

**ETHICS: ARE LAWYERS THE LAST LINE OF DEFENSE FOR  
CRITICAL ACCOUNTING, CORPORATE GOVERNANCE AND  
AUDITING ISSUES UNDER SARBANES-OXLEY?**

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## **ETHICS: ARE LAWYERS THE LAST LINE OF DEFENSE FOR CRITICAL ACCOUNTING, CORPORATE GOVERNANCE AND AUDITING ISSUES UNDER SARBANES-OXLEY?**

### **I. INTRODUCTION**

In representing the organizational client, the corporate lawyer often confronts conflicting duties of loyalty, confidentiality, and zeal owed to the various “constituents” or interest groups that make up the organizational client. In the case of a corporation, these “constituents” may consist of a board of directors, management and shareholders.

Problems for the corporate and securities lawyer arise because at various times, including securities offerings and corporate acquisitions, the interests of the organizational client’s constituents diverge. The corporate counsel is then placed in the position of determining who commands his primary loyalty and how he can adequately fulfill his duties and responsibilities to each constituent in the face of their conflicting interests. Because the Model Code and Model Rules fail to explain how a corporate lawyer can determine the “entity’s” interest in such situations, the lawyer must confront competing loyalties and duties of confidences to the various groups with little or no guidance as to how he might resolve the conflicts.

Reycraft, Conflicts of Interest and Effective Representation: The Dilemma of Corporate Counsel, 39 Hastings Law Journal 605, 608-609 (March 1988).

This paper will briefly address the history of the ethical rules applicable to the corporate attorney and then set forth the various conflicts and competing interests that the corporate attorney may encounter. After a brief discussion and comment on the recent focus on attorney “professionalism,” the Appendices set forth the Model Rules applicable to the corporate attorney as adopted by the American Bar Association, a specific example of the Association’s Model Rules, and one state’s effort to stress “professionalism” in the regulation of attorney conduct.

### **II. HISTORY OF PROFESSIONAL ETHICS**

#### **A. American Bar Association Model Code and Model Rules**

In 1908 the American Bar Association (“ABA”) enacted 32 Canons of Professional Ethics. In 1969 the

ABA replaced its Canons with the Model Code of Professional Responsibility. Most states adopted codes of professional responsibility based upon the ABA’s Model Code.

The Model Code was organized into canons, ethical considerations, and disciplinary rules. The canons provided the theoretical structure and set forth general directives to lawyers about the law of professional responsibility. The ethical considerations were more detailed than the canons and discussed the actual fact situations that might arise under each canon. The ethical considerations were aspirational in nature only and were not considered binding, although lawyers were supposed to strive to follow them. The disciplinary rules were provisions that lawyers had to follow in order to avoid disciplinary liability. The rules established the minimum standards that were enforced by the disciplinary committees.

In response to criticisms about the Model Code’s focus on litigation and the Code’s structure of canons, ethical considerations, and disciplinary rules, the ABA established the Kutak Commission (named for its Chairman, Robert Kutak) to draft another code of ethics. In 1983 the Model Rules of Professional Conduct replaced the Model Code, based on the work of the Kutak Commission. The Model Rules were organized in an approach that was similar to the restatement, with the rule in the text and elaboration in the comments.

Although the ABA codes of conduct only have force as a body of rules with its voluntary members, the ABA Model Rules were designed to serve as a model for states to consider and adopt, and indeed the ABA codes have been used as the basis for state and federal codes. The enactment of the ABA Model Rules caused most of the states to at least reconsider their local codes of ethics. Approximately 35 states have replaced their codes based upon the structure and content of the Model Rules. States that have adopted some version of the Model Rules include: Arizona, Arkansas, Connecticut, Delaware, District of Columbia, Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Washington, West Virginia, Wisconsin, and Wyoming. ABA/BNA Manual on Professional Conduct 01:3 (1991)(State Ethics Rules).

#### **B. Texas Disciplinary Rules of Professional Conduct**

In 1984 the State Bar of Texas formed the Model Rules of Professional Conduct Special Committee, led by Orrin Johnson, to consider the ABA Model Rules

for possible adoption in Texas. In 1989 the new Texas Rules were adopted by the Bar membership and became effective January 1, 1990.

