

THE PARADOXICAL CORPORATE AND SECURITIES LAW IMPLICATIONS OF COUNSEL SERVING ON THE CLIENT'S BOARD

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Lawyers are not plumbers, although many who are lawyers, not to mention their clients, may have cause to question why this is so. The difference is not the apparel that each wears when performing a task for the client. Nor is the difference that one works more frequently below the desk than does the other. What separates lawyers from so many worthy callings is that lawyers are members of a profession, both socially and vocationally. Plumbers are only vocationally professionals.

A profession is not distinguished by the fact the pay is good and the work steady. Rather, it is the responsibilities assumed by those who are its members that distinguishes their trade as a profession. These responsibilities run not merely to the client, but are even more broadly directed to many facets of society. Hence, the lawyer has obligations to his client, but also the court and sometimes even third parties. It is the existence of these responsibilities that distinguish a true profession from other purely commercial vocations.¹ There has been extensive commentary published on whether lawyers who serve on their client's board of directors seriously compromise their professionalism by doing so. The arguments on both sides are now well understood. The vortex of this debate swirls about whether such services compromises the independence of judgment that underlies important pillars of a lawyer's professional obligations in ways that rob the attorney of his ability to function in the professional manner envisioned by governing ethical standards and directives. Although this debate continues, and likely will for years to come, it is now time to do what is practical and declare a victor.² Lawyers,

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1. When explaining what a profession is, Roscoe Pound was less earthy in his reference. He states that an organized profession is not "the same sort of things as a retail grocers' association." *See* R. POUND, *THE LAWYER FROM ANTIQUITY TO MODERN TIMES* 7 (1953).

2. There is another reason to declare a victor. With so much already having been written on this topic, it is now impossible for commentators to offer a fresh insight. The author's own review of the material impressed upon him the frequency that old wine was refilling old empties.

in large numbers, are serving on their clients' boards and, in an increasingly competitive environment, one should expect their pace in doing so will increase.³ It is over and it is time to move on and consider the consequences of such dual service.

This Article assumes that dual service will continue to be a practice, but not because it is the socially optimal result. Rather, dual service will continue to exist because it is, and has been, sufficiently pervasive to provide cause to believe no jarring change, such as proscription by the American Bar Association (ABA) or state bar organization, is even likely to occur. This Article provides a new perspective on the topic by examining the junction of a lawyer serving on his client's board and well-accepted corporate and securities principles. While this inquiry should strike many as natural, the conclusions reached within this Article are paradoxical. As examined below, dual service has the effect of increasing the protection accorded the beneficiaries of the examined corporate and securities law principles. The paradox lies in the fact that the invitation to serve comes from a firm's managers and the examined principles are those crafted with a special objective of protecting shareholders and investors, even the corporation, from misconduct by the managers. As demonstrated in this Article, dual service results in managers being subject to greater scrutiny and lawyers to a loss of some of the client's business. Further, dual service even makes it possible for a competing lawyer to get his foot into the client's door, a result that an attorney who agrees to serve on his client's board certainly does not seek. Hence, why the invitation? And why the acceptance of the offer to serve on the client's board?

I. THE OPACITY OF PROFESSIONAL STANDARDS

Just as results are not clear within many areas of law, so it is with the guidance one acquires from professional directives bearing on a lawyer's service on the client's board. But of course, if the rules were clear, there would be much less to debate. The touchstone of the debate is rule 1.7 of the Model Rules of Professional Conduct, a provision adopted in an

3. The inertia accompanying the current practice is reflected in the American Bar Association not heeding the advice of its task force that recommended dual service by the attorney should be discouraged. See ABA SECTION OF LITIGATION, THE LAWYER-DIRECTOR: IMPLICATIONS FOR INDEPENDENCE: REPORT OF THE TASK FORCE ON THE INDEPENDENT LAWYER 63-64 (1998) (not calling for a blanket prohibition of dual service). This report prompted instead an even milder response than that recommended by its task force. See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998), discussed *infra* in text following note 14.

overwhelming number of states. The comment to the rule addresses directly, but simply, the attorney's service on her client's board: "If there is a material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director."⁴ A similar lack of specificity is found in the recent American Law Institute's treatment of a lawyer's ethical obligations, which forbids lawyers from representing a client when "there is a substantial risk that the lawyer's representation . . . would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to . . . a third party."⁵ Assessing "risk," and the parameters of such an assessment, are problematic and the fount of the debate that has surrounded attorneys' service on a client's board.⁶ However, this assessment is not made easier by the multi-headed nature of the lawyer's corporate client.

Ambiguity in the risk assessment facing the lawyer-director is exacerbated by Model Rule (of Profession Conduct) 1.13, which provides: "A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."⁷ Corporate law professors revel in teasing out of their students just who is the "corporation" and especially within the context of transactions that pit managers against owners, as regularly occurs in shareholder proposals, defending control, and going private transactions. Thus, on a given issue, there might not be any risk of conflict of interest vis-a-vis the board of directors, but could one exist with the shareholders?⁸ Furthermore, what if the prevailing norm is a more communitarian view of the corporation that includes labor, suppliers, and the communities where the corporate offices are located? Who, then, is the corporation?

Obviously, the attorney is required to assess potential conflict of interests in a wide range of areas, many being as problematic as that posed

4. MODEL RULE OF PROF'L CONDUCT R.17 cmt. n.14 (1999).

5. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 121 (1998).

6. There is no disagreement, however, that the lawyer-director should abstain from voting when the board considers the question of legal fees or other issues which implicate the lawyer-director's law firm. See, e.g., Robert P. Cummins & Megyn M. Kelly, *The Conflicting Roles of Lawyer as Director*, 23 LITIG. 48 (1996); JOHN F. X. PELOSO & IRWIN H. WARREN, THE LAWYER-DIRECTOR: IMPLICATIONS FOR INDEPENDENCE, 1998 A.B.A. SEC. LITIG. TASK FORCE REP. ON THE INDEPENDENCE OF LAWYERS 14. But this is the only issue where the commentators agree the attorney's independence to the client is so compromised.

7. MODEL RULES OF PROF'L CONDUCT, R. 1.13(a) (1999). The Restatement similarly identifies the client as the organization that interacts with the lawyer through its "responsible agents." See RESTATEMENT OF THE LAW GOVERNING LAWYERS, § 96(1)(a) (1998).

