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## Access to Justice: The Social Responsibility of Lawyers

### Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century

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I am very honored to be invited to present the lecture this year in honor and in memory of Dean Tyrrell Williams of this superb law school. His distinguished service here as professor and dean spanned a thirty-three year period in our nation's history from 1913 to 1946, covering two World Wars, the Great Depression, and social as well as industrial sea changes. He guided this law school well, as my good friend Dean Seligman guides it today.

I believe Dean Williams, if he were here today, and Dean Seligman, who is very much a presence here today as well as a national force in legal education and thought, would agree that we are now in a new period of sea changes. One can look at many facets of the changes that have already occurred in this young, twenty-first century.

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\* Chief Justice of the Supreme Court of Delaware. This Article includes remarks prepared for delivery by Chief Justice Veasey in presenting the annual Tyrrell Williams Lecture on October 28, 2002, at the Washington University School of Law in St. Louis, Missouri. Significant events have transpired after the presentation of this lecture, particularly with respect to action by the Securities & Exchange Commission in promulgating rules mandated by Section 307 of the Sarbanes-Oxley Act.

We survived the electronic worry known as Y2K that surrounded the turn of the century. We saw a presidential election narrowly decided in the Supreme Court. We experienced the horrors of September 11th. We are painfully working our way through the war on terrorism. We have the uncertainties of the threats posed by Iraq and North Korea. We have also faced the upheavals and corporate and ethical sea changes brought about at many levels as a result of the collapse of Enron and other major corporations. The aftermath of these changes is the springboard for my remarks, because I think it will be the corporate lawyers who will either bring us out of—or sink us deeper into—this morass.

There is, of course, considerable recent foment in the United States arising out of the collapse of Enron and other corporate disasters. I cannot comment on the Enron litigation or the other cases because of the constraints of the Canons of Judicial Ethics. But it is safe to say that this foment has provoked debate about the effectiveness of standards governing directors as the principal engine driving Corporate America, as well as the lawyers who counsel them.

In recent months, the developments in both Corporate America and Congress have raised some fundamental questions. Corporate scandals, the dramatic decline in the stock markets, and Congress's rush to achieve a legislative fix have left investors, directors, and lawyers breathless. These events raise fundamental questions of federalism, among other issues.

The media has devoted considerable “ink” to the provisions and long range implications of the Sarbanes-Oxley Act<sup>1</sup> with its strong federal regulatory bent, affecting corporate officers, directors, accountants, and lawyers. Sarbanes-Oxley impacted but did not substantially preempt state corporation laws, like Delaware's, that govern the internal affairs of corporations. Also, listing requirements, such as those recently adopted by the New York Stock Exchange (NYSE) and NASDAQ, which have been submitted for approval to the Securities and Exchange Commission (SEC), will have a significant impact on internal corporate affairs.

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1. 15 U.S.C. §§ 7245-66 (2002).

Likewise, Sarbanes-Oxley did not take over traditional state-based ethics rules and disciplinary enforcement, but did make some inroads. I would like to briefly discuss some of the corporate governance and ethical issues, beginning with some perspective on state corporation law.

## I. STATE CORPORATION LAWS

State corporation law, both statutory and judge-made, is the organic governing body of law that determines investor rights and director duties, and governs the internal affairs of corporations. Absent specific congressional preemption, federal law is not designed to regulate the internal affairs of corporations.<sup>2</sup> Federal law, primarily in the disclosure area, does affect the conduct of corporate directors and officers. The interaction and tension between state and federal law in the corporate/securities arena traditionally implicates a delicate federalism balance that could significantly be tipped by aggressive federal action.

State incorporation statutes are largely enabling acts that provide directors and stockholders with considerable latitude for private ordering, consistent with investor protection. Delaware decisional law also contemplates a large role for the courts on a case-by-case basis in applying the directors' fiduciary duties of loyalty, care, and good faith. The courts' enforcement of these fiduciary duties must balance entrepreneurial risk-taking with investor protection.

My thesis is that the Delaware model works well overall, both for stockholders and management, but that one should be cautious in concluding that current events should dictate a new, more regulatory, federally-based regime of corporate governance. Any precipitous sea change in corporate governance could well have an adverse effect on investor value.

Interestingly, New York University Law School Professor Robert Daines recently wrote a comprehensive article on the subject of investor value in Delaware corporations.<sup>3</sup> Additionally, in a summary

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2. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977).

3. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

published in the Autumn 2002 edition of the New York University Law School Magazine, Professor Daines stated, in part:

I examined the market valuation of 4,481 exchange-traded firms between 1981-1996 and I found that Delaware firms are (a) worth significantly more than firms incorporated elsewhere and (b) significantly more likely to receive takeover bids and to be acquired. These results are consistent with the theory that Delaware law facilitates the sale of public firms through its relatively clear and mild takeover law, expert courts, and because its political economy makes it relatively unlikely to protect a firm's managers from takeover.