The Texas Committee started with the Model Rules, but made many changes for several possible reasons:

- To conform to Texas practice; e.g., forwarding fees; *Compare* Texas Rule 1.04(f) and Model Rule 1.5(e);
- To adopt standards higher than those proposed by the ABA; e.g., revealing confidences and client information; *Compare* Texas Rule 1.05 and Model Rule 1.6;
- To restore omitted standards; e.g. the prohibition of threatening disciplinary charges to gain an advantage in a civil matter; *Compare* Texas Rule 4.04 and former Model Code DR 7-105; or
- To reflect more acceptable disciplinary standards; *Compare* Texas Rule 1.04(a) and Model Rule 1.5(a) (“unconscionable” versus “unreasonable” fee).

Schuerk & Sutton, A Guide to the Texas Disciplinary Rules of Professional Conduct, 27A Hous. L. Rev. 1, 7 (1990).

### III. INSIDE COUNSEL AND OUTSIDE COUNSEL

#### A. Definitions

Basically two different groups of attorneys perform corporate work, inside and outside counsel. Inside or house counsel are usually corporate employees who devote all of their professional time to the service of a single client, their employer, and receive a salary.

Outside counsel are usually involved in private law practice and typically advise several corporate clients, although some outside counsel may devote all of their practice to a single client. Outside counsel normally negotiate a fee.

#### B. Legal Status of House Counsel

In the law of professional responsibility, house counsel are basically treated the same way as outside counsel in private practice. For instance, when performing legal services, house counsel can and must invoke the attorney-client privilege, as well as observe any other rules designed to protect confidential client information. House counsel owe the client corporation the same duties of zeal and loyalty as are owed by outside counsel. House counsel are also subject to

disciplinary powers of the state in which they practice and are licensed.

### IV. ETHICAL ISSUES FOR THE CORPORATE COUNSEL

#### A. Who is the Client?

Model Rule 1.13(c) states that an attorney employed or retained by an organization represents the organization acting through its duly authorized constituents. A corporate lawyer and the corporation have a fiduciary relationship. *Bryan v. Bartlett*, 435 F.2d 28, 37 (8<sup>th</sup> Cir. 1970), *cert. denied*, 402 U.S. 915 (1971). *See also, Lane V. Chowning*, 610 F.2d 1385, 1389 (8<sup>th</sup> Cir. 1979)(lawyers who represent a corporation serve in the same fiduciary capacity as directors). Therefore, the loyalty of the corporate lawyer must be directed solely toward the interests of the entity.

A corporate lawyer does not, however, owe a similar fiduciary duty to any individual officer or director of the corporation. *See* Model Rule 1.13, comments 3 and 8. This means that when the interest of the corporation as a whole and any of its officers or members materially diverge, the corporation’s attorney must pursue the interests of the whole and not the divergent interests of any of the parts. The corporation’s attorney may attack the interests of the officer only because of the attorney’s overriding duty to pursue the interests of the corporation. For instance, the corporate lawyer may not assist one group of shareholders in achieving an advantage over other shareholders with respect to ownership or control of the organization. Further, the corporate lawyer may not aid one group of shareholders to set up a competing enterprise.

A conflict of interest question may arise when a former corporate officer or director is later engaged in litigation with the corporation. The former director or officer may have shared confidential information with the corporation’s attorney while the officer was with the corporation. Probably much of that information would have been protected by the attorney-client privilege, but the fact that the communication was confidential would not prevent the attorney from appearing on the corporation’s behalf against the former official. Basically the corporation and not the officer would have the right to determine whether to waive the right to confidentiality. A corporate officer or director should therefore assume that any confidentiality to be assigned to communications with the corporation’s lawyer would be assigned for the benefit of the corporation and not for the benefit of the officer or director. *See* Model Rule 1.13, comment 3.

The conflict problem might be avoided by ensuring a definite understanding among the corporate constituents as to where the corporate attorney’s first

loyalties lie. All interested parties should be made aware of, and the corporate attorney should be certain and consistent about, the extent to which the corporate attorney represents the various interests of the corporate constituents. See Model Rule 1.13(d) and comments 8 and 9.

### B. Former Client Corporation Conflicts

Under the Model Rules, as a former client the corporation can object to any representation by its former attorney that would be directly adverse to the corporation. Model Rule 1.7(a). The Texas Rules go further to provide that as a former client, the corporation can object to any representation by its former lawyer that is adverse to the corporation and is substantially related to any matter handled by the lawyer during his tenure as the corporation's lawyer. Texas Rule 1.06(b). Since the lawyer may have been extensively exposed to the corporate business during his tenure as corporate counsel, the scope of disqualification may be quite broad under the substantial relationship test for former client conflicts of interest.