8. For an excellent overview of the problems created by the embrace of the entity as the client of rule 1.13, see Susanna M. Kim, *Dual Identities and Dueling Obligations: Preserving Independence in Corporate Representation*, 68 TENN. L. REV. 179, 190-99 (2001).

by serving on the client's board. Hence, arguing that, because lawyers acting as corporate counsel must even grapple with possible conflicts of interest on other matters—even when not a director—having the additional capacity of director is simply a change in scale in addressing her independence.⁹ Indeed, due to the pervasiveness of the obligation to be watchful of conflicts that compromise the lawyer's autonomy, some conclude that the lawyer is especially well equipped to handle the ethical issues that she will face as a consequence of serving on the client's board.¹⁰ Placing the matter in context, there is the broader issue of how independent the lawyer is, whether or not she serves on the client's board, when her firm receives significant fees from the corporate client.¹¹ Critics of dual service invoke something of a “piling on” argument, emphasizing that dual service further erodes the lawyer's ability to dispassionately assess the risks of a serious conflict between her interest and the interests of the client.¹²

Today, the template for the attorney considering whether to serve on his client's board is not Model Rule 1.13, but the somewhat more finite flashing amber light of ABA Formal Opinion 98-410.¹³ Following the call of an ABA Task Force that the ABA should in most cases discourage the attorney serving on the client's board,¹⁴ the ABA Committee on Ethics and Professional Responsibility took a less dramatic step in its Formal Opinion 98-410. The Formal Opinion sets forth extensive cautionary warnings and guidelines attorneys should follow in agreeing to serve on their client's board. Among the points attorneys should raise with their clients before agreeing to serve in a dual capacity is (1) that the responsibilities as a lawyer will differ from those of being a director; (2) that conflicts may arise from time to time that require the lawyer to either cease representing the client or resign the directorship; (3) that dual service poses a risk to the

9. See, e.g., Patrick W. Straub, *ABA Task Force Misses the Mark: Attorneys Should Not Be Discouraged from Serving on Their Corporate Clients' Board of Directors*, 25 DEL. J. CORP. L. 261, 274-75 (2000); Micalyn S. Harris & Karen L. Valihura, *Outside Counsel as Director: The Pros and Potential Pitfalls of Dual Service*, 53 BUS. LAW. 479, 482-83 (1998).

10. Harris & Valihura, *supra* note 9, at 491.

11. See Craig C. Albert, *The Lawyer-Director: An Oxymoron?*, 9 GEO. J. LEGAL ETHICS 413, 424 (1996); Robert H. Mundheim, *Code of Professional Forbid Lawyers to Serve on Boards of Corporations for Which They Act as Counsel*, 33 BUS. LAW. 1507, 1514 (1978) (discussion by participants and panel comments of Kenneth Bialkin).

12. See, e.g., Bernard S. Carrey, *Corporate Lawyer/Corporate Director: A Compromise of Professional Independence*, 67 N.Y. ST. B. J. 6, 7 (Nov. 1995) (cautioning further that “the potential for conflict and compromise is always present, and unfortunately too often realized in hindsight”).

13. Reported in Formal and Informal Ethics Opinions 1983-1998, at 478.

14. See ABA SECTION OF LITIGATION, *THE LAWYER-DIRECTOR: IMPLICATIONS FOR INDEPENDENCE*, REPORT OF THE TASK FORCE ON THE INDEPENDENT LAWYER 63-64 (1998).

attorney-client privilege; (4) that there may be a necessity to withdraw as a director from any matter related to the lawyer's or his firm's relationship to the company; (5) that the attorney's position of director must not compromise the rendering to the client of advice and judgments regarding legal matters; (6) that the attorney will dutifully carry out a matter even if the lawyer did not support the decision as a director; and (7) that the attorney will not serve as the company's lawyer when the duties of being a director conflict with the professional obligations of acting as the company's lawyer.¹⁵

Although Formal Opinion 98-410 may be seen as providing important cautionary warnings to the client, the mandated warnings are likely to be heavily discounted by the client who views the very generalized events alluded to in each of the preceding warnings as unlikely to occur.¹⁶ More importantly, the Formal Opinion provides a ready template for the attorney to enter into the dual relationship with the corporate client, but it provides no additional specificity regarding the conflicts that will cause the attorney to withdraw from either serving as the company's director or its lawyer. As such, Formal Opinion 98-410 exacerbates the opacity problems that already existed under the professional standards because it offers an encouraging signal for the attorney who, once having given the professional *Miranda* warnings to the client, may charge forward into a relationship where conflicts are omnipresent. Although Formal Opinion 98-410 provides such encouragement, it does nothing to clarify the ambiguity of what constitutes a conflict or what is the appropriate response to a conflict of the director-lawyers' roles.

15. The Committee on Lawyer Business Ethics of the ABA Section of Business Law, *The Lawyer as Director of a Client*, 57 BUS. LAW. 387, 393-96 (2001) (providing guidelines the lawyer should follow to work through the question of serving on the client's board).

16. We may well wonder whether lawyers tend to over-emphasize or under-emphasize the presence of a conflict of interest. Although lawyers generally tend to overstate downside risks when advising a client, see Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629 (1997), is this tendency moderated when the lawyer assumes a dual role as director and lawyer? Furthermore, if the conflict is to be addressed by directing the client to seek the services of another lawyer, is it less likely that the lawyer's tendency to overstate risks will continue unabated? Here, we might well wonder whether both the client and the lawyer will not blunder ahead, being both overconfident in their respective abilities to both identify and appropriately address the conflicts that may arise in the future. See Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Misperceive Stock Market Investors and Cause Other Social Harms*, 146 U. PA. L. REV. 101 (1997).

II. TWO VIEWS OF THE CLIENT'S ATTORNEY AS DIRECTOR

In the face of the great uncertainty regarding when dual service compromises the attorney-client privilege and what constitutes such a conflict as to requires a lawyer to withdraw as either the company's counsel or director, one may legitimately question why either the attorney or his client would opt for dual service. Certainly, those who advocate a prohibition of the attorney serving on the client's board see the prohibition as a necessary prophylaxis to avoid otherwise problematic judgments by the attorney.

Proponents of dual service argue that the attorney's service as a director enhances the efficiency of an arrangement beneficial to both the lawyer and the company. Such proponents see a prohibition as removing from the boardroom a category of individuals who "are among the best kind of directors a company should have."¹⁷ The lawyer's perspective is both unique and valuable because the lawyer may have knowledge on certain matters, such as litigation or regulatory issues that other directors lack.¹⁸ Dual service enables the lawyer to acquire greater familiarity with the client's business, which translates to his law firm providing more effective representation.¹⁹ Many companies do not anticipate the need for their attorney to be at all meetings of directors. Thus, board membership assures an attorney's perspective at all meetings. And, of course, there are more meretricious considerations, such as the inevitable prestige factor for the attorney serving on a successful company's board as well as the fact that such service, euphemistically, "solidifies" the firm's relationship with the client.²⁰

17. See Mundheim, *supra* note 11, at 1516 (remarks of Kenneth J. Bialkin). As stated more bluntly: "Some of the best of us are not only damn good lawyers, but damn good businessmen; and to deprive the business community of the opportunity to use those people's services in both roles . . . would be a terrible mistake." *Id.* at 1515, 1516 (remarks of Kenneth J. Bialkin).

18. See Harold M. Williams, *Corporate Accountability and the Lawyer's Role*, 34 BUS. LAW. 7, 10 (1978). Another benefit here is that getting the lawyer involved in the initial decision making is more likely to occur if the lawyer is also a director; if not so involved, the lawyer may learn of a problem only after it has occurred, thereby posing a great challenge in serving the client's interest. See Robert H. Mundheim, *supra* note 11, at 1508.

19. See JAMES H. CHEEK, III & HOWARD H. LAMAR, III, LAWYERS AS DIRECTORS OF CLIENTS: CONFLICTS OF INTEREST, POTENTIAL LIABILITY AND OTHER PITFALLS (PLI Corp. Law & Practice Course Handbook Series No. B4-6940, 1990), available at Westlaw, 712 PLI/Corp. 461. For a discussion of the non-pecuniary rewards of serving on boards of directors, see James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROB. 83, 91-99 (1985).