I found no support for the claim that managers harm shareholders by incorporating in Delaware or that federal regulation of firm governance is required because Delaware law is relatively harmful to investors.<sup>4</sup>

At the end of the day, the enabling model, at least in Delaware, rests on a two-fold trust in the board of directors and in the judiciary. That trust, in turn, is predicated on two fundamental principles. The first is character, and by that I mean integrity, expertise, diligence, good faith, independence, and professionalism. These qualities are important both in directors and in the courts. The second fundamental principle is a coherent economic rationale dedicated to the best interests of stockholders.

First, the directors. All the attributes of character are important. Perhaps the most effective stockholder protection device is the independence of directors. Stockholders vote for directors and expect proper governance from them. Their expectation is a strong bond of trust which is vested in the directors whose primary motivation must be in the best interest of stockholders. Competent and ethical corporate counselors are a key ingredient of proper corporate conduct by directors.

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4. Robert Daines, *Does Delaware Law Matter?*, NYU: THE LAW SCHOOL MAGAZINE, Autumn 2002, at 17, 20, available at <http://www.law.nyu.edu/magazines/autumn02/LSMGFNEW03.pdf> (last visited Jan. 24, 2002). *But see* Guhan Subramanian, *The Disappearing Delaware Effect* (forthcoming 2003).

Second, the courts. The courts enforce the trust vested in the directors. Courts should be reluctant to interfere with the good faith business decisions of directors and should not create surprises or wild doctrinal swings in their expectations of directorial behavior. Investors, as the owners of corporations, have certain expectations of the role of courts in the enforcement of fiduciary duties. Central to these expectations is the assumption that courts will be prompt, fair, clear, predictable, stable, and economically coherent.<sup>5</sup> In enforcing both the statutes and fiduciary duties, courts must be firm when violations occur and realistic in fostering good faith entrepreneurial risk-taking.

## II. THE ROLE OF THE BOARD

Under state statutory law, the business and affairs of the corporation are to be managed by, or under the direction of, the board of directors. The board hires management, personified by the CEO, while management makes most of the “enterprise decisions” (e.g., whether the plant should be in Peoria or Pittsburgh or London or Liverpool). Thus, enterprise decisions are distinguishable from “ownership decisions.” The interests of stockholders are directly affected by ownership decisions, which can sometimes happen in corporate mid-life, but which usually come as a part of final period decisions (such as mergers).

The overarching concept of corporate internal affairs revolves around the standard of conduct for directors, as distinct from the standard of review which is applied by courts to director conduct.<sup>6</sup> Standards of conduct are the aspirational standards that directors should follow in carrying out their responsibilities to either manage or direct the management of the corporation’s business and affairs. That is, directors shall act loyally, with due care, in good faith, and in the honest belief that they are acting in the best interest of the corporation. I would exhort today’s directors to seek expert

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5. E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1, 3 (2002).

6. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993). See also MODEL BUS. CORP. ACT § 8.30 and § 8.31 (2001) (codifying standards of director conduct and director liability).

counseling and to implement best practices in carrying out these standards of conduct.

The courts apply varying standards of review to the standards of conduct that is expected by corporations of their directors. Thus, a director's breach of a standard of conduct may or may not result in liability.

### III. THE BUSINESS JUDGMENT RULE

The keystone of state-based corporation law is the business judgment rule. Investors expect directors to take prudent, good faith business risks for the economic gain of the enterprise. Courts are ill-equipped to second-guess business decisions, so they focus on process and honesty. The business judgment rule can be stated in various ways. Recently, the Delaware Supreme Court stated in the Disney case of *Brehm v. Eisner* that:

The business judgment rule has been well formulated by *Aronson* and other cases. *See, e.g., Aronson*, 473 A.2d at 812 (“It is a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.”). Thus, directors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.<sup>7</sup>

As we parse this formulation, note that each key element of the rule is important in an analysis of the standards of director conduct and in the standards of court review.

- *It is a presumption*, which merely means that a person challenging director conduct for liability purposes must present a particularized pleading, and ultimately proof, to

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7. *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000).

rebut the presumption. Importantly, the presumption is rebuttable.

- *Business decision*, which means that only one of the two principal functions of directors is implicated. The business judgment rule applies only to decisions of directors. The directors' oversight function is not implicated in the analysis of the traditional business judgment rule, although directors do use judgment in carrying out their oversight function. Like directors' decisions, however, the oversight function is also subject to a fiduciary duty analysis.
- *Acted on an informed basis*, which means that directors must have exercised due care in considering all material information reasonably available before making a business decision.
- *In good faith*, which means that either the director's decision or the oversight function must be rationally and honestly carried out.
- *Honest belief in the best interests of the corporation*, which means that the director's motivation must be driven by the best interests of the corporation and its stockholders and not on any personal, disloyal or bad faith interest.