### C. Situations In Which Constituent Interests Diverge

Some typical situations wherein the corporate attorney might encounter possible conflicts of interest problems include:

- Sale of the corporation or stock in the corporation;
- Cases of fraud and self-dealing by management (e.g., failure to make the appropriate disclosures in securities offerings);
- Battles for corporate control;
- The departure of one of the principal officers from the corporation; and
- A shareholder derivative or other direct action brought against the corporation and its officers and directors.

### D. Different Roles of Counsel

Corporate attorneys may be involved with the corporation in many different roles beyond the typical rendering of legal opinion. For instance, corporate attorneys may be associated with the corporation as a director or investor, or even as an officer. However, when adopting different roles within a corporation, the

attorney may encounter several conflicts or liability risks.

Lawyers are more vulnerable to lawsuits when they step out of their professional role and take a more active part in their client's business by promoting deals, soliciting investors, conducting meetings at the firm's premises, and becoming tied to client companies as directors or general partners. Such conduct makes lawyers appear less like advisors and more like principals, who may be charged with, participating in and furthering the client's wrongful conduct. *Reycraft, supra* at 615.

#### 1. Director or Officer

Should an attorney agree to serve as an officer or a member of the board of directors of the client corporation? The Model Rules apparently permit it. See Model Rule 1.7, comment 14. Several arguments could be advanced against a corporation's attorney also serving as a member of the board: (1) the possible threat to the professional independence of the attorney; (2) the possible disqualification of the attorney-director and his firm from representing the corporation in any suit in which the lawyer-director would be named as a defendant-director; (3) the possibility that the attorney-director's conversations with other corporate officers might not qualify as privileged attorney-client communications; and (4) the possibility that the damage liability of the director-lawyer might increase along with the director-lawyer's higher standard of care as a director.

Perhaps attorneys should be prohibited from serving as directors or officers of the companies that they advise, as is the case with accountants. See American Ass'n of Certified Pub. Accountants, Code of Ethics, Rule 101 (1980). However, two possible arguments may be advanced in support of the Model Rule:

- Economic reality: the feeling of outside lawyers that their corporate retainer would be more secure if they also served as a member of the corporation's board or management; and
- Management's perception: the feeling of management that the lawyer would become more familiar with the corporation's affairs, and the other members of the board would benefit from the attorney's presence during meetings.

Wolfram, *Modern Legal Ethics*, p. 424 (West Publishing Co. 1986). Note that comment 14 to Model

Rule 1.7 does not prohibit such a dual role unless the attorney would be unable to exercise his independent professional judgment.

## 2. Corporate Investor

Outsiders may attempt to gain control of the corporation. During these attempts the attorney-shareholder's support might create serious conflicts of interest.

## V. SHAREHOLDER DERIVATIVE ACTIONS

### A. The Nature of the Conflict

A shareholder derivative action is usually brought by one or more shareholders on behalf of the corporation in order to recover against one or more third parties that are alleged to have wrongfully caused injury to the corporation. The shareholder seeks to compel the defendants to pay damages to the corporation. Often included among the defendants are the corporation's directors, officers, or even other groups of shareholders that are charged with participating in the wrongs. The corporation is usually named as a nominal defendant because the persons in control often resist the claims of the plaintiff shareholder.

The two principal conflict issues or questions involved in derivative actions include:

- Whether the same lawyer or firm should represent both the corporation as an entity and one or more officers and directors; and
- Who in the corporation should hire and direct the lawyer who represents corporation.

### B. Rule of Separate Representation

The requirement that the corporation as an entity be separately represented from its officers and directors is determined by a consideration of the actual conflict of interests. *See* Model Rule 1.13, comment 2. It may be that the claim only seeks minor relief or does not directly involve the corporation in any significant way.

The requirement that the corporation be separately represented does not mean that the individual officers and directors must bear the expense of their separate lawyers. The corporation may pay the litigation expenses of the director or officer. However, when the corporation directly compensates the lawyers who represent the individual directors or officers, the rules regarding full disclosure and consent apply, just as in other instances in which a third party pays a lawyer's fee to represent a client. *See* Model Rule 1.17, comment 10.