20. See Robert P. Cummins & Megyn M. Kelly, *The Conflicting Roles of Lawyers as Directors*, 23 LITIG. 48 (1996).

To be sure, the lawyer's perspective can be provided without dual service by assuring his attendance at all meetings of the directors.²¹ Furthermore, the company can always appoint to its board lawyers who have no professional relationship with the company.²² However, the latter scenario poses a Catch-22. If the profession places a bar to a lawyer serving on her client's board, a lawyer would be reluctant to accept appointment to a company's board because such service translates to the inability to secure legal business with the company.²³

Another benefit of dual service is the prevalent view that the board accords greater weight to the lawyer's input when it understands that the lawyer is a board equal and not merely an advisor.²⁴ Thus, the presence of the lawyer as a director enhances the lawyer's voice as lawyer. To this argument, the opponents of dual service warn that the conflicts are numerous and often only recognized when their consequences are felt, which can be too late for the client.²⁵ As Dean Robert Mundheim has observed, the lawyer-director's advice faces at least two compromising dimensions when a conflict of interest arises.²⁶ First, how does the conflict impact the lawyer's own advice or judgment shared with her fellow directors?²⁷ Second, with the lawyer candidly explaining her conflict of interest, what impact does that disclosure itself have on the clear and efficient judgments of the lawyer's fellow directors?²⁸

III. IMPLICATIONS FOR GOVERNANCE

The contemporary view of corporate governance prescribes a divide between doers and watchers. This distinction arises from the view that the

21. See CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 13.7.5 at 740 (1986).

22. See Mundheim, *supra* note 11, at 1516 (discussion by participants and panel remarks of Lloyd N. Cutler).

23. See Mundheim, *supra* note 11, at 1510. But, of course, lawyers may well take a longer view and an absolute bar would invite them to do so. The lawyer barred from a professional relationship with a corporation on whose board he serves may see board service as getting something of the professional shoe in the client's door. Once establishing a rapport and warm relationship with the CEO and others within the corporation, the lawyer's resignation could be timed to coincide with the award of some of the company's legal business. Such a prospect would also be seen by the company's present outside counsel, which could make for an interesting dynamic within and without the boardroom.

24. See Harris & Valihura, *supra* note 9, at 483. See also Mundheim, *supra* note 11, at 1514 ("A lawyer, merely invited as a guest and limited to legal advice when requested, would not have the franchise to speak or raise the questions which should be raised . . .") (remarks of Ken Bialkin).

25. See Carrey, *supra* note 12, at 7. See generally Albert, *supra* note 11, at 431.

26. See Mundheim, *supra* note 11, at 1509.

27. *Id.*

28. *Id.*

board should include a critical mass of independent directors whose function is not the development or even review of business policy but the evaluation of senior management's stewardship of the firm.²⁹ The prevalence today of the outside board or, more generally, the rise of the independent director is tangible evidence of the vitality of the monitoring model. The monitoring model first served as a means to evaluate management's stewardship. Its critical contributions were the board rewarding or removing senior officers and providing important insulation between the officers and the firm's auditors. However, the model has become the most significant force in shaping the law's development in such diverse areas as derivative suit litigation, takeover defenses, and the treatment of minority stockholders. For example, the special litigation committee arms the corporation with a means not only for an outside director to clean the corporation's stable, but to provide it with a voice with regard to the question whether a derivative suit serves the best interests of the corporation.³⁰ And, when the wagons are circled in response to a hostile bid to takeover the firm, courts regularly give great weight to the judgment of the independent directors who deliberate and bless certain defensive measures.³¹ Doctrine also accords outside directors a pivotal role in protecting minority stockholders from managerial or majority oppression. The presence of a committee of independent directors who, for example, negotiate and/or approve the terms of an acquisition between the corporation and its controlling stockholders is the surest route to resurrect the presumptions of fairness for what otherwise is clearly a self-dealing transaction that might fail to meet the inherent fairness standards.³² In contrast to these episodic insertions of the outside director

29. This view is best stated in MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 141-48 (1976), and is the cornerstone of the American Law Institute's Corporate Governance Project. See *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* §§ 3.01-3.05 (1992).

30. See generally James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 *DUKE L.J.* 959.

31. The source of this weight is the leading case on the topic, *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), wherein the independent directors met separately with their attorneys and financial advisors to consider what response, if any, to make a hostile tender offer. Absent evidence of such independence subjects the defensive maneuvers to extremely close scrutiny with the likely effect they will be struck down. See *Mills Acquisition Co. v. McMillan*, 559 A.2d 1261, 1287-88 (Del. 1988).

32. See *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 498-500 (Del. Ch. 1990) (presence of independent committee restores presumptions of fairness); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937-38 (Del. 1985) (same). For a case in which the committee was so compromised as not to shift the burden of proving intrinsic fairness from the controlling stockholder, see *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

in corporate doctrine are the more systematic structural efforts that rely on the independent director. Examples of such structural embraces are standing committees that are heavily populated, sometimes exclusively, by outside directors, such as the compensation, nominating,³³ and audit committees.³⁴

As illustrated above, a cornerstone of so much of corporate law today is the monitoring model, and more specifically, the outside director. The role for such directors is not defined as much by what the director knows as by the individual director's independence from management. The general fiduciary obligation of directors that they be reasonably informed with respect to any matter coming before them and, more generally, should adequately inform themselves on the conduct of the corporation's business fits somewhat poorly the outside director. One cannot easily come from outside—where she has extensive obligations—and be able to have an acute understanding of the internal workings of the firm or even its performance. The imbalance between, on the one hand, the fiduciary demands of directors and, on the other hand, the position of the outside director are addressed by the broad recognition, frequently even embodied in statutes, that directors may satisfy their duty to be reasonably informed by relying on the reports, opinions, and data prepared by others. The position set forth in the ABA Model Business Corporation Act is reflective of both the practical necessity and the board's authority to rely upon others in meeting the directors' duty to be reasonably informed:

In discharging board or committee duties, a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on information, opinions, reports or statements . . . prepared or presented by . . . legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence . . .³⁵

Approaches, such as that taken by the Model Act, may well be seen as purely enabling and not prescriptive of what directors should do. However, the above-quoted provision takes on a prescriptive quality when

33. *See, e.g.,* Gaillard v. Natomas Co., 256 Cal. Rptr. 702 (Cal. Ct. App. 1989).

34. *See generally* Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees*, 54 BUS. LAW. 1067 (1999).