There are nuances surrounding court review that I do not have time to bore you with today. Many nuances arise in mergers and acquisitions, including takeovers. These nuances include the enhanced business judgment rule established in the *Unocal/Unitrin*<sup>8</sup> cases, enhanced scrutiny as discussed in *Paramount v. QVC*<sup>9</sup> and *Revlon*,<sup>10</sup> and entire fairness as discussed in various cases involving potential self-dealing.<sup>11</sup> I leave these nuances for another day.

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8. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

9. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

10. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

11. *See, e.g.*, *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993); *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001); *Gotham Partners v. Hallwood Realty Partners*, 805 A.2d 882 (Del. 2002).

## IV. FIDUCIARY DUTIES

What emerges from the construct of state corporation law, as exemplified by the Delaware corporation law, is the judge-made law of fiduciary duties. The judge-made law of fiduciary duties emerged from the construct of state corporation law, and is exemplified by the Delaware corporation law. The bases for these duties can be gleaned from the business judgment rule. There are also a number of ways to articulate fiduciary duties. I will simply refer to the three principal duties that arise out of the formulation of the business judgment rule, establishing the standard of conduct for directors: the duties of care, loyalty, and good faith.<sup>12</sup>

- *The duty of care*, which is strictly process due care, means that directors must exercise appropriate care when making a business decision and in carrying out their duty of oversight. Thus, the concept of “substantive due care,” as well as tort concepts measuring whether a decision is “reasonable” or whether an honest mistake in a business decision is “negligence,” are all foreign to corporation law.<sup>13</sup> Process due care itself requires that the director consider all material information that is *reasonably* available, and is measured by a standard of gross negligence.<sup>14</sup>
- *The duty of loyalty*, which in its most simplified form is a prohibition against self-dealing or self-interest, or serving any interest except that of the corporation and its stockholders.<sup>15</sup>
- *The duty of good faith*. There is some debate about whether this is really one of the fiduciary duties or whether it is subsumed in the duty of loyalty.<sup>16</sup> Although the duty of

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12. *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

13. *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000).

14. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1994); *Brehm*, 746 A.2d at 264 n.66.

15. *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

16. *See, e.g., Nagy v. Bistricher*, 770 A.2d 43, 48-49 n.2 (Del. Ch. 2000); *Emerald Partners*



good faith may be subsumed in the duty of loyalty, the opposite is not true. Thus, I think it is accurate to consider the duty of good faith as an additional duty beyond the duty of loyalty, at least for some purposes.<sup>17</sup> Certainly a director who sublimates the corporate interest to his own personal interest is probably acting disloyally, and in bad faith as well. But perhaps not all bad faith conduct necessarily implicates the disloyal concepts of self-interest or self-dealing.

In my opinion, good faith requires an honesty of purpose and eschews a disingenuous mindset of seeming to act for the corporate good without genuinely caring for the well-being of the constituents of the fiduciary. Although the concept of good faith is not fully developed in the case law, an argument could be made that reckless, irresponsible, or irrational conduct, which is not necessarily self-dealing or larcenous, could implicate the concepts of good faith. Moreover, in the new post-Enron era of corporate responsibility, which requires new standards to be set by federal statutes, SEC rules, or voluntary best practices, good faith is likely to emerge as a central issue of the directors' standard of conduct. It may or may not emerge as a standard of liability, however.

Irrationality is the outer limit of the business judgment rule and may be the functional equivalent of the waste test, or it may show that a decision is not made in good faith. If the board's decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, bad faith may, in some circumstances, be inferred.<sup>18</sup>

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v. Berlin, 2001 WL 115340 (Del. Ch.), *rev'd and remanded* by 787 A.2d 85 (Del. 2001). See also DREXLER ET AL., DELAWARE CORPORATION LAW & PRACTICE § 15.02 (2002) (“[i]t is difficult to see how good faith as a concept is not encompassed within the other legs of the ‘triad’”).

17. *Malone*, 722 A.2d at 10 (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“The director’s fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty.”)).

18. See *In re RJR Nabisco, Inc. Shareholders Litig.*, 1989 WL 7036 (Del. Ch.). See also *Brehm*, 746 A.2d at 263.

## V. GOOD FAITH RELIANCE BY DIRECTORS

It is important to corporate America that we have directorial candidates who are willing to serve, and that they be provided with adequate pay, indemnification, and insurance. Also, they should not be seen as guarantors of good results, or as preventors of the malfeasance, misfeasance, or nonfeasance of others. They should be entitled to rely in good faith on corporate documents, committees, and experts to a significant degree in making their business judgments. In this connection, the Delaware law may come to aid the director.

