 20, 2003 memorandum of Deputy Attorney General Larry D. Thompson announcing a revised set of principles governing federal prosecution of business organizations) ("The main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation."); SEC Release No. 34-44969, 2001 WL 1301408 (October 23, 2001) (Report on the Relationship of Cooperation to Agency Enforcement Decisions) (describing the nature and extent of a company's cooperation with the SEC as important factors to be taken into account in determining whether an enforcement action will be brought against the company).

5. See, e.g., Restatement (Third) of the Law Governing Lawyers § 14 & cmts. e-f (conditioning attorney-client relationship on client's intent and lawyer's failure to "manifest lack of consent," and stating that failure of corporate counsel to clarify whom he represents "in circumstances calling for such a result might lead a lawyer to have enteredinto client-lawyer representations not intended by the lawyer"); Nancy J. Moore, Conflicts of Interest for In-House Counsel: Issues Emerging from the Expanding Role of the Attorney-Employee, 39 S. Tex. L. Rev. 497, 506 (1998) (noting the inability of many corporate employees to understand the distinction between the lawyer's role as corporate counsel and his role as counsel for the employee in his individual capacity); see also Rosman v. Shapiro, 653 F. Supp. 1441, 1445 (S.D.N.Y. 1987) (implying attorney-client relationship between corporate counsel and corporate officer where attorney represented close corporation and officer "reasonably believed that [attorney] was representing him"). But see Talvy v. Am. Red Cross, 205 A.D.2d 143, 149-50, 618 N.Y.S.2d 25, 29-30 (1st Dep't 1994) ("Unless parties have expressly agreed otherwise in the circumstances of a particular matter, a lawyer for a corporation represents the corporation, not its employees."), aff'd mem., 87 N.Y.2d 826, 661 N.E.2d 159 (1995).

6. DR 7-104(a)(2) states that "[d]uring the course of the representation of a client a lawyer shall not give advice to a party who is not represented by a lawyer, other than the advice to secure counsel, if the interests of such party are or have a reasonable possibility of being in conflict with the interests of the lawyer's client." However, since the employee will not typically be named in any related action actually being litigated before a tribunal while the governmental investigation is still pending, the employee, properly speaking, may not be a "party" within the meaning of this provision.

7. As noted above, DR 5-109(A) prescribes what corporate counsel must instruct a corporate constituent in cases where the interests of the corporation and the constituent "differ." Where the interests of the entity and the interests of the constituent are actually adverse, however, the New York Code provides no additional guidance and requires nothing more. It nevertheless may be advisable to consider that in situations of actually adverse interests, the ABA Model Rules provide specific guidance not also provided by the New York Code. Comment 10 to ABA M.R. 1.13 states: "There are times when the organization's interest may be or become adverse to those of [the constituent]. In such circumstances the lawyer should advise any constituent . . . that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for the constituent individual, and that discussion between the lawyer for the organization and the individual may not be privileged." Of course, there are many situations in which the entity's and the constituent's interests will or might "differ" within the meaning of the New York Code yet such warnings and separate representation will not be necessary.

8. Less sophisticated corporate clients might also mistakenly believe that multiple representation carries the benefit of ensuring that their employees are represented by attorneys whose first loyalty is to the corporation. In such cases, it is incumbent upon corporate counsel to make clear to the corporation that he will owe a full and equal duty of loyalty to the employee clients, and that, if she is unable to discharge that duty, she will not be able to continue representing the employee clients.

9 . Although there is an exception to the obligations of DR 4-101 "where an attorney acts for two or more clients jointly," the scope of this exception is not entirely clear. Some authorities suggest that it is limited "only to the evidentiary privilege and applies only in subsequent litigation between the clients." NYSBA Comm. on Prof'l Ethics Op. 555 (1984). These sources stress that before confidences may be shared between jointly represented clients, "the circumstances must clearly demonstrate that it is fair to conclude that the clients have knowingly consented to the limited non-confidentiality." Id. Courts, however, have appeared more willing to infer such consent from the nature of the relationships in a multiple representation. See Tekni-Plex, 89 N.Y.2d at 137, 674 N.E.2d at 670 ("Generally, where the same lawyer jointly represents two clients with respect to the same matter, the clients have no expectation that their confidences concerning the joint matter will remain secret from each other . . . ."); accord Talvy, 205 A.D.2d at 149-50, 618 N.Y.S.2d at 29-30. Given these differing approaches, the Committee believes that it will always be advisable, prior to sharing the confidences of one client with another, for the lawyer to obtain the client's consent, after full disclosure. See DR 4-101(C)(1). This can be done in an engagement letter that sets out the understandings and agreements between the corporate client and the employee client with regard to the sharing and control of confidential information.