35. A.B.A. Model Business Corporation Act § 8.30(d)(e)(2) (1998).

read against the general standards for director liability that envision liability when directors do not discharge their obligation to be reasonably informed and, more to the point of the attorney as director question, recognizes liability when it is established a director acted with:

[A] lack of objectivity due to the director's familial, financial or business relationship with . . . another person having a material interest in the challenged conduct (A) which relationship . . . could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation, and (B) after a reasonable expectation to such effect has been established, the director shall not have established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation . . .³⁶

The most straightforward implications of the preceding provision is that there are a range of issues in which the attorney as director will minimally have the burden of proving her vote was not corrupted by fear that to have voted otherwise would jeopardize the pecuniary relationship the attorney had with the corporation. Simply stated, there exists good cause to doubt that the attorney-director does not enjoy the same business judgment rule presumption of propriety when approving a transaction that involves a conflict of interest on the part of senior officers. To be sure, the attorney-director has the benefit of the few cases that have considered whether he is "interested" in the transaction before the board so he cannot be included among those deemed independent for the purposes of approving a self-dealing transaction involving senior management. The cases have consistently held that a director does not cease being independent solely because his firm enjoys substantial legal fees from the corporation.³⁷ Nevertheless, the case law is far from definitive. First, the suits finding that the attorney-director is independent arise primarily in disputes involving the securities law antifraud provision. In such cases, the issue is whether the corporation's decision to purchase or sell shares was carried out by an independent decision maker. In such a question, dominance or control of the decision-making process is the focus. In contrast, the governance issue that arises when independent directors are called upon to assess a conflict of interest transaction focuses upon the reasonableness of their actions.³⁸ In this case, the guidance from

36. *Id.* § 8.31(a)(2)(iii)(A)(B).

37. The leading case is *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979).

38. For an analogous approach, consider the actions of the SEC in amending the rules for the

provisions, such as the earlier-quoted excerpt from the Model Business Corporations Act, should call for a different focus regarding the independence of those advising the independent directors. Nevertheless, cases holding that the firm's counsel can be an independent director can as easily be read as also holding that other directors may continue to enjoy the protection of the state's business judgment rule when they rely upon the advice, report, or opinion of the firm's outside counsel who has a significant financial relationship with the firm.

However, one has reason to believe that the criteria that we apply in determining whether the attorney-director is to be viewed as an independent director is quite different from that of whether her fellow directors may justifiably rely upon the attorney-director in considering a conflict of interest transaction involving senior management. In such situations, courts have fairly consistently required that the attorney advising the subgroup of the board not be the same firm that customarily advises senior management. To conclude otherwise would be inconsistent with the aspirational requirement that reliance upon counsel is not permitted when the director has "knowledge that makes reliance unwarranted." An example is *Stepak v. Addison*,³⁹ an outside law firm that had served for many years as the company's counsel represented the individual officers in criminal proceedings and subsequently advised the outside directors in their consideration of a demand made upon the board that it initiate suit against the officers. The court held the directors' reliance upon counsel was outside the ambit of an informed business judgment. *Stepak* is consistent with the common practice among committee's impaneled to mediate or approve transactions pitting management, and/or its controlling stockholder against the corporation and/or its minority holders to retain advisors, legal and non-legal, who have no prior relationship with the corporation.⁴⁰

Investment Company act to condition future exemptions from regulatory provisions designed to protect the fund's shareholders from actions of its managers upon, among other factors, the approval of independent directors who are advised by counsel that is independent from the fund's advisors. *See* Role of Independent Directors of Investment Companies, Securities Act Rel. No. 33-7932 (Feb. 5, 2001).

39. 20 F.3d 398 (11th Cir. 1994).

40. The independence of council is a significant consideration in weighing the independence of a board committee charged with the responsibility of assessing whether the corporation's interest in derivative suit questioning a transaction by its managers. *See* *Einhorn v. Culea*, 612 N.W.2d 78, 93 (Wis. 2000); *Cuker v. Mikalauskas*, 692 A.2d 1042, 1048 (Pa. 1997). *See also* *Cutshall v. Barker*, 733 N.E.2d 973, 980-81 (Ind. Ct. App. 2000) (New counsel retained *after* initiation of derivative suit can represent the corporation and the committee without impugning the committee's independence.); *Drilling v. Berman*, 589 N.W.2d 503, 509 (Minn. Ct. App. 1999) (absence of relationship with the defendants by the committee's attorney weighed positively in assessing committee's independence).

The more difficult part of divining what implications to draw from the conflict of interest implications of the above-quoted provisions is what actually changes if the attorney, whose advice may be conflicted because of an important monetary relationship with the corporation through his ties with management, also serves on the client's board. The easy answer is that it is the attorney's professional, not directorial, relationship that is material in determining whether the attorney-director's board colleagues may justifiably rely on her advice. This response, however, ignores the important practical and perceptual dimensions of a conflict of interest.

To illustrate the problem, consider the following hypothetical. *Z* Company is engaged in the energy business and on December 20, *Z* will announce a self tender for its shares, offering \$5 above the share's current \$20 market price. Before the self tender is announced, *Z*'s board approves accelerating the exercise date of managements stock options, so they can be exercised on December 18 rather than later in the new year as presently provided. The result is that *Z*'s senior managers, who are aware of the forthcoming self tender, are likely to exercise their options before the shares rise to \$25 upon announcement of the self tender. By *Z*'s board resolving to accelerate the exercise date, the senior officers enjoy a substantial tax savings and the corporation loses a deduction equal to the applicable tax rate multiplied by the number of shares acquired through the options multiplied by \$5. Assume further that *Z*'s board, when making its decision, was advised by outside counsel who did not inform the board that a consequence of their decision the corporation would forego a large tax deduction. Is *Z*'s board's reliance on counsel any the less justified if that counsel is also a director of the corporation?

The astute observer of corporate law will note that the above hypothetical is only barely fictional; the facts reflect those in the landmark decision, *Zapata Corp. v. Maldonado*.⁴¹ In *Zapata*, the Delaware Supreme Court set forth the substantive review procedures to be followed in response to a recommendation of a special litigation committee that a derivative suit be dismissed. *Zapata* did not address the question posed

Thus, a special litigation committee's recommendation was viewed as flawed because it failed to be advised by counsel that was independent of the managers who were the subject of the committee's review. See *In re Pharm, Inc.*, 750 F. Supp. 641, 647 (S.D.N.Y. 1990); cf. *Kaplan v. Wyatt*, 499 A.2d 1184, 1190 (Del. 1985) (in-house counsel who merely scheduled interviews not fatal to the committee's independence).

41. 430 A.2d 779 (Del. 1981). Judicial review of special litigation committee recommendations is a highly nuanced subject—even within Delaware. For a review of the various approaches and issues faced within each approach, see JAMES D. COX *ET AL.* 2 CORPORATIONS § 15.8 (1st ed. 1995) (annually supplemented).

above: Is the board's reliance on counsel permitted when counsel is also a director? To address this question, consider the result if the directors did not rely on outside counsel, but instead relied on a report of one of the officers (its general counsel) who was known to be covered by the options and who ultimately benefitted by the exercise date being accelerated. This should strike most as a situation in which "reliance is unwarranted" because reliance is being placed upon an individual with a material financial interest in the transaction. Even if the general counsel was not covered by the option, his opining on matters, which could so directly affect the fisc of his superior, is cause for viewing the directors' reliance as unwarranted.⁴² The control over the future career of the general counsel by those who benefit from the acceleration of the exercise date demands the directors to be advised by independent counsel.