### A. Section 141(e)

Section 141(e) provides that directors shall be “fully protected in relying *in good faith*” upon corporate records, reports of officers or committees of the board, or experts whom the director “reasonably believes” to be opining within their expertise and who have “been selected with reasonable care by or on behalf of the corporation.”<sup>19</sup> But if the facts cast doubt upon § 141(e)’s presumption of a director’s good faith reliance or selection with reasonable care, then the director will have fallen short of an expected standard of conduct. Whether the director will resultingly be exposed to liability is another question that will depend on the standard of review applied to the circumstances.<sup>20</sup>

### B. Section 102(b)(7)

A legislative basis for making these distinctions can be found in the Delaware General Assembly’s 1986 enactment of section 102(b)(7) of the General Corporation Law. That statute permits the stockholders to include a provision in the certificate of incorporation which exonerates directors from personal liability in damages for mere due care violations.<sup>21</sup> Nevertheless, the statute does not

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19. DEL. CODE ANN. tit. 8, § 141(e) (2002) (emphasis added); see *Brehm*, 746 A.2d at 261.

20. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

21. DEL. CODE ANN. tit. 8, § 102(b)(7) (2002).

eliminate due care as a standard of conduct, so it remains not only as an aspiration but also as an expectation. Moreover, a breach of the duty of care can be a basis for equitable relief.

In the wake of the 1985 case of *Smith v. Van Gorkom*,<sup>22</sup> the Delaware General Assembly, and the legislatures of most states that followed the Delaware enactment, wanted honest and well-meaning directors to be willing to serve on a board and to take entrepreneurial risks without worrying about mere negligence suits. Stockholders who adopted the exoneration provisions in corporate charters were presumably like-minded.<sup>23</sup> Today, in a pure due care case without any viable claim of violating either the duty of loyalty or the duty of good faith, the Delaware courts may permit a dismissal on the motion of a claim for damages against a corporation's directors on the basis of a charter provision which incorporates section 102(b)(7).<sup>24</sup> But where the claim also implicates a properly pleaded cause of action for violating the duty of loyalty or the duty of good faith, such a claim will survive a motion to dismiss and may implicate an entire fairness scope of review.<sup>25</sup>

The precise language of section 102(b)(7) must be parsed to put this issue in context. The statute provides that the certificate of incorporation may contain:

A provision eliminating . . . the personal liability of a director . . . for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate . . . the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional

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22. *Smith*, 488 A.2d at 872.

23. E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681 (1998) [hereinafter Veasey, *Economic Rationale*]; Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, Speech to the University of Pennsylvania Law School on Norms and Corporate Law (Dec. 8, 2000), reprinted in 149 U. PA. L. REV. 2179 (2001).

24. *Malpiede v. Townson*, 780 A.2d 1075, 1093 (Del. 2001).

25. See *Emerald Partners v. Berlin*, 787 A.2d 85, 93-94 (Del. 2001); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.<sup>26</sup>

Thus, the statute, like the case law formulations of fiduciary duties, seems to treat the duty of good faith as separate from the duty of due care and the duty of loyalty. Purely as a matter of statutory construction, it is hornbook law that separately-stated provisions are presumptively separate, and the legislature is presumed to not have intended for provisions to be redundant.<sup>27</sup>

As far as the Delaware case law is concerned, however, the jurisprudence on good faith is unresolved. Therefore, I express no opinion on whether or when a separate duty of good faith that is not subsumed in the duty of loyalty should apply upon court review, but both exist as standards of conduct.

In the *Caremark* litigation, Chancellor Allen suggested in dictum that the standards of conduct of directors have emerged since the mid-1960s when the Delaware Supreme Court decided *Graham v. Allis-Chalmers Mfg. Co.*<sup>28</sup> That case held that directors could not personally be liable for failing to actively ferret out low-level law violations, but could be liable if there were “red flags” that put them on notice of the violations. In the thirty-three years from *Graham* to *Caremark*, the expectation of director conduct had changed. In *Caremark*, a key issue was the emergence of the federal sentencing guidelines that could benefit a corporation with an effective law compliance system, an expectation not present in 1963 when *Graham* was decided. Indeed, in a 1980 law review article that I co-authored with William E. Manning, we noted that such expectations may already have evolved in the then seventeen years following *Graham*.<sup>29</sup> Our view then was that because the Business Roundtable had declared in 1978 that “recent lapses in corporate behavior”

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26. DEL. CODE ANN. tit. 8, § 104(b)(7) (2002).

