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THE ROLE OF INSIDE COUNSEL IN CORPORATE ACCOUNTABILITY

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Over the past two and one-half years of my Chairmanship, I have addressed the responsibility of various parties critical to effective and credible corporate accountability, including boards of directors, independent auditors, internal auditors, audit committees, corporate secretaries and the bar. Today I would like to focus on inside corporate counsel.

In recent years, the responsibility and prestige of inside corporate counsel has increased dramatically. This development is primarily due, I believe, to the increasingly complex environment in which business functions, and secondarily to the skyrocketing cost of outside legal services. Whatever the causes, the development requires that we give appropriate attention to the increasingly vital and unique role of corporate counsel in the process of corporate accountability.

It is this role of inside counsel about which I would like to speak today. But, I would like to frame my discussion in the context of a larger issue -- the movement for increased federal involvement in corporate accountability. This movement includes within it a theme of increased federal concern for professional conduct which is related to, and in important ways responds to, increased demands for corporate accountability. The theme is that we must increasingly look to the professional -- specifically

lawyers and accountants -- to be critical contributors to the discipline essential to effective corporate accountability. While I subscribe to the theme, I resist its achievement through ever-increasing federal involvement. But such involvement may only be avoidable if professionals, themselves, meet the challenge through the establishment of a system of effective self-discipline.

The pressures for federal intervention into internal corporate affairs

I have been speaking for some time about a drama entitled "federal legislation on corporate accountability." It is a play which dramatizes the tendency of our society to look to government for the solution to perceived problems -- often at the expense of the private sector. As are many popular plays, this production is based on genuine problems and abuses which cry out for solution. And the moral of the story, if we allow it to run its course, seems to be that it takes federal legislation to assure that the private sector behaves responsibly.

We are in the midst of this drama; but I would like to rewrite the moral and the ending. My moral is that the superior achievement of our private enterprise system and our unequaled political and personal freedoms are mutually intertwined and mutually reinforcing characteristics in our society. We must be extremely cautious -- perhaps

much more so than the proponents of federal corporate governance measures may recognize -- in tampering with their balance.

The way to rewrite the ending and avoid federal intervention, however, is not to proclaim that the perceived problems are non-existent, that the proponents of change are anti-private-enterprise or subversive, or that the consequences of reform would be catastrophic. Rather, we must make the existing process work as well as we can, by each discharging our responsibility to assure that corporate power is effectively and responsibly exercised, in a manner consistent with both the disciplines of the marketplace and the non-economic aspects of the public interest. The only viable substitute for federal intervention is to better define the roles and responsibilities of each of the players in the process -- boards of directors, management, counsel and accountants -- and hold each to high standards of performance and effective self-discipline. Mechanisms to further these ends must become effective structural components of the process of accountability.

This is not an easy task. It requires a continuous sensitivity to the need to match corporate processes to the constantly changing social environment. The goal of those who believe in the efficiency and effectiveness of

our present methods of private economic decision-making must be to stimulate the corporate sector to fully appreciate the need for it to address squarely the issue of corporate accountability. If business and professional leadership is inadequate to the task, I expect that the political processes will ultimately take more and more of the control out of the hands of private managers and transfer it to federal regulators. And that is a prospect that I would neither greet with enthusiasm nor expect to be, in the long run, consistent with a system of private enterprise.

A major problem with the private sector is that too few speak for the system of private enterprise. We make demands on its behalf and enlist its name and cause when it serves our purpose, or is convenient or beneficial to our self-interest -- but calls to duty or for responsibility on behalf the system are few and far between -- and the responses even fewer.

The Pressures for Federal Oversight of Professional Conduct

A very important element in the play of which I have been speaking is the increased demands for enhanced accountability on the part of professionals -- lawyers and accountants -- who play significant roles in the drama. These demands are fueled by perceived and real inadequacies in the self-disciplinary methods which these professions now employ to

ensure competence and high standards of conduct, and also by perceptions that lawyers and accountants have societal responsibilities, which are not being met, to ensure that the conduct of their clients comports with ever-increasingly stringent societal expectations.