The final scenario assumes that no officer serves on the board, that outside counsel serves on the board, and that the outside counsel joins four outside directors in voting in favor of accelerating the options' exercise date. Because there is approval by a majority of the outside directors, even after discarding the vote of attorney-director, it could be concluded that the presumptions of the business judgment rule applies. However, to so conclude appears to overlook the clear significance of the requirement that reliance on counsel is permissible provided the director "does not have knowledge that makes reliance unwarranted." Accepting the guidance from the securities law cases holding that substantial legal fees alone do not render the attorney-director interested in a transaction, it is logical to believe that in order for the director to enjoy the benefits of such reliance, that individual must have the freedom to consider whether more than the size of the legal fees may compromise the attorney's judgment. For example, there exists a question of whether the legal fees are significant to that attorney's firm or that attorney's position in the firm. Moreover, there is every reason to believe that the threshold showing required to render reliance unwarranted is not the same as that which frustrates one's independence within the context of the state conflict of interest statute. Recall that state conflict of interest statutes carefully define the type of interest—direct or indirect—that defines who is independent for the purpose of reviewing and approving a conflict of interest transaction. The

42. Those who are under the control of the party engaged in a self-dealing transaction are not seen as independent. *See Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) (committee of "outside" directors empaneled to approve fairness of merger lacked independence because its members prior and on-going affiliations with companies controlled by the defendant and they received substantial compensation through such affiliations).

statutes also condition such approval being by the independent directors acting in “good faith.” This good faith requirement, unless it is to be rendered superfluous, transcends the narrower definition of director or indirect conflict of interest. As such, a relationship may not be of the type that falls within the scope of the type of transaction regulated by a conflict of interest statute, although it still may raise questions regarding one’s good faith. It is just such a matter that the approving body should explore if it is to enjoy the benefits of the not having “knowledge that makes reliance unwarranted.” This reasoning may, at first blush, however, appear to prove too much. If directors in the position to approve a self-dealing transaction must be skeptical of the advice they are receiving from the attorney-director, then they should likely be skeptical in all cases. After all, the complaint is that the source of our concern for the advice given is not due to the relationship of the attorney as director, but because of the attorney as attorney for the firm. That is, the infecting relationship is always present with outside counsel; we start with a very substantial conflict of interest (when the attorney is opining on a matter related to the senior executive’s dealings with the corporation) and add to it, perhaps only at the margins, when we make the advising attorney a director. Hence, the conflict does not arise upon the attorney’s appointment to the board. It already existed. Viewed in such a manner, any broad conclusion of directors who are not able to rely on counsel when counsel is a director must apply when the counsel is not also a director.⁴³ So, what separates the two situations? Is it only that the conflict is drawn more boldly when counsel sits as a director?

More than mere perception is at issue here. In such conflict of interest matters, the true divide is the ability of the non-conflicted directors to deliberate among themselves. Their internal deliberations can lead to many possible courses of action; one course could be to ponder the advice of counsel and perhaps question whether further external advice is necessary. When counsel is part of the deliberative process, the course of action directors may pursue is more circumscribed than when the directors cordially ask the advising counsel to wait in the hallway. The difference is neither subtle nor trivial. The requirement that counsel “does not have knowledge that makes reliance unwarranted” invites open and independent deliberations among the directors whether they should so rely. This

43. For the view that, because management—and more particularly the chief executive officer—retains outside counsel, such counsel when serving as a director should be considered an inside director in a similar manner as the CFO or other subordinate would be treated, see *Williams, supra* note 18, at 11.

decision-making cannot, as a practical matter, occur when the attorney-director is a participant in the deliberations. In the attorney-director setting, the outside directors could ask the attorney to recuse herself. Although this makes the directors' deliberations appear more independent, it also makes those who remain in the room look more like outside director committees in other contexts so that the analogy may well carry forward to demand that they too obtain fully disinterested counsel. Moreover, a decision to ask the attorney-director to recuse herself erodes the reasonableness of the remaining directors to rely upon the attorney as their attorney. Just what are the parameters for their considering whether it is appropriate to continue to rely on counsel to advise them on the same matter that they once doubted the independence of the advice counsel would provide on a conflict of interest transaction involving senior management?

Thus, the dual service by the company's attorney can be seen as expanding the instances in which board committees must be impaneled to address conflict of interest transactions. In a sense, such stratification of the board is natural, regardless of there being dual service, because the common approach for conflict of interest transactions is to focus upon the approval by the disinterested directors. However, as seen above, with dual service, the segregation of directors does not occur along the lines of those who have a direct financial interest in the transaction and those that do not. Instead, the divide is with those who appear to be financially linked to the transaction or financially dependent upon management. This separation moves the transaction and the process toward, if not to, the presently recognized instances in which a subcommittee of the board addresses special conflict of interest problems, such as takeover defenses, where the conflicts of interest are indirect, not direct. As addressed *supra*, in those instances, courts have grown accustomed to the independent directors being advised by their own counsel and other advisors. That is, independence in the subcommittee context implicates not just the individual director's status, but also the information that the independent director receives in the decision-making process. Thus, the paradox for the attorney-director who serves on his client's board is that such service likely expands the instances in which a competing law firm gets its foot in the boardroom door. This is hardly the desire or the goal of the attorney in deciding to undertake such service. Moreover, the managers who invite the attorney to join the board will find that dual service expands the instances when their conduct will be assessed by a independent board committee that is advised by counsel unfamiliar to management.

IV. DUAL SERVICE AND THE SECURITIES LAWS

The disclosure requirements of U.S. securities laws appear on many fronts, including those the issuer must make in connection with the public or private placement of its securities, the periodic reporting of information required for public companies, proxy solicitations, takeover requirements, disclosures needed to update and correct earlier releases of information, and the more pervasive need for public announcements not to commit half truths. The linchpin for assuring a company's compliance with the securities laws is the attorney. Regularly, it is the attorney, most likely outside counsel, whose expertise in the nuanced and arcane requirements of the securities laws enables her to advise the client on when disclosure must occur as well as what must be disclosed. Because of their central role, lawyers are correctly seen as among the gatekeepers for the integrity of the disclosure requirements of securities laws. Although lawyers do not provide the same certification function as do accountants, and lawyers' reputations are not nearly as important as those of underwriters distributing the issuer's securities,⁴⁴ the lawyers' expertise in interpreting the demands of the securities laws naturally thrusts them to the forefront to guide the client through the regulatory thicket.

Among the most significant developments within the securities laws are the professional requirements for lawyers advising clients on securities law issues. These developments occurred not around state or ABA standards, but through interpretations of the disclosure demands of the securities laws. At one level, all lawyers fear their reputations will be harmed should they assist their clients in engaging in an act later deemed to constitute a securities violation. That fear takes on a special significance when more than the lawyer's reputation is at risk for participating in the client's violation. Lawyers can be aiders and abettors of their clients' violations, and are sometimes even included among the primary participants of a securities violation. The focus here is not to review these developments that expose the lawyer *qua* lawyer to responsibility under the securities laws, but to examine closely how the role of lawyer as gatekeeper is affected by also serving on the client's board of directors.