27. See *Oceanport Indus., Inc. v. Wilmington Stevedores, Inc.*, 636 A.2d 892, 900 (Del. 1994) (noting that “words in a statute should not be construed as surplusage if there is a reasonable construction which will give them meaning”).

28. 188 A.2d 125 (Del. 1963).

29. E. Norman Veasey & William E. Manning, *Codified Standard: Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1980).

emphasized the need for corporate law compliance procedures, “the expected role of a director has grown to include the installation of legal compliance systems.”<sup>30</sup>

Counsel today need to advise directors that there may be a potential for personal liability for the “utter failure” (in the words of the Chancellor in *Caremark*) of the directors to assure that an adequate law compliance program is in place, where that failure amounts to a sustained or systematic failure to exercise reasonable oversight.<sup>31</sup> The Delaware Supreme Court, however, has not so squarely held. But the Supreme Court has held that there can be a violation of one or more of the fiduciary duties of care, loyalty, and good faith for intentionally disseminating false financial information to stockholders.<sup>32</sup>

Today, the *utter failure* of directors to follow the minimum expectations of the standards of director conduct, Sarbanes-Oxley, or the NYSE or NASDAQ Rules, might likewise raise a good faith issue. There is no definitive answer to that question, but counsel should advise the directors of that possible exposure, and encourage the utmost in good faith behavior.

## VI. DIRECTOR INDEPENDENCE

Throughout the Delaware statutes and case law, the concept of director independence is cited as a fundamental expectation. Accordingly, a director’s pure independence on paper and fierce independent conduct in practice is almost always desirable, and is sometimes, but not always, required. There is no single definition of independence in Delaware law, although it is clear that theoretical independence and independent action require the absence of either the appearance or the reality of any directorial interests other than the merits of the corporate activity for the best interests of the

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30. *Id.* at 929-30.

31. *In re Caremark Int’l Inc., Derivative Litig.*, 698 A.2d 959, 970-71 (Del. Ch. 1996).

32. *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998) (“When the directors disseminate information to stockholders when no stockholder action is sought, the fiduciary duties of care, loyalty and good faith apply. Dissemination of false information could violate one or more of those duties.”).

corporation and the stockholders—particularly, the minority stockholders.<sup>33</sup>

For many years, I have urged seven general protocols of best practices. One protocol is that boards of directors should have a heavy majority of “purely” independent directors.<sup>34</sup> Of course, there is a legitimate point of view that director independence is not always best for the directors because insiders who are more knowledgeable about the corporation, or who have more at stake, will be better strategic decisionmakers, as well as better managers.<sup>35</sup> But, in my view, on balance, stockholder confidence is best served by a heavy preponderance of independent directors.<sup>36</sup>

The proposed rules of the NYSE and NASDAQ, as well as some aspects of the Sarbanes-Oxley Act, require independence and provide some cryptic content to the concept of independence. These independence concepts result in a new and evolving standard of conduct for directors. They are not inconsistent with the Delaware case law expression, but they are somewhat more explicit. Yet codes of best practices can and should be considered for more precise explication.<sup>37</sup>

Under the proposed NYSE Rules, the board of directors must judge whether a given director has “no material relationship” so that the director may be considered as independent from the corporation.<sup>38</sup>

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33. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984); Kahn v. Tremont Corp., 694 A.2d 422, 428-29 (Del. 1997); McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000).

34. Veasey, *Economic Rationale*, *supra* note 23, at 687-88; *see also* Brehm v. Eisner, 746 A.2d 244, 255-56 (Del. 2000).

35. Veasey, *Economic Rationale*, *supra* note 23, at 687 (citing Letter from Frank H. Easterbrook, Circuit Judge, U.S. Court of Appeals for the Seventh Circuit, to E. Norman Veasey, Chief Justice of the Supreme Court of Delaware (Apr. 10, 1988) (on file with THE BUSINESS LAWYER, University of Maryland School of Law)); *see also* James D. Westphal, *Second Thoughts on Board Independence*, 23 THE CORPORATE BOARD 136 (Sept./Oct. 2002).

36. William T. Allen, *Independence, Integrity and the Governance of Institutions*, Speech to the National Association of Corporate Directors Annual Meeting 7-8 (Oct. 27, 1992) (on file with THE BUSINESS LAWYER, University of Maryland School of Law); Veasey, *Economic Rationale*, *supra* note 23, at 687-88.

37. *See Brehm*, 746 A.2d at 256 n.30.

38. NYSE Corporate Governance Rules Proposals, § 303A(2)(a) (“No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.”).

Interestingly, over fifty percent of the NYSE companies are Delaware corporations. A future question may arise as to whether a determination that a director has no material relationship for purposes of the NYSE Rules would involve a violation of the duty of good faith under Delaware law, when the deciding board was not acting in good faith. There is no definitive answer to that question, but at the end of the day, it will probably fall upon the corporation's General Counsel or other outside counsel to see to it that this good faith duty is properly carried out.