Historically, as you know, a lawyer's standards of conduct, and the sanctions imposed for his or her transgressions, have been the province of local bar disciplinary authorities. But, just as the pressure for federal intervention into internal corporate affairs has increased, so, in many ways, has the movement to impose federal standards with concomitant federal sanctions on professionals involved in the accountability process. Indeed, there is an increasing tendency to look to the government for the establishment of professional conduct, and the imposition of professional discipline, in general.

The Ethics in Government Act is a good example both of this trend and of the rigidity that federal legislation often brings with it. The debate over the SEC's Rule 2(e) is also a part of the trend. Another example is the petition regarding lawyers' responsibilities, presented to the SEC by Georgetown University's Institute of Public Interest Representation. This matter is now in rulemaking before the Commission, so I am not going to comment on it substantively; but, to me, it is significant that the Institute brought

its petition to the Commission, rather than to organizations in the private sector. Still another example is the recent case of Armstrong v. McAlpin, [2d cir. 1979] in which the disqualification of a former SEC lawyer was imputed to his law firm despite adherence to screening procedures approved by the ABA, the New York bar, the SEC and the district court.

The Role of Inside Counsel in the Accountability Process

It is my urgent hope that this shift, from traditional forms of professional self-discipline to those imposed by governmental regulators, can be reversed by a better articulation of the responsibilities of professionals. In my talk to the ABA's Section of Corporation, Banking and Business Law a year ago, I referred to corporate lawyers generally as "architects -- consciously or unconsciously -- of the accountability mechanisms in our corporate structure." This is certainly true of inside counsel, whose special expertise, position in the corporation, and professional obligations, enable them to make a unique contribution to the accountability process.

We all know that a lawyer's professional responsibilities are not diminished when he becomes an employee. But he assumes a unique position. Inside lawyers play a daily role in shaping events as they occur, in determining

corporate policies, and in helping to establish the tone and standards for the conduct of corporations.

I appreciate profoundly the difficult position of inside counsel -- I have been there. At times the conflict between counsel and management can feel like being pulled apart on the rack. But my objective here is to press for standards -- not to empathize or commiserate.

Internal counsel's responsibility runs far beyond narrow legal issues. Although not the only officer who deals with corporate problems which are not exclusively related to the profit and revenue producing activities of the corporation, he is one of the few corporate officers who is likely to hear from all of the corporation's internal and external constituencies. Thus, inside counsel is uniquely involved in an assessment of risks and consequences in the types of situations which typically give rise to public concern and reaction.

Because they are corporate insiders, internal attorneys are in a unique position to help the companies which they serve, and through them the corporate community as a whole: to focus attention on the issues of corporate responsibility to assess the consequences of alternative courses of conduct to weigh the short- and long-term costs and benefits; and to decide on positive steps which, in the context of the

objective of each particular corporation, can help to promote accountability and thus retard the pressure for federal restraints. As in the case of outside counsel, the inside attorney's job extends beyond answering questions which focus only on what the law allows -- or what is worth the risk that the law does not forbid it. The inside attorney should also be concerned with the process by which the company evaluates the potential impact on itself of conduct which could be construed to be unethical, albeit technically legal. And, a fundamental task is to sensitize and inform management and directors regarding the implications of the public's expanding perceptions of corporate responsibilities. Finally, inside counsel is in a unique position to implement a program of preventive law. On the scene and in intimate contact with the management, he can help avoid many corporate decisions which fail to take into account those perceptions and their implications. Counsel has no monopoly on virtue, but sound legal advice should lead to a decision that is morally and ethically sound as well as legally acceptable. The advice should be textured to include the social purposes the law is intended to serve and the societal expectations flowing therefrom.

As more corporations establish nominating, compensation and audit committees, the role and responsibility of inside counsel increase in importance. His input into questions of board structure and function can be vital to the effective performance by the board and its oversight committees of their accountability function. I would urge, in this regard, that those of you who have not already done so read the ABA Committee on Corporate Law's report on Overview Committees of the Board of Directors [34 Business Lawyer 1837 (July 1979)]. While I might not agree with its conclusions in every respect, it is in general an excellent analysis of the functions which such committees can and should play in the accountability process.