44. See generally Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15 (1995).

A. Heightened Diligence for Registered Public Offerings

The gatekeeper designation is most apparent in Section 11 of the Securities Act of 1933, which is the most specific of all the securities law liability provisions in identifying those who can be held financially responsible. Section 11 conscripts to the gatekeeper role senior management, the issuer's directors, all the underwriters, and those who provide an express certification function, such as accountants. It assigns to each such designated person liability for a material misrepresentation in the registration statement unless the person establishes compliance with section 11's demanding due diligence requirements, namely that the designated person "had, after reasonable investigation, reasonable ground to believe and did believe" the registration statement was not materially misleading.⁴⁵ The quarterbacks for the registration statement, the issuer's attorney and the underwriter's counsel, are both noticeably lacking from this exclusive list of possible defendants. These two attorneys customarily have a significant involvement in the preparation and review of the registration statement. Moreover, attorneys are not swept into section 11 liability through the Act's control person provision.⁴⁶

In contrast to the attorney *qua* attorney who escapes statutory responsibilities under section 11, the attorney who also serves on the client's board has significant exposure to liability under section 11. The most dramatic illustration of this is *Feit v. Leasco Data Processing Equipment Corp.*,⁴⁷ where the court held that Leasco's registration statement covering securities to be issued in its acquisition of Reliance Insurance Company was materially misleading in failing to disclose that as a result of the acquisition Leasco would gain control of approximately \$100 million in assets (the "surplus surplus") that was not necessary for operating Reliance's insurance business.⁴⁸ Among Leasco's directors was Hodes, an attorney with the law firm that represented Leasco.

As the court in *Feit* describes:

Hodes [had] been a director . . . three years or more at the time of this registration statement. He participated extensively in the

45. Securities Act § 11(B)(3)(A), 15 U.S.C. § 77k(b)(3)(A) (2000).

46. Liability of controlling persons for Section 11 violations can arise under Section 15 of the Securities Act, 15 U.S.C. § 77o (2000). One's ability to persuade and counsel does not render one a control person. See *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986). However, the director who is the general counsel and reviewed most corporate disclosures fits the control person designation. See *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396-97 (11th Cir. 1996).

47. 332 F. Supp. 544 (E.D.N.Y. 1971).

48. *Id.* at 550-51, 572-74.

discussions leading up to the exchange offer for Reliance shares . . . and was constantly involved in the deal throughout both the preliminary and execution stages of the transaction. He, or a representative of his law firm, attended all meetings and was consulted on all matters pertaining to the acquisition. He was directly responsible for preparation of the registration statement and initiated all the research regarding reorganization of Reliance and separation of its surplus surplus.⁴⁹

Because of Hodes' deep involvement with the issuer and the acquisition, a level one would find unremarkable for outside counsel, the court treated him as an "insider."⁵⁰ The distinction between inside and outside director is not found in the text of section 11, but arises from the courts' interpretation of the due diligence defense wherein what constitutes a "reasonable investigation" or "reasonable ground to believe" is informed by, among other factors, the individual's expertise and involvement with the issuer. Therefore, in the classic securities law decision, *Escott v. BarChris Construction Corp.*,⁵¹ the attorney-director Grant was unable to establish his due diligence defense, grant failed, among other matters, first, to review the purported contracts with customers that managers falsely represented firm orders, and secondly, to review the agreement with the issuer's factor, which doing so would have revealed that the issuer was the guarantor of the total amount of customer notes sold to the factor but which the managers represented the issuer was only responsible for twenty-five percent.⁵² The attorney-director, certainly if deeply involved in overseeing the preparation of the registration statement, has a more substantial burden than other non-management directors because he is readily treated as an insider on a scale equal to the company's officers.

Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the registration statements than outside directors.⁵³ Indeed, the burden on the attorney-director appears to even

49. *Id.* at 576.

50. *Id.*

51. 283 F. Supp. 643 (S.D.N.Y. 1968).

52. *Id.* at 689-92.

53. *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 579 (E.D.N.Y. 1971). The court, in fact, goes even further, to hold that Hodes, like other insiders, as part of their obligation to undertake a reasonable investigation had a duty to expend non-trivial efforts in an attempt to learn if

exceed that imposed upon the underwriters. In a recent decision, the Ninth Circuit reversed the district court's grant of the underwriter's motion for summary judgment that was based upon the underwriters uncritical acceptance of managements' representations.⁵⁴ In reversing on this point, the panel reasoned that underwriters are under an obligation to play devil's advocate with management's representation but stopped short in its reasoning of requiring, as *BarChris* and *Feit* had, that for underwriters to satisfy their due diligence obligations they must independently examine documents supporting management's representations.⁵⁵ On this point, it is relevant that the underwriters in *Feit* were deemed to have established their due diligence defense because of their counsel's reliance upon representations by Leasco's management that was not contradicted by other publicly available information available to the underwriters and their counsel.⁵⁶ However, had their counsel also served as a director, the result likely would have been different.

As interpreted by *BarChris*, *Feit*, and *Software Toolworks*, the protection afforded investors by section 11 is greatly heightened when the issuer's counsel serves on his client's board compared to when he does not. Absent service on the corporation's board, the attorney at most is faced with liability under the general antifraud provision for which liability requires at least reckless behavior on the attorney's part.⁵⁷ Even this liability does not exist in the circuits that require the misleading statement be attributed to the defendant before he can be a primary participant.⁵⁸ Furthermore, the attorney's direct liability to investors

Reliance had surplus surplus. Thus, the court's reasoning is not limited to the narrower basis that Hodes must have known there was significant surplus surplus such that he could not meet the "reasonable ground to believe" prong of his due diligence defense. Much like Grant in *BarChris*, the court separately concluded he failed to demonstrate he carried out a "reasonable investigation." *Id.* at 580-81.

54. *In re Software Toolworks, Inc.*, 38 F.3d 1078 (9th Cir. 1994), *rev'g in part and aff'g in part* 789 F. Supp. 1489 (N.D. Cal. 1992).

55. *See id.* at 1088.

56. *Feit*, 332 F. Supp. at 582-83.

57. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200-01 (1976). Regarding the meaning of scienter, and particularly the different formulations of recklessness, see JAMES D. COX ET AL., *SECURITIES REGULATIONS CASES AND MATERIALS* 730-34 (3d ed. 2001).

58. *See, e.g., Ziembra v. Cascade Int'l, Inc.*, 256 F.3d 1194 (11th Cir. 2001) (lawyers who draft, edit and review the client's misleading promotional materials cannot be responsible under section 10(b) and rule 10b-5 as primary participants unless the investors who relied upon the reports can attribute the misleading statements to the attorney); *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998) (same for accountants). Circuits adhering instead to the "substantial participation test" reach a different result. *See, e.g., In re Software Toolworks, Inc.*, 50 F.3d 615, 629 (9th Cir. 1994) (invoking the substantial participation test, accountants and underwriters are primary participants when they draft, review, and edit misleading materials, even though the materials are attributed only to their

outside the securities laws is even more doubtful—barring actual fraudulent intent.⁵⁹ However, the attorney as a director is subject to the full demands of the due diligence defense. The attorney so invited to serve on the corporation's board can be expected to have an involvement in the client's affairs equal to that of Grant in *BarChris* or Hodes in *Feit*. The leading commentary on the meaning of *BarChris* crisply states the section 11 burdens imposed on the attorney-director:

In short, assuming that every director's investigation must meet certain qualitative standards, for the attorney-director the higher standard stated and applied in *BarChris* would mean doing many of the same things as other directors but doing them in a more professional way (as befits a professional man), conducting a more extensive and intensive investigation and, most importantly, verifying facts.⁶⁰

To be sure, the demands placed upon attorney-directors, such as Hodes in *Feit* or Grant in *BarChris*, may call for no greater skill, care, and competence generally expected of professionals providing service to their clients. However, one cannot be blind to the fact that the standard for diligence and magnitude of liability under section 11 are much greater than arise in connection with a professional malpractice claim.⁶¹ Thus, exposure to section 11 liability by serving on the client's board will enhance the attorney's commitment to perform at such a professional level. Therefore, one has every reason to believe that courts' treatment of the attorney as insiders such as in *BarChris* and *Feit*, and the concomitant ratcheting up of the meaning of due diligence, will reduce the frequency and scale of misleading statements in the registration statements.

client).