10. For an example of one such potential complication, see infra note 13.

11. Cost savings will not ordinarily be among the potential advantages to the employee client because the cost of separate counsel would in many, if not most, cases be borne by the corporation. Payment of such costs by the corporation is plainly allowed so long as there is full disclosure and the client consents. See DR 5-107.

12. To determine whether to withdraw from employment in the context of a multiple representation, a lawyer should refer to, inter alia, DR 2-110 and EC 5-15.

13. In seeking the prospective waivers and advance permission to reveal confidential information (see discussion infra at 13), counsel should also bear in mind any specific reporting requirements to which the corporate client may be subject. For example, certain corporations, such as banks and broker-dealer firms, are subject to federal laws that require them to report suspicious financial transactions by filing suspicious activity reports ("SARs"). See, e.g., 12 C.F.R. pt. 21. If counsel for such a corporation undertakes the simultaneous representation of a corporate employee, counsel may obtain, in the course of representing that employee, otherwise privileged information regarding suspicious transactions that, as an agent of the corporation, counsel may be obligated to disclose to the corporation and that the corporation, in turn, may be obligated to report to the government. As such, counsel for corporations with reporting requirements should consider seeking prospective waivers and advance permission to disclose information from any potential employee client that would permit the filings of such reports. While DR 4-101(C)(2) permits an attorney to reveal client "[c]onfidences or secrets when . . . required by law . . . ," the precise scope of this provision is unclear. It is thus uncertain whether the attorney, absent consent from the employee client, could report to the government information acquired in the course of representing that employee. Moreover, given that some of the reporting laws prohibit the filer of a SAR from informing any party that is involved in the underlying transaction, see, e.g., 31 U.S.C. 5318(g)(2)(A)(i), a prospective waiver prior to undertaking the representation may be the only opportunity for counsel to obtain the employee client's consent.

14. In evaluating the validity of prospective waivers, reviewing courts try to ascertain whether the client was reasonably informed about the future matter. See Restatement (Third) of the Law Governing Lawyers § 122 (2000) (defining "informed consent" to a prospective (as well as current) waiver as "requiring that the client or former client have reasonably adequate information about the material risks of such representation"). ABA Formal Op. 372 ("the particular future conflict of interest as to which the waiver is invoked [must have been] reasonably contemplated at the time the waiver was given"); NYCLA Ethics Op. 724 (an advance waiver is valid if "the subsequent conflicts should have been reasonably anticipated by the original client based on the disclosures made and the scope of the consent sought"). Where the attorney specifically identifies the party or parties with whom the client's interests potentially could differ and explains how that divergence could occur, courts have tended to uphold prospective waivers. See Unified Sewerage Agency v. Jelco Inc., 646 F.2d 1339, 1345 (9th Cir. 1981) (quoting In re Boivin, 533 P.2d 171, 174 (Or. 1975); accord Fisons Corp. v. Atochem N.A., Inc., No. 90 Civ. 1080 (JMC), 1990 U.S. Dist. LEXIS 15284, at *15 (S.D.N.Y. Nov. 14, 1990); see also Interstate Props. v. Pyramid Co., 547 F. Supp. 178, 181-82 (S.D.N.Y. 1982). In the scenarios being considered in this opinion, the party with whom the client's interests might differ normally will be reasonably clear. Cf. W.R. Grace & Co. v. Goodyear Tire & Rubber Co., No. 1:99-CV-305, 1999 U.S. Dist. LEXIS 22554, at *12-*16 (W.D. Mich. 1999) (upholding prospective waiver executed by members of defense group that prohibited members from objecting "to the continued representation by Common Counsel of all or any of the other members [of the group] in connection with any legal services arising out of" the subject of the agreement). Moreover, even in litigation, courts have upheld prospective waivers involving representation of a corporation and its constituents. See In re Rite Aid Corp. Sec. Litig., 139 F.Supp.2d 649 (E.D. Pa. 2001) (permitting a lawyer who represented the corporation and several of its executives to withdraw from representing one of the executives and continue to represent the corporation after a conflict developed, based upon a written engagement letter containing an advance waiver); see also Zador Corp. v. Kwan, 37 Cal. Rptr. 2d 754 (Cal. Ct. App. 6th Dist. 1995) (upholding an advance waiver permitting a lawyer who represented a corporation and an individual to continue representing the corporation after a conflict developed between the corporation and individual).