The role of inside counsel in the implementation of and compliance with the Foreign Corrupt Practices Act is another good example of these general principles. Part of his responsibilities is the obligation to recommend written policies, establish procedures and monitor their implementation. He is in a special position to know what an adequate internal control environment in his company requires, to understand the legal principles involved, and to advise as to their implementation and the methods necessary to monitor compliance. Compliance with the Foreign Corrupt Practices Act is a peculiarly appropriate activity for

inside counsel, because he should know the business intimately enough to have a sense of the specific aspects and personalities which are most likely to present problems.

The inside counsel has dual obligations of loyalty. While he assumes a duty of service to his employer -- as must any employee -- he also must discharge his responsibilities as a professional -- as must any lawyer. In normal circumstances, these dual obligations do not conflict. There may, however, be situations in which the requirements of law or the obligations of the legal profession could force even the inside lawyer to consider resignation, disclosure of unlawful conduct, or other measures which sometimes confront outside counsel and which are more traumatic for inside counsel since they involve a risk of ending the inside attorney's employment relationship. While the pressures on inside counsel may be greater to play along with the team, and the disruption to his career should he feel compelled to resign or risk being fired far greater, his conduct obligations do not appear any less than those of outside counsel.

Inside counsel, if he is to be effective, requires independence. In some companies, of course, he lacks independence and his role is more circumscribed. Where that is the case, we must, at a minimum, recognize that he

is performing, not as an attorney, but as a legal technician -- knowledgeable in the technicalities of the law, but disabled from exercising the independent judgment which is the hallmark of a professional. Anyone dealing with him should be aware of the incapacity.

The Ethical Problems of Inside Counsel

My theme so far has been that there is pressure for federal control of corporate accountability mechanisms, and of professional conduct. I have also sought to describe the opportunities open to corporate counsel to affect the accountability process. However, the tensions imposed by his unique position also create difficult conduct problems. It is one thing to say that federal intervention can be avoided by effective self-discipline, but it is quite another to give meaningful guidance as to specific issues.

There are three issues, in particular, that I would now like to discuss from this perspective. The first is "who is the client" of the inside counsel. The second involves the circumstances under which an inside counsel should agree to serve as a director of his corporate employer. And the third involves the duty of inside counsel to proffer legal advice to his corporate client without having been asked to do so.

There is evidence that the legal profession is endeavoring to come to grips, in a meaningful way, with these, and other controversial issues which have arisen in the accountability dialogue. I am referring specifically to the efforts of the ABA's Commission on Evaluation of Professional Standards to revise the Rules for Professional Conduct.

About a month ago, a revised draft of the Rules for Professional Responsibility appeared in the press. Now that the draft is -- albeit unofficially -- a matter of public record, I will comment on how it would deal with the above three issues as I discuss them in turn.

Who is the Client?

This is a deceptively simple question, for traditional wisdom has long had it that a lawyer employed or retained by a corporation owes his allegiance to that entity, and not to a stockholder, director, officer, employee or any other individual connected with the corporation. [EC5-18] However, as many of you have probably found out through experience, this rule is of little help in resolving real-world dilemmas -- particularly those involving inside counsel. What, for example, are the obligations of inside counsel who discovers that the CEO has made a sensitive payment to a foreign official to secure a major contract?

Or who discovers that a principal product is defective in life-threatening ways?

The need to ascertain who the client is arises most often when a corporate manager who has responsibility for a particular matter has taken or determines to take action which counsel believes to be improper. Speaking directly to this point, Section 1.13(a) of the ABA Commission's draft rules provides that if a lawyer knows that a corporate official is engaged in or intends to commit a legally improper action which is "likely to result in significant harm to the organization," the lawyer is required to "take necessary measures to assure further consideration" of the action. Five measures are expressly set out in the rule, as examples of the options open to counsel faced with this situation -- all assuming he exercises professional integrity in assessing "likelihood" and has a comprehensive vision of what constitutes "significant harm" -- and they run the gamut from seeking reconsideration by the person who is regularly responsible for the matter up to and including resignation. Moreover, Section 1.13(b) provides that if an action by the board (1) will in reasonable probability result in irreparable harm to the corporation, or in substantial injury to a stockholder, (2) would be an indefensible

violation of the law, and (3) the corrective measures set out in section 1.13(a) do not work to prevent it, then the lawyer

shall take further measures to prevent the violation, including giving notice to the injured persons, making the lawyer's resignation known publicly, or reporting the matter to appropriate regulatory authority.