59. See *infra* note 60.

60. Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case, Part I - Section 11 of the Securities Act of 1933*, 55 VA. L. REV. 1, 35 (1969).

61. Professor Folk points out that one important area of difference is that the burden of proof is on the malpractice claimant to prove nonadherence to professional standards, whereas Section 11 places the burden on the plaintiff. *Id.* at 36. More troubling is that ordinary or even gross negligence does not give rise to a cause of action on the part of remote users of financial information, and recovery on behalf of the corporation may be limited by procedural impediments that accompany derivative suits or because they can be laid to the firm's managers. See, e.g., *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 457-58 (7th Cir. 1982).

B. Signing Form 10-K

The securities law implications of an attorney serving on his client's board of directors are much more straightforward in the context of section 11 responsibilities than they are under the antifraud provision section 10(b). In most litigation under the antifraud provision, dual service does not change the result. However, after the rejection of aiding and abetting liability in *Central Bank of Denver v. First Interstate Bank of Denver*,⁶² dual service assumes great significance when the misleading statement appears in the client's Form 10-K. In this setting, the significance of the attorney's dual capacity arises from the holding of *Central Bank of Denver* that defendants are responsible only for those misrepresentations they "make."⁶³ Under the liberal "substantial factor" approach, the attorney becomes such a primary participant through drafting, editing, and reviewing the misleading portions of the document—assuming such activities are committed with the requisite scienter.⁶⁴ However, some circuits follow a much more conservative approach. Relying upon the reasoning of *Central Bank of Denver* that aiding and abetting liability, if permitted, would also lift the plaintiff's obligation to prove reliance, these courts impose the additional requirement that the misleading statement must on its face be attributable to a person before that person can be a primary participant.⁶⁵ Under this approach, the attorney who crafts the misleading statement that appears in her client's reports is not liable under the antifraud provision if that report does not expressly attribute the statement to the attorney.⁶⁶ However, when the report is a document filed

62. 511 U.S. 164 (1994). On the general scope of primary participant liability after *Central Bank of Denver*, see Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999), and Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691 (1997). On the scope of possible approaches for extending liability as a primary participant beyond those who transact directly with the defrauded plaintiff, see James D. Cox, *Just Deserts for Accountants and Attorneys After Bank of Denver*, 38 ARIZ. L. REV. 519 (1996).

63. *Id.* at 520.

64. See, e.g., *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263 (6th Cir. 1998) (en banc) (attorney who in conversations with investors repeats misrepresentations of his clients is a primary participant); *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996) (primary participant liability sufficiently pleaded by allegations the accountants had drafted, reviewed, and edited misleading financial announcement); *In re Software Toolworks, Inc.*, 50 F.3d 615, 627, 629 (9th Cir. 1994) (same).

65. See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 177 (2d Cir. 1998).

66. See *Ziembra v. Cascade Int'l Inc.*, 256 F.3d 1194 (11th Cir. 2001) (primary participant liability requires those who draft, edit, and review the misleading representations be identified). Cf. *In re Kendall Square Research Corp. Sec. Lit.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (accountant who

with the SEC whose rules require the signature of the issuer's board of directors, the requisite attribution is provided. In this case, the attorney who also serves on the client's board and signs the Form 10-K thereby loses anonymity and is liable.⁶⁷ To the extent such a threat of liability elicits greater caution on the part of the attorney than underlying professional standards, we can conclude dual service results in some increase in investor protection.

C. Professional Obligations Under Rule 102(e)

A more intriguing dimension of the attorney's service on the client's board is its dual impact upon the attorney's obligations pursuant to Rule 102(e)(ii) of the SEC's Rules of Practice⁶⁸ and its impact on the securities law obligations of other members of the board. This provision authorizes the SEC to undertake disciplinary action against those who "practice" before the Commission when, among other forms of misbehavior, the person is "found by the Commission" to have engaged in "unethical or improper professional conduct."⁶⁹ The full effect of this provision is set forth in *In re Carter*.⁷⁰

Carter and Johnson were outside attorneys for National Telephone Company. On several occasions they had advised National's CEO, Sheldon L. Hart, that National should disclose the full terms of its lending agreement with a consortium of banks, which, if triggered (as it ultimately was), would require a winding down of National's business. The facts set forth in the SEC enforcement proceeding clearly documented Hart's total disregard of this disclosure advice. The Commissioners in *In re Carter*

merely reviews and approves circulation of financial statements is not a primary participant if its name is not associated with the false representations therein).

67. This is true because SEC Form 10-K is required to be signed by at least a majority of the corporation's directors. See Securities Exchange Act Form 10-K, General Instructions D (2)(a), published in 5 Fed. Sec. L. Rep. (CCH) ¶ 31,102, at 22061. Those who sign the report with knowledge that it includes a material misrepresentation are deemed to have "made" that representation and, hence, are primary participants, even under the heightened attribution standards of *Wright*. See *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000); *In re JWP, Inc.*, 928 F. Supp. 1239 (S.D.N.Y. 1996).

68. 17 C.F.R. § 201.102(e) (2002).

69. *Id.* Refinements purporting to introduce clarity and coherence to this standard as it applies to accountants was added by subsection (iv) of rule 102(e) in 1998. See Securities Act Release No. 33-7593 (Nov. 16, 1998). However, this change did not address similar concerns with respect to other professionals, such as lawyers. See Daniel L. Goelzer & Susan Ferris Wyderko, *Rule 2(e): Securities and Exchange Commission Discipline of Professionals*, 85 NW. U. L. REV. 652 (1991).

70. *In re Carter*, Exchange Act Release No. 17,597 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,150 (Feb. 28, 1981).

announced the following as being among the duties of the securities lawyer:

When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.⁷¹

Initially counselling accurate disclosure is sufficient, even if the advice is not accepted. However, there comes a point at which a reasonable lawyer must conclude that the client is not following his advice, or perhaps his advice was not even sought in good faith, and that the client is involved in a continuing course of violating the securities laws. At this juncture, the lawyer must take further, more affirmative steps, in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of nondisclosure:

The lawyer is in the best position to choose his next step. Resignation is one option A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try to enlist the aid of other members of the firm's management. What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client.⁷²

Observe that neither Carter nor Johnson served on National's board, and observe further, that the above-described chain of obligations when dealing with the obviously uncooperative manager appears to place the attorney's direct resort to the board of directors on the same level as resigning. Whatever the next step, the Commission calls for "some prompt

71. *In re Carter*, *supra* note 70, at 84,172. The recently enacted Public Company Accounting Reform and Investor Protection Act of 2002 (more generally, Sarbanes-Oxley Act), PL 107-204 (July 30, 2002), codifies rule 102(e) and calls for the SEC to adopt rules for attorneys practicing before it requiring steps similar to those set forth in Carter-Johnson when the attorney learns of a material violation of the securities laws.