### C. Who Should Hire and Direct the Attorney?

The issue of whom should hire and direct the lawyer's representation of the corporation may be answered in the context of the corporation's consent to the joint representation. However, a shareholder derivative action in which there is a substantial conflict of interest problem might also raise a question about the nature of the corporation's consent as an entity separate from its co-defendant officers and directors. For example, one might question the directors' voting the corporation's consent to common representation of the directors and the corporation.

One court's possible solution was to disqualify the lawyer from continuing to represent either the corporation or its officers and directors, and to appoint new independent counsel for the corporation. *See Rowen v. LeMars Mut. Ins. Co.*, 230 N.W.2d 905, 913-16 (Iowa 1975). Another solution that would suggest more of an appearance of board independence might be to require that the selection of new corporate counsel be made by outside directors not named as defendants in the derivative action, or to have the consent to the joint representation approved in a meeting not attended by the corporation's controlling person.

## VI. COMMUNICATION AND ACCESS TO CORPORATION

Attorney communication and access to the corporate client is different for house and outside counsel.

### A. House Counsel

The nature of the attorney-client relationship between house counsel and corporate personnel differs from a typical outside counsel relationship in the following ways:

- The relationship is likely to be ongoing, indefinite, and not confined to a single type of legal matter;
- The relationship is likely to be set up by some type of corporate policy and not the result of a freely contracted client-lawyer relationship; and
- The relationship is likely to be part of a larger bureaucracy, placing constraints on the relationship.

Wolfram, *supra*, at 741.

### B. Outside Counsel

Many outside attorneys work within a structured bureaucracy as well – the large law firm. Outside attorneys must also contend with the existing corporate client's bureaucracy when gathering information and

giving legal advice. One important question is the point of entry into the client's corporate structure.

The problem is whether outside counsel should report to house counsel or to some other corporate officer. Outside counsel would probably prefer to remain free to communicate at any level, including the highest level with the corporation. Corporate clients, however, may prefer that outside counsel be accountable to house counsel, at least for routine communications and advice.

### C. Rejected Advice

Model Rule 1.13(b) and (c) offers the corporate attorney advice on how to proceed when faced with possible violations by a corporate constituent of a legal obligation. "...Model Rule 1.13 is a good road map to guide a lawyer's search, within the organizational geography of a corporate client, for a person or body willing and able to countermand and subordinate's illegal action." Wolfram, *supra*, at 744.

#### 1. Mandatory Actions

Model Rule 1.13(b) places an obligation on the part of corporate counsel to take reasonable steps to protect the corporation's interest when the attorney knows that an illegality has occurred or is being planned. Model Rule 1.13(b) describes and limits the corporate attorney's duty in four ways:

- The action must be that of "an officer, employee or other person associated with the organization;"
- The illegality must relate to the lawyer's representation;
- The illegality must be "likely to result in substantial injury to the organization;" and
- The illegality must be "a violation of a legal obligation to the organization, or a violation of law, which reasonably might be imputed to the organization."

This last limitation would cover all injuries to the corporation, such as a waste of corporation assets or the acts of an officer or employee that would create liability for the corporation under the doctrine of respondeat superior. The rule would not cover situations wherein the officer's illegality is not within the doctrine of respondeat superior (e.g., smuggling drugs for personal gain).

#### 2. Discretionary Options

Model Rule 1.13(b) provides that "the lawyer shall proceed as is reasonably necessary in the best

interest of the organization." The rule directs that the attorney give due consideration to the seriousness of the violation and its consequences, the scope and nature of the attorney's representation, the responsibility in the organization and the apparent motivation of the person involved, any applicable policies of the organization, and any other relevant considerations.

Specific options may include:

- Asking reconsideration of the matter;
- Advising that a separate legal opinion be sought; and
- Referring the matter to a higher authority in the organization, including the highest authority if the matter is serious enough.

None of the above-listed options is mandatory, and other options may work (e.g., asking a senior colleague to counsel the officer or employee). The most serious option is the referral of the matter to the "highest authority that can act in behalf of the organization as determined by applicable law." Model Rule 1.13(b)(3). Comment 5 to Model Rule 1.13 seems to limit that authority to the board of directors or to the independent directors of the corporation.