## VII. BEST PRACTICES AND OPTICS

Statutory law provides that the corporation shall be managed by, or under the direction of, the board of directors.<sup>39</sup> This means that they are in charge! The directors are not merely advisors to the CEO. They are the people who hire and fire the CEO. They must be actively engaged in the development of the company's strategic direction and must supervise how that direction is implemented by management.<sup>40</sup> Delaware decisions which reflect that directors should conduct themselves in accordance with best practices is not a recent development and long preceded Enron, Sarbanes-Oxley, and the NYSE Rules.<sup>41</sup>

A combination of best practices, a clear record of good faith conduct, and hard work as directors will improve the "optics" of how a court will look at the issues. Moreover, the optics must be genuine—not just a "good show"—but good faith. For example, if independence is an issue, the court's inquiry could not only include the resumé of the director and her relationships with both the corporation and other directors, but also how she has actually conducted herself and the practices that the corporation may have in place.

The NYSE and NASDAQ Rules impose a more detailed set of best practices, and the same is true of Sarbanes-Oxley. Yet, in my

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39. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2002).

40. See COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 3-7 (3d ed. 2001); Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427, 1429-36 (Aug. 1995).

41. *Brehm*, 746 A.2d at 256.

opinion, the voluntary codes of best practices should be considered as even more definitive. There are many examples in these voluntary codes, but I would like to develop here just one approach to a new paradigm. That paradigm focuses on independence, committee responsibilities, and the role of counsel.

#### VIII. THE GOVERNANCE COMMITTEE OF THE BOARD

First, assuming that a heavy majority of directors should be independent, the voluntary codes should clearly define independence. Second, the Audit Committee, the Compensation Committee, and the Nominating/Governance Committee, all consisting 100% of independent directors, should have detailed charters setting forth their duties. Counsel should be certain that those charters are clearly drafted and fit the particular corporation. Counsel should also monitor compliance with those charters as well as law compliance generally. Third, the Nominating/Governance Committee (which I will call the "Governance Committee") also fits the new paradigm, providing a good vehicle for ensuring effective best practices.

With the help of the General Counsel or its own outside counsel, the Governance Committee should see to it that the right things are done. Time does not permit me to elaborate on the best practices that this committee should pro-actively superintend. All that time does permit me to do in these remarks is to provide a partial, topical checklist, as follows:

- Define and Monitor Director Independence
- Nominate Directors
- Executive Sessions of Independent Directors
- Law Compliance Systems
- Internal Controls
- Business Ethics Code Compliance
- Disclosure Documents
- Training of Directors



- Conflicts of Interest
- Reporting Malfeasance, Misfeasance or Nonfeasance within the Corporation
- Corporate Opportunities
- Insider Trading
- Stockholder Relations

Counsel should consult experts, current literature, and her own common-sense professionalism in guiding the committee to employ the most modern implementation of the paradigm corporate culture that is designed to fulfill investor expectations in this dynamic area of corporate governance. In this new world there is pressure on all of the players. First, there is pressure on each director in deciding whether to serve on a board, to prepare for that service, and then to function as a director effectively, competently, and in good faith. Second, the pressure on the key officers—CEO, CFO and General Counsel—is intense. But perhaps the most intense pressure is on the General Counsel. The General Counsel may not only need a competent team of in-house lawyers, but will also need outside counsel who are either at his elbow or are independently counseling the various committees.

Corporate directors must look to competent and ethical counsel to advise them on their fiduciary duties and to protect against fraudulent conduct that the lawyer may come to know. Central to this theme is the fact that the lawyer for the corporate entity will owe her allegiance only to the entity and, thereby, to its stockholders.

This brings me to the latest developments in professional ethics and, in particular, how these rules apply to the lawyer for the corporation.

#### IX. ETHICS 2000 AND THE “SEVEN C’S”

Five years ago, the American Bar Association (ABA) established a special commission known as Ethics 2000 to review, evaluate, and recommend change, where necessary, to the Model Rules. The Model Rules were originally adopted by the ABA in 1983, and have been adopted in some form in over forty states. In some instances the states adopted important departures from the Model Rules. Moreover,

the ABA itself adopted about thirty-nine amendments to the Model Rules over the years. It was, indeed, time in 1997 when the Ethics 2000 Commission was chartered to have a good hard look at the Rules in light of considering those changes, the dynamics of the legal profession, and the American Law Institute's Restatement of the Law Governing Lawyers that was nearing completion.