The operation of these rules is further explained in the commentary. Thus, in a normal case, it is easy to determine who the client is:

When, in performing duties for the organization, officials and employees act and make decisions in conformity with law, they speak for the organization. The lawyer for the organization must accept such actions and decisions even if their utility or prudence is doubtful. Policy and action decisions including ones entailing serious risk, are not as such within the lawyer's province.

This does not mean that a lawyer should not give his advice on matters of policy, but that he should defer to the appropriate corporate official if his advice is not taken. The lawyer's role does not include second-guessing policy decisions made by businessmen. While I agree that business decisions are not generally for the corporate lawyer to make, it is not as simple as the draft rules appear to imply to separate the spirit of the law from business policies and risks. Even in the "normal" case, a large measure of judgment may well be required.

The commentary goes on to express the view, however, that in matters involving substantial legal questions, a lawyer's advice should be sought and followed. If a corporate official or employee does not do so, he is derelict in his own duty and not a proper representative of the organization. In such a case, the commentary provides that "the lawyer is obliged to seek a proper representative of the client in the matter in question, referring the matter to a higher authority." Presumably, a "proper representative" is one who will ask for or listen to the lawyer's advice, and factor it into his own decision-making process.

The extent of the lawyer's obligation to go over the head of an individual normally responsible for a matter depends on the nature of the problem. For example, he should only take a matter to the CEO "if the matter is of importance commensurate with that officer's authority." But "if the legal question is critical and the consequences substantial, the lawyer has an unmistakable duty to refer the matter upward." Of course, if the CEO himself is involved, the lawyer should go to the board. And, the commentary contemplates that if rejection of his advice by the board of directors means "that a derivative action would plainly succeed," the lawyer must consider resignation or, "as a last resort," informing appropriate public authorities.

One difficulty in employing this standard is the determination of when a derivative action would "plainly succeed."

Evaluating the outcome of litigation is a risky business.

Moreover, should the lawyer factor in the probability that a derivative action might not be brought in the first instance?

I suspect not. If he determined that an action, if brought, would succeed, his obligation could well extend to making such information public, as I read this section.

I am encouraged that the bar committee's draft appears to face squarely the dilemma which corporate counsel face in dealing with the legal construct known as the "corporation." It is one thing to say, abstractly, that a corporate lawyer represents, and is ultimately responsible to, the entity. But, as you all know, it is quite another to advise a CEO that he cannot do what he wants. If adopted in its current form, new Section 1.13, should help lawyers and corporate managers understand the legal and ethical obligations involved, and thereby make it easier for the lawyer both to give unpopular advice and to insist on its implementation.

While I believe Section 1.13 is a positive step, I am concerned that it may be interpreted too narrowly. The commentary provides that the duty defined in this section "does not extend to third persons who may be injured by

wrongful act of the organization." The rationale, presumably, is that third parties are outside the boundaries of persons who constitute the "client," and to whom counsel owes a duty. I would consider it very unfortunate if a corporate lawyer was thereby deemed to have no duty at all to object to unethical corporate policies or to policies which could have a detrimental impact on society or the environment, on the grounds that they would not result in a strictly "legal" injury or that the injury would not fall directly on the client. Often, and increasingly, such injuries to society -- whether legally cognizable or not -- ultimately are revisited on the corporation, with significant consequences to shareholders and management. The imposition of ethical responsibilities running to third parties, or in cases where there is no legal injury or violation of law in the immediate sense, raises very difficult questions concerning the scope of those responsibilities. While drawing an appropriate line will not be easy, I do not believe this section requires that it be read so narrowly as to exclude such questions, and submit that it would be inappropriate to do so.

The work of the ABA Commission is not yet finished. The draft which was made public is unofficial, and is subject to modification, improvement or obfuscation

as the drafting process continues. I would hope that any changes that are made would retain and improve the spirit and guidance provided by Section 1.13 and its commentary. It should be the purpose of the rules to provide leadership and certainty in establishing the standards for the profession essential for it to meet its responsibilities in light of the expectations of the society of which it is an integral part, rather than to provide safety and refuge.