Obtaining a shareholder action as an option in most instances would require the revealing of confidential client information in violation of Model Rule 1.6. Model Rule 1.13(b) requires that the measures taken shall be designed to minimize the risk of revealing confidential information. This may mean that corrective action would not include notifying public agencies or persons who have already been victimized by the illegality.

#### 3. Withdrawal

Model Rule 1.13(c) provides that if a corporate lawyer is unsuccessful, the lawyer may resign under Model Rule 1.16 if the action is clearly a violation of law and is likely to result in substantial injury to the organization. Even house counsel is required to withdraw if further representation would result in the lawyer's violation of the rules of professional conduct or other law. Model Rule 1.16(a)(1).

Wolfram notes that "Rule 1.13 calls forth neither heroism nor much action on the part of a lawyer for an organization. The rule and the comments are filled with cautions about not upsetting apple carts and not going over heads." Wolfram, *supra* at 746; *see also* Model Rule 1.13, comments 4 and 5.

## VII. THE SARBANES-OXLEY ACT OF 2002

On July 30, 2002, President Bush signed into law new accounting reform and securities law/corporate

governance legislation called the Sarbanes-Oxley Act of 2002. Among other things, the Act provides for the creation of a new public accounting oversight board, imposes new reporting and corporate governance rules on public companies, imposes new rules and requirements on accounting firms that audit public companies, and establishes new criminal penalties for securities fraud, destruction of documents, and knowingly filing false certifications of the accuracy of periodic reports that contain financial statements.

One provision of the Act is particularly relevant to the question of self-reporting and voluntary disclosure in white-collar criminal cases involving corporations. Section 307 of the Act provides as follows:

Not later than 180 days after the enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting 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 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 (adopting, as necessary, *appropriate remedial measures or sanctions* with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors. (Emphasis added.)

#### A. Effect of Section 307 on the Attorney-Corporate Client Relationship

As the italicized language above suggests, this section of the Act raises a number of significant statutory interpretation issues, discussed further below, that will need to be addressed by the SEC in formulating the required rules and probably will eventually have to be resolved by the courts. Beyond these interpretation issues, however, the Act has the potential to alter significantly the relationship between public companies and their attorneys. On its face, Section 307 appears to go quite far toward changing

the role of corporate attorneys from confidential advisors to public watchdogs and whistleblowers. The effect of the new law may be to blur the distinction between independent public accountants who have traditionally played the public watchdog role, *see generally United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), and outside counsel who have enjoyed a confidential relationship with their corporate clients, *see generally Upjohn Co. v. United States*, 499 U.S. 383 (1981).

In *Upjohn* the Supreme Court confirmed that the attorney-client privilege and the work-product doctrine protect communications between corporate counsel and the corporation's employees, so long as the purpose of the communications is to provide legal advice to the corporation and prepare for potential litigation. *Id.* By extending the availability of the attorney-client privilege beyond a corporation's "control group" and by extending work-product protection to interviews of lower level employees by corporate counsel, the *Upjohn* Court recognized the importance of employees at all levels communicating with corporate counsel and obtaining advice on compliance with the law. *See Upjohn*, 449 U.S. at 392; *see also* Sherman L. Cohn, *The Organizational Client: Attorney-Client Privilege and the No-Contact Rule*, 10 GEO. J. LEGAL ETHICS 739, 754 (1997) ("The Court's opinion clearly supports the idea that corporations need privacy to the extent afforded by the attorney-client privilege to comply with laws, and that internal investigations should be protected as a corporate effort to monitor compliance.") The *Upjohn* Court was also concerned that without the confidentiality protections of the attorney-client privilege and the work-product doctrine the depth and quality of investigations to ensure compliance would suffer and employees might be deterred from seeking advice on how to comply with the law. *See Upjohn*, 449 U.S. at 393 n. 12.

Ironically, the outcome that the Supreme Court sought to avoid in *Upjohn* in 1981 appears to be promoted, albeit indirectly, by the attorney reporting requirements in Section 307 of the Sarbanes-Oxley Act of 2002. The attorney-client privilege and work-product doctrine protections that the *Upjohn* Court sought to provide for corporations and other business entities are undercut if attorneys representing a corporation are viewed by corporate employees and officials as potential informants and whistleblowers rather than as trusted confidential advisors. In this regard, Section 307 seems likely to exacerbate the inherent tensions that are present when an attorney represents a business entity that can act only through its officers and employees, who as individuals are not the clients of that attorney.