I have had the honor to chair this extraordinary and diverse Ethics 2000 Commission of thirteen outstanding scholars, judges, practitioners, and public citizens. After an open five-year process of over fifty meetings, ten public hearings, and many drafts exchanged on our website, our final product was presented to the ABA House for approval in the summer of 2001 and the winter of 2002. Nearly all of our recommendations were adopted, and now a newly-minted set of ABA Model Rules is under the consideration of state supreme courts and their advisory committees for adoption in the respective states. Also, the three recommendations of Ethics 2000 that were not approved by the ABA House are offered for consideration to the state supreme courts. I will later discuss one of these: Rule 1.6 on confidentiality.

We did not change the basic architecture of the existing Model Rules. In fact, we recommended change only where necessary. As a result, we have a blend of the new and the time-honored existing Rules. To oversimplify the many provisions of the new Rules now printed in over 120 pages of text and comments, I would characterize the highlights as the "Seven C's." They are:

- Competence
- Communication
- Candor
- Conflicts
- Confidentiality
- Corporate Clients
- Courage

All seven are relevant in today's environment, but my focus today is especially on four in the context of the professional responsibilities

of the corporate counselor: conflicts, corporate clients, confidentiality, and courage.

First, as to conflicts, the corporate lawyer must be clear that her client is the corporate entity and only the corporate entity. In my view, she should avoid the conflicts under Rule 1.7 by not personally representing an officer, director, or employee.

Second, as to the corporate client, when the corporate lawyer comes to know of a crime or fraud being perpetrated by an officer or employee, she must report that violation up the chain of command to the board of directors to expose and prevent the fraud within the corporation. This action is required by Model Rule 1.13, which sets forth a roadmap to direct the lawyer for the corporation to employ intra-corporate remedies to stop a fraud by a corporate officer or employee. The remedies in Rule 1.13 include going up the chain of command to the board of directors or the independent directors, if necessary. At the board level it is likely that the fraud would be stopped. Directors are not likely to risk jeopardizing their careers and reputations by allowing a corporate officer or employee to perpetrate a fraud or crime injuring the corporation or innocent third parties.

Further, as to the corporate client, that client must be protected under Rule 4.2 by the corporate lawyer from unethical contacts with the key persons within the corporate client. Specifically, there may be attempts by outsiders, including federal and state investigators, without consent, legal authority, or court order, to communicate with current officers, directors or others who supervise, direct, or regularly consult with the corporation's lawyer. New Rule 4.2 permits investigators some leeway, but would prohibit these attempts by others. This rule has been a battleground for both lawyers and state courts because past United States Attorney Generals have wanted to create a law enforcement exception to the no-contact rule. That effort was successfully thwarted in this city in the Eighth Circuit with the able service of the St. Louis trial lawyer Frank Gundlach, who represented the Conference of Chief Justices as *amicus curiae* in the *McDonnell Douglas* case.<sup>42</sup> Later, in the McDade Amendment,<sup>43</sup>

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42. *United States ex rel. O'Keefe v. McDonnell Douglas Corp.*, 132 F.3d 1252 (8th Cir. 1998).

43. 28 U.S.C. § 530B (Supp. V 1999).

Congress codified the primacy of state courts over lawyer ethics rules.

Third, as to confidentiality, there may be instances where the lawyer has properly used Model Rule 1.13, but has not been able to persuade the board of directors to deal with fraud by an officer. In addition to Rule 1.13, the Model Rules provide other avenues that lawyers may take to disassociate themselves from a client's crime, such as a "noisy withdrawal" from the representation of a client who seeks to perpetrate a fraud. That is, the withdrawing lawyer may give "notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like."<sup>44</sup>

The key issue as to confidentiality is whether the lawyer should have the ability under Model Rule 1.6 to disclose client information outside of the organization, if the disclosure is reasonably necessary to prevent, mitigate, or rectify the perpetration of a substantial fraud using the lawyer's services. Ethics 2000 recommended that the lawyer be given that discretion in its proposed Rules 1.6(b)(2) and (3). Forty-one jurisdictions already permit the disclosure of a client confidence to prevent the client from perpetrating a fraud that constitutes a crime, thus departing from the Model Rule that had been in effect since 1983.

This discretion was the most controversial issue before the ABA House, which voted against the Ethics 2000 proposal in August 2001 and opted to stay within the narrow confines of Rule 1.6 prohibiting such disclosure. The lawyer's discretion to disclose is left to his professional judgment, and gives the lawyer leverage within the corporation to prevent the fraud or crime. Interestingly, Delaware and Missouri—at least for the present—follow the 1983 Model Rule 1.6 of no disclosure, putting these states in the minority among the current state rules. Maybe that will change in this post-Enron world, and maybe the ABA House will change its rule prohibiting any such disclosure.