Issued: June, 2004

NEW YORK STATE BAR ASSOCIATION
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ETHICS OPINION 978

New York State Bar Association

Committee on Professional Ethics

Opinion 978 (08/06/2013)

Topic: Counsel to closely held corporation

Digest: An attorney acting as general counsel to a closely held corporation 1) represents the entity and not its directors/sole shareholders and 2) must explain to the directors/shareholders that he does not represent them when he becomes aware that action to be taken on behalf of the entity may be divergent from their personal interests.

Code: Rule 1.13(a) Rule 1.4(b)

BACKGROUND

1. An attorney acts as general counsel for a closely held corporation in which its directors are also the sole shareholders. The attorney does not represent the directors/shareholders. Discussions are on-going within the corporation as to certain issues relevant to the corporation's by-laws and shareholder agreements the result of which will impact the corporation's ability to take advantage of a tax/property evaluation benefit. While the change will benefit the corporation, half of the directors will be personally disadvantaged by it. The lawyer is aware that the interests of the individuals will diverge from those of the entity and/or the other directors/shareholders when these issues are raised and the lawyer fears the board will deadlock and be unable to take advantage of the benefit.

QUESTION

2. Is the lawyer required to raise the issues on behalf of the organization because of the relevance to the discussion or is the lawyer prohibited from raising the issues because the lawyer is aware of the divergent personal interests of the shareholder directors?

ANALYSIS

3. As Rule 1.13(a) notes, "[w]hen a lawyer employed or retained by an organization is dealing with the organization's directors, . . . shareholders or other constituents, and it appears that the organization's interests may differ from those of the constituents with whom the lawyer is dealing, the lawyer shall explain that the lawyer is the lawyer for the organization and not for any of the constituents." As Professor Simon notes, '[t]he essence of the rule is in the final clause, which says that a lawyer who is employed by an organization 'is the lawyer for the organization and not for any of its constituents.'" Simon's New York Rules of Professional Conduct Annotated 2013 Edition, p.633.

4. The question then becomes whether the lawyer must raise the issue with the client, the organization, or remain quiet because of the awareness of the divergent interests among the director/shareholders. Rule 1.4(b) requires that "[a] lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." If knowledge of the issue is reasonably necessary to permit the client to make an informed decision, then it must be raised. At this juncture, Rule 1.13(a) will provide guidance to the lawyer. Now that the lawyer has made the decision that this is something he must raise with his client, the organization, and that it may be adverse to the personal interests of the directors/shareholders or presents a conflict between the interests of the directors/shareholders, the lawyer is required to explain to the director/shareholders that he is the lawyer for the organization and not for any of them personally. Comment 2A to Rule 1.13(a) notes:

> There are times when the organization's interests may differ from those of one or more of its constituents. In such circumstances, the lawyer should advise any constituent whose interest differs from that of the organization: (i) that a conflict or potential conflict of interest exists, (ii) that the lawyer does not represent the constituent in connection with the matter . . ., (iii) that the constituent may wish to obtain independent representation, and (iv) that any attorney-client privilege belongs to the organization and may be waived by the organization. . . .

CONCLUSION

5. When a lawyer acting as general counsel to a closely held corporation becomes aware of an issue, the knowledge of which is necessary for the entity to make an informed decision and proposes a change that may be contrary to the personal interests of certain directors/shareholders, the lawyer must advise the entity of the issue and should consider, as appropriate, advising the directors/shareholders (1) the lawyer is the lawyer for the organization and not for the directors/shareholders, (2) that an actual or potential conflict of interest exists, (3) that the directors/shareholders may wish to retain counsel on their own behalf, and (4) that any attorney client privilege belongs to the organization and may be waived by the organization.

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