## B. Section 307 and Waiver of Privilege Protections

Section 307 of the Sarbanes-Oxley Act also may increase the pressures on business entities to waive the protections of the attorney-client privilege and the work-product doctrine when evidence of misconduct subject to the Section 307 reporting requirement is discovered. Although the various levels of attorney reporting required by Section 307 (initially to senior executives and potentially to board committees composed of independent directors or to the full board of directors) will not constitute a waiver, because all of the recipients of the report are within the corporate privilege under *Upjohn*, ultimately the recipients of the report may conclude that they are compelled to waive the privilege and immediately report the matter to the DOJ, the SEC, or other appropriate federal law enforcement officials.

The Corporate Sentencing Guidelines, the Holder Memorandum, and the SEC's new cooperation policy all require prompt self-reporting of violations of law if corporations wish to receive lenient treatment from the government. (Of course, none of these policies provide any assurances of lenient treatment, so a company that seeks to obtain lenient treatment by self-reporting does so at its own risk – as illustrated by the DOJ's decision to seek a felony conviction of Arthur Andersen after that firm voluntarily reported destruction of documents relating to its work for Enron. See Kurt Eichenwald, "Arthur Andersen Convicted of Obstruction of Justice," *The New York Times*, June 15, 2002 ("In early January, as lawyers for the firm were examining laptop computers for email messages related to Enron, they were stunned to discover that the records had been wiped clean. In the days that followed, top executives of the accounting firm learned of the huge effort to destroy documents in the fall. Andersen alerted the SEC, the Justice Department and the congressional committees investigating Enron.)) Thus when confronted with a Section 307 report, the corporation may conclude that it has no practical alternative but to report the matter to law enforcement authorities. When that occurs outside attorneys who reported the matter under Section 307 will have set in motion a chain of events that resulted in a waiver of privilege and, in some cases, criminal prosecution of their client. It is difficult to reconcile this scenario with the approach that the Supreme Court took in *Upjohn*, when it stressed the importance of the attorney-client privilege in the corporate context to facilitate thorough internal investigation of potential wrongdoing and confidential counseling to foster compliance with the law.

This inconsistency with *Upjohn*, coupled with the broader issue of the potential erosion of the attorney-client privilege and work-product doctrine in the

corporate context, highlights the importance of the rules that the SEC is required to promulgate to implement Section 307 of the Act. Unfortunately, the language of 307 itself raises a number of difficult interpretation issues that may not lend themselves to resolution through the rulemaking process.

Attached hereto as Exhibit B is the overview section of the new regulations issued by the SEC on the Sarbanes-Oxley Act as it relates to attorneys.

## VIII. DOCUMENT RETENTION AND DESTRUCTION

Document retention and document destruction – a long-recognized complex and burdensome undertaking – has taken on significantly greater importance for corporate America in light of Congress's recent adoption of the Sarbanes-Oxley Act. For years, companies have struggled with the explosive growth of both paper and electronic records. Entire industries have been spawned to deal with record keeping requirements and the management of paper to develop policies and rationale for the systematic destruction of records when they are no longer needed for business or legal requirements.

Sarbanes-Oxley has radically changed the risks and benefits associated with effective document management and destruction policies.

Also known as the Public Company Accounting Reform and Investor Protection Act of 2002, Sarbanes-Oxley requires that all publicly traded companies maintain all correspondence, communications, electronic documents, faxes and application data and records between themselves and their public auditors for a five (or seven) year period. See Sarbanes-Oxley §§ 103(a)(2)(A)(iii)(II)(aa) and 802, creating 18 U.S.C. § 1520 (authorizing new SEC regulations that will apply to auditors, and may apply to public companies as well).

### A. Sarbanes-Oxley Record Keeping Requirements

#### 1. 18 U.S.C. §1519

Of greatest concern is the broad and ill-defined language in § 802 of the Sarbanes-Oxley. This section creates a new provision in the Federal Criminal Code, 18 U.S.C. § 1519 provides:

#### **§ 1519. Destruction, alteration, or falsification of records in Federal investigations and bankruptcy**

"Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within

the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.”

An aggressive prosecutor may well argue that a manager’s receipt of one email from one employee reporting a potential accounting issue or garden-variety employment discrimination claim triggers application of § 1519. From the moment a company manager receives a complaint, the company is presumably responsible for maintaining every email and document for the next five years that could possibly confirm or relate to alleged issues. The risk is compounded where a company has a policy of regularly deleting all emails and documents. Simple failure to determine how the company’s regular document retention policy will be implemented could constitute conduct violating new § 1519.