Should a Lawyer Sit On the Board of a Corporation He Represents?

The second issue I would like to address is the question whether a lawyer should serve both as a corporation's inside general counsel and as a director. As most of you know, I have expressed the view that outside counsel should not sit on the board of a corporation he represents -- nor should members of management other than the CEO -- as I do not believe that those who have substantial conflicting economic interests in a corporation, dependent upon the pleasure of management, ought to be its directors. Nevertheless, it is fairly common practice to have a corporation's general counsel serve as a management member of the board. This practice has been criticised on a number of grounds in addition to those I have raised. First, it has been argued that it is difficult for a general counsel who is also a director to give independent legal

advice which is not influenced by business considerations. On the other hand, his relationship with management -- in particular the CEO -- may suffer if he articulates legally-based objections to management policies without considering business-related justifications for them. While management directors are often expected to, and typically do, speak with one voice at board meetings, the general counsel has independent ethical obligations imposed by his profession -- such as those in Section 1.13, just discussed -- which are not lessened by his election to the board. Thus, there may be insoluble conflicts of interest inherent in such dual service.

Finally, there are technical problems with dual service, involving such matters as the extent to which the attorney-client privilege and work product rule apply, and whether a director who is also general counsel will be held to a higher standard of care than are other directors because of his unique expertise and access to information.

However, the arguments are not all on one side. His expertise and access to information could well make a general counsel a valuable addition to a board, assuming he is capable of acting with the requisite independence and freedom.

The proposed rules address this dilemma. First, they define "general counsel" as

a lawyer who acts on a regular and continuing basis for a client as the principal source from whom or under whose direction the client is provided with legal advice and assistance.

In keeping with its general policy, the draft rules make no distinction between the ethical obligations of lawyers serving as inside or outside "general counsel."

Having defined a general counsel, the draft rules go on to provide in section 1.12(e) that "a lawyer shall not serve as general counsel of a Corporation or other organization of which the lawyer is a director." While some -- although not all -- would applaud this rule as providing needed certainty, it is inflexible.

And, the draftsmen of the rule apparently contemplate that the flat ban may be controversial, as they have suggested two alternate provisions. The first alternative would allow dual service upon full disclosure to and the consent of all "having an investment interest in the enterprise." While there is no commentary on this alternative, it is possible that some sort of proxy disclosure, followed by an affirmative vote of the shareholders, would satisfy the test. Perhaps, this would work with respect to a closely-held corporation. I seriously doubt, however,

with regard to a public company, that this is the sort of conflict which can effectively be cured by disclosure.

The second alternative is to apply the ban on dual service only:

When doing so would involve serious or recurring risk of conflict between the lawyer's responsibilities as general counsel and those as director.

This limitation begs the question, and would be of little help in analyzing a particular situation. The commentary does not offer much help, either. It indicates only that dual service as general counsel and as a director can often be "useful," and that "when the risk of compromising the independence of the counsel is remote, it is not improper that general counsel be a member of the board." I would submit, however, that in today's complex business and regulatory environment, most significant business decisions made by a typical board have legal ramifications as to which the general counsel is or normally should be involved as a lawyer. Thus, it may well be an unusual case where the risks involved in dual service as general counsel and as a director could be fairly considered to be "remote."

Having served on boards with corporate counsel who were totally independent -- as well as with some who were not -- I am inclined to view an absolute ban on dual service as insufficiently flexible. I am not convinced, however,

that it is possible to develop a conduct rule which adequately resolves the inherent conflicts in dual service. I do not find either alternative proposed by the draft rules to be any more satisfactory than would be a flat ban, and I suspect that continuing the search for an effective compromise will ultimately prove fruitless.

I would suggest, however, that there is no impediment to having general counsel attend board meetings as an active participant. Indeed, I believe it should be standard practice. Such a procedure could give the company and the board the benefits of counsel, without presenting the dilemma posed by dual service.