Proposed Rule 1.6(b)(2) of Ethics 2000, like the existing rules in eighty percent of the states, permits disclosure outside of the corporation to prevent or rectify criminal fraud. The proposed Rule

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44. MODEL RULES OF PROF'L RESPONSIBILITY R. 1.6 cmt. 14 (2002); *see also* R. 1.2 cmt. 10; R. 4.1 cmt. 3.

accomplishes at least three ends: (a) it gives the corporate lawyer leverage to force a satisfactory intra-corporate remedy or prevention while using Rule 1.13; (b) it is the ultimate recourse if the highest authority in the entity thumbs its corporate nose at the lawyer; and (c) it would bring the ABA in line with those forty-one states and the expectations of the public, if ultimately approved by the ABA House of Delegates, which one would reasonably expect in today's environment.

Finally, as to courage, I don't believe the word is found in the Model Rules, but it is certainly implied by concepts of lawyer morality and independence found in various Rules and in the Preamble. It is the spirit of Atticus Finch,<sup>45</sup> to which we must all aspire as members of this profession, for the corporate lawyer to be independent, and to employ the strength, courage, and leverage to force best practices and a prevention of fraud. Indeed, the lawyer must sometimes have the courage to "just say no" to the CEO or the board when they seek to embark on a questionable course of conduct. This is easier said than done, but it *must* be done when the situation arises.

## X. FEDERALISM ISSUES

In July 2002, Congress enacted the Sarbanes-Oxley Act as a result of the recent corporate scandals. Section 307 of the Act requires the SEC to adopt rules by January 2003 requiring lawyers in certain situations to go up the chain of command. The pertinent part of section 307 of the Sarbanes-Oxley Act requires the SEC to adopt rules

[S]etting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission *in any way in the representation of issuers, including a rule—*

(1) requiring an attorney to report *evidence of a material violation of securities law or breach of fiduciary duty or similar violation* by the company or any agent thereof, to the

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45. HARPER LEE, *TO KILL A MOCKINGBIRD* (Little, Brown & Co. 1998) (1960).

chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer *does not appropriately respond* to the evidence . . . requiring the attorney to report the evidence . . . to the board of directors.<sup>46</sup>

Although this provision is clearly an attempt to codify a mandatory Rule 1.13 at the federal level, there are still numerous drafting and scope issues that will have to be addressed. I expect that the SEC will clarify and resolve these and other issues in an appropriately clear and limited manner when it promulgates the rules required by the statute.

Some may say that state corporation law or ethics rules are “too weak” to deal effectively with corporate misconduct, the perceived sloth of some directors, and the timidity or complicity of corporate lawyers. I do not agree with that assessment. Perhaps some who hold that view have been swept up in the horrors of the moment and desire to do anything and everything with an intent to “protect” investors or employees. But we must be careful. I would paraphrase the Hippocratic oath: Whatever we do, first do no harm! In my view, neither the Delaware statutory or fiduciary duty laws, nor state-based ethics rules, are weak. In fact, they are balanced and firm. Tipping the balance by excessive federal preemption could cause harm to investors.

On the federalism front, as it relates to corporate governance, recent headlines express concern about excessive federalization and overregulation by Congress. Recent memoranda from various law firms raise these questions and offer good advice on the current environment, as well as examples of best practices by corporate boards. For example, in recent Wachtell, Lipton memoranda many points were made including these:

The danger from Enron is much more the possibility of onerous new legislation and regulation than the likelihood of a change in the law with respect to director liability. If directors and those who are members of audit committees follow

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46. 15 U.S.C. § 7245 (2002) (emphasis added).

customary procedures, there should be no increased liability exposure.

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The courts recognize the necessity of not changing the rules that assure directors that they will not be held personally liable for even negligently failing to discover misrepresentations by management and the auditors, and that this assurance is critical to having competent, independent people continue to serve as directors of public companies.

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The Sarbanes-Oxley Act and the NYSE rules have not changed the business judgment rule or the other fundamental tenets of corporation law applicable to boards of directors; nor have they weakened the structures insulating directors from personal liability that have been developed over the years in order to avoid discouraging competent people from serving as directors.

On the ethics front, in my opinion, federalization would be similarly problematic for several reasons, including some troubling drafting issues in the Act, enforcement mechanisms, as well as the obvious potential threat to the principles of federalism. The McDade Act is already on the books as a federal law mandating that ethics rules be state-based, and thus it is important for the SEC which that are called for in the legislation to clarify and limit the many drafting and federalism concerns that are raised by the Act. Most state supreme courts are conducting a review of their ethics rules in this new environment. Sarbanes-Oxley implicates a tilt to some limited federal regulation of lawyers, and it is my hope that the tilt can be contained. We await the SEC rules implementing section 307 of the Sarbanes-Oxley Act as we also await action by state supreme courts on a comprehensive new set of rules of professional conduct.