72. Goelzer & Wyderko, *supra* note 69, at 664-65. Because the Commissioners viewed the standard for conduct it believed proper for securities lawyers confronting an uncooperative client, such as Hart, was new, it did not discipline either Carter or Johnson.

action” on the part of the attorney. Within the Commission’s crisp formulation of the securities lawyer’s obligations, several conclusions arise from the additional feature of that lawyer serving on his client’s board. First, such service makes it more likely that the attorney will be aware earlier than if the attorney does not have a dual capacity that the manager is ignoring the attorney’s disclosure advice. Indeed, had this occurred, Carter and Johnson no doubt would have learned much earlier that National’s financial state had reached the point that the draconian wind-down provision of the loan agreement had been triggered. This late notification necessarily meant that their disclosure advice would have occurred even earlier than if they were not board members and had learned of the company’s deteriorated financial position. Second, the apparent hurdle the Commission envisioned with the attorney bypassing management and taking her concern to the board should be lower when the attorney is also a director. When the issue is raising a concern regarding the company’s disclosures with one’s fellow directors, it is reasonable to view direct resort to the board of directors should not be seen as such a substantial step as to place it on the same level as resignation of the firm’s attorney as the Commission states it to be in the above-quoted formulation of the attorney’s obligation. Absent the attorney serving as a director, going to the board obviously strains the relationship between the CEO and the attorney—a point that indubitably explains why the Commission placed this alternative on footing equal to that of resignation. However, the conflicting fiduciary obligations of the attorney to inform the fellow directors of a matter bearing on managements’ stewardship⁷³ places this option at a lower order in terms of its collateral impact than when the attorney is not also a director. Thirdly, because the option of reporting the attorney’s concerns directly to the board of directors is not an unexpected or unauthorized communication, there is every reason to believe that the attorney’s resort to the board should occur earlier than would be the case when there is no dual service.

D. Reliance Upon Counsel Defense

The final dimension of dual service under the antifraud provision focuses upon the ability of other directors to rely upon the advice of the attorney when the charge is they acted recklessly. The ability of officers

73. See, e.g., *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787 (S.D.N.Y. 1978) (recognizing obligation of directors to inform fellow directors of conflict of interest on the part of investment banking firm advising firm on its acquisition).

and directors to rely upon counsel's advice regarding their disclosure obligations is well recognized.⁷⁴ Although such reliance is not a complete defense, but only a factor in considering whether the person relying acted with scienter, the presumption of absence of reliance is a high one if all the factors of the defense are made out.⁷⁵ Similar to the approach taken in so many areas, inquiries into whether the directors acted with scienter, especially whether they acted recklessly in meeting their disclosure obligations, is informed by the fiduciary obligations of directors under state law. For example, in *In re Digi Int'l, Inc. Securities Litigation*,⁷⁶ the Eighth Circuit upheld the granting of the outside directors' motion for summary judgment on whether they acted with scienter upon proof they relied in good faith upon the advice of counsel. The issue before the court was the propriety of recognizing revenue arising from a complicated and novel business transaction. The accountants changed their opinion on the matter several times, but counsel remained firm on the pivotal issue upon which revenue recognition depended.⁷⁷ If one reviews *In re Digi* through the lens of state law doctrine, there is ample reason to conclude the record revealed no evidence rendering the directors' reliance inappropriate.

The more troubling question of the directors' reliance on the disclosure advice of the director-counsel arises in the instances described earlier where reason suggests that to discharge their state law monitoring obligations in self-dealing transactions that the directors' independence is seriously compromised if they are advised solely by the attorney-director. To illustrate this, consider the facts of the classic decision in *United States v. Dixon*.⁷⁸ Lloyd Dixon, president of AVM Corporation, concealed substantial loans he received from AVN by repaying the loans (with funds borrowed from others) just before the close of the fiscal year. He defended his non disclosure of the loans on the firm's Form 10-K and proxy statements by arguing he believed, albeit erroneously, that loans to company officers need be disclosed only if they were outstanding at the end of the fiscal year. The court rejected this defense, relying upon a trial

74. The classic work on this subject is Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976).

75. The defendant seeking to invoke the defense must prove that "[1] he made complete disclosure to counsel, [2] sought advice as to the legality of his conduct, [3] received advice that his conduct was legal, and [4] relied on that advice in good faith." *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir. 1994). See also *SEC v. Savoy Ind., Inc.*, 665 F.2d 1310, 1315 (D.C. Cir. 1981).

76. Exchange Act Release No. 00-3162 [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,467, at 96,794 (July 25, 2001) (8th Cir. 2001).

77. *Id.* at 96,796.

78. 536 F.2d 1388 (2d Cir. 1976).

court finding that Dixon knew that the SEC rule required disclosure of any loans above specified amounts to company officers during the year—regardless of whether they were outstanding at the end of the year.⁷⁹ Now, consider what the position would be if the issue is whether the directors who signed the Form 10-K had recklessly committed a disclosure violation.

The most intriguing interface between directors' state law obligations and their disclosure obligations under the federal securities laws arises in the self-dealing context. Certainly, we would not wish for AVM's directors to rely on Dixon regarding how the loans should be treated on the forthcoming Form 10-K. *In re Digi* supports the view that the outside directors can rely on outside counsel. Although that case did not concern a matter of self-dealing, it did focus on when the company could recognize revenue, which could indirectly affect, for example the bonuses of managers so that their neutrality on the outcome of the attorney's opinion is a matter of great interest to them. However, does some of the protective shield of *In re Digi* disappear if the advising attorney is a boardroom colleague? As seen earlier, this dual relationship seems to pose a serious conflict under state law. Because independence goes to the process—a matter that is exclusively before the states, whereas scienter bears upon the directors' state of mind—the conclusions one reaches on reliance upon counsel in the former context need not guide you in the latter. Certainly, the elements of a recklessness inquiry that bear upon the directors' state of mind should allow inquiry into whether they foolishly relied upon counsel. In making this inquiry, the insights from Part III assume special prominence. Just as reliance would appear unjustified if the AVM directors were aware of Dixon's yearly reversal of the loans, should not their reliance be misplaced when it is reposed upon counsel whose ongoing relationship with the firm was dependent upon Dixon's approval? Here prudence would appear to call for a second opinion, much as occurred in *In re Digi*. Failure to do so, and the directors' reliance upon counsel, could well be reckless. At the same time, their willingness to seek a second opinion, as seen earlier, likely will be compromised when the attorney has a dual capacity. Furthermore, failing to obtain another opinion under these circumstances likely suggests recklessness on the part of the directors because they have thereby incurred a known risk that the disclosure advice they are receiving is compromised because of their own reluctance to obtain independent advice. Thus, the directors may lose the

79. *Id.* at 1395.

benefit of the defense of reliance upon counsel when their attorney has a dual relationship with the firm.

CONCLUSION

There is no data indicating how frequently the attorney serves on his client's board. Casual conversation suggests this is the exception and not the rule. Attorneys who agree to so serve are not acting unprofessional, but they do incur additional burdens in so doing. The analysis of this Article shows concerns not yet considered in the long debate on the desirability and implications of dual service. As shown here, the costs of dual service for both the client and the attorney are much greater than has been captured by earlier commentators. Even so seen, the competitive legal landscape is such that we can expect dual service not merely to grow with time as law firms become increasingly concerned about securing their relationship with the corporate client. If this occurs, the implications examined here will no doubt become reality.

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