The Duty of General Counsel to Offer Advice

The third issue I would like to discuss is the inside counsel's duty to offer advice whether or not he is asked to do so. Nothing is as grating as gratuitous legal advice; primarily, I suppose, because it so often calls into question the wisdom of proposed management action. Unfortunately, however, some businessmen do not always request legal advice when they should. Thus, a corporate lawyer must sometimes ask himself whether he should raise questions concerning corporate plans about which he has not been asked for advice, but which he thinks might be legally or ethically improper.

The new draft Rules address the question of unasked-for advice. Section 2.5 provides that, while lawyers generally need only speak when spoken to, a general counsel shall proffer advice, whether asked for or not,

concerning any transaction or course of action contemplated by the client that has a substantial likelihood of being fraudulent or inflicting serious legal wrong on another person, including the government, if the lawyer knows of the contemplated conduct and reasonably should have recognized the likelihood of its being wrongful.

Noting the general rule that a lawyer is not expected to give advice until asked to do so by the client, the commentary on this rule explains that a general counsel -- whether inside or outside -- has a broader obligation. Because general counsel's function "is to protect the client's legal position in all aspects, particularly in anticipating legal problems through preventive counseling," the commentary concludes that "general counsel is therefore expected to call important matters to the client's attention without special request." However, this obligation does not make the general counsel an auditor or investigator. His duty apparently arises only if he has actual knowledge of the matters in question, and if the consequences are sufficiently serious.

I am concerned that the focus not be too narrowly placed on a lawyer's actual knowledge. It is important to recognize that general counsel cannot be a guarantor of the propriety of corporate conduct. However, the draft Rules appear to imply that general counsel has no duty of inquiry whatsoever. Surely, there are circumstances in which a lawyer should know the facts whether or not he does in fact know them, and this is particularly true of inside counsel who are privy to corporate events which it might be unreasonable to expect outside counsel to monitor.

It would be impossible for inside general counsel to adequately perform his role if he did not have his hand on the pulse of the corporation. Inside general counsel, therefore, should be required to do more than wait for information to trickle his way. And, inside general counsel, I believe, is now and should continue to be required to take reasonable steps to know what is going on in the company, let alone act when so-called "red flags" put him reasonably on notice that something might be seriously wrong.

This provision, of course, does not place a "ceiling" on general counsel's responsibilities, but rather a "floor." He is not estopped, and indeed should be expected, to raise questions about matters which do not rise to the level

contemplated by Section 2.5, but which nevertheless risk significant legal or ethical consequences for the corporation.

I would also hope that this provision would be liberally interpreted and not be capable of evasion by corporate procedures designed to insulate general counsel from corporate actions about which he is not requested to comment.

While the commentary correctly points out that general counsel is not ultimately responsible for the course of action adopted by the client, general counsel must also be aware of his duties in the event proffered advice is rejected. The draft rules contain no cross-reference to the discussion in Section 1.13 regarding a lawyer's duty upon becoming aware of an existing or impending improper corporate action; but, the duty to take corrective steps pursuant to Section 1.13 would not appear to be any different where the advice rejected was proffered under Section 2.5. Indeed, it might well be greater.

No discussion of professional conduct such as this should end without an italicized footnote to the effect that implementation of conduct rules is incomplete unless coupled with an effective disciplinary process, administered

with integrity. I would hope that in the near future, the bar will turn its attention to this issue, as its disciplinary processes are equally in need of most critical review.

* * *

In conclusion, while there may not be any analytic distinction between the conduct obligations of inside and outside counsel, there are obvious factual differences in applying the standards that flow from the far more intimate relationship that typically exists between inside counsel and the client. This relationship is the source of both inside counsel's greatest contribution and his largest burden. He will often be privy to information which triggers obligations, and about which his independent firm brethren know nothing. I would hope, as we move towards an enhanced system of corporate and professional accountability, that corporate managers will understand and appreciate inside counsel's enhanced responsibilities; and that society itself will come to recognize that the corporate community, and the professions which are part of it, can establish systems of self-discipline which obviate the need for further governmental involvement in the process. The ABA Commission's draft rules offer the opportunity for a positive step in this direction. I would urge that this opportunity not be dissipated, but rather, that it be seized upon by

all interested parties as an unique opportunity to assure that the future of the profession, and of business, remains the province of the private sector.