It is critical to note that – unlike many of the Sarbanes-Oxley provisions – Section 1519 applies to both private and public companies.

## 2. 18 U.S.C. § 1520: Destruction of Corporate Audit Records

This section requires that an accountant who conducts an audit of an issuer of securities subject to the Securities Exchange Act of 1934, shall maintain audit and review work papers for a period of five years from the end of the fiscal period in which the audit or review was concluded.

## 3. Sarbanes-Oxley § 103

This section requires public company accounting boards to establish rules requiring that “each registered public accounting firm shall prepare and maintain for a period of not less than seven years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report.”

Audit reports of public companies are expressly directed to evaluate the company’s internal controls and procedures, including the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the asset of the insurer. See Sarbanes-Oxley § 103(a)(2)(A)(iii)(II)(aa). Given that accounting firms are required to maintain records for seven years, it appears reasonable to believe that auditors will take the position that adequate internal controls will require the maintenance of records for seven years in public companies.

In addition to Sarbanes-Oxley, numerous other federal and state statutes require companies to maintain

detailed business and accounting records. These requirements make mandatory the prudent business practice of retaining records.

## IX. THE PROBLEM

### A. Hypothetical Fact Pattern

The manager of internal audit at XYZ Corp., a public company, discovers an email from a retired manager relating to a transaction that occurred three years ago. Upon initial review, the records appear to reflect a transaction that was not booked in accordance with generally accepted accounting principles (“GAAP”).

Issue: Whether the company must immediately suspend its regular document destruction policies and begin to gather all relevant records. Because this accounting issue is within the proper administration of the SEC, failure to immediately cease the company’s regular document retention and destruction policy may be deemed to violate 18 U.S.C. § 1519.

### B. Possible Application of 18 U.S.C. § 1519

Of critical importance in attempting to apply § 1519 to the above-described scenario will be the effort to establish whether the company, or its individual managers, acted “with intent to impede, obstruct, or influence . . . any matter within the jurisdiction of any department or agency of the United States.” It is instructive in this regard to review cases which make clear that intent is rarely proved by direct evidence. The courts commonly permit inferences to establish intent in criminal proceedings. “A conviction for wire fraud requires proof of the specific intent to defraud or deceive. Proof of such intent, however, can arise by inference from all of the facts and circumstances surrounding the transaction.” *U.S. v. Rivera*, 295 F.3d 461, 467 (5<sup>th</sup> Cir. 2002)(emphasis added)(jury permitted to infer store owner had requisite intent to participate in use of stolen credit cards); *U.S. v. Brechtel*, 997 F.2d 1108, 1116 (5<sup>th</sup> Cir. 1993)(. . . the government may demonstrate intent by circumstantial evidence. An inference of intent to defraud arises where a responsible bank insider acts to produce a transaction which he knows will benefit him, without disclosing his interest therein).

More troubling is the jurisprudence which has recognized that intent may be established where an individual or party is deemed to have been “willfully blind” to legal requirements. Defendants who were ignorant of legal requirements have been deemed to satisfy the criminal intent element in numerous cases. *U.S. v. Wells*, 262 F.3d 455, 465 (5<sup>th</sup> Cir. 2001)(the purpose of the deliberate ignorance instruction is to inform the jury that it may consider evidence of the defendant’s charade of ignorance as circumstantial proof of guilty knowledge. The instruction is proper

where the evidence shows (1) subjective awareness of a high probability of the existence of illegal conduct, and (2) purposeful contrivance to avoid learning of the illegal conduct); *U.S. v. Scott*, 159 F.3d 916, 922 (5<sup>th</sup> Cir. 1998)(the evidence at trial must raise two inferences: (1) the defendant was subjectively aware of a high probability of the existence of the illegal conduct; and (2) the defendant purposely contrived to avoid learning of the illegal conduct).

Finally, some Circuits have recognized that collective knowledge can establish intent. In other words, the knowledge contained within different departments and different locations of a single corporation may be deemed collective knowledge of a corporate defendant. *U.S. v. Osorio*, 929 F.2d 753, 761 (1<sup>st</sup> Cir. 1991)(the criminal responsibility of a corporation can be founded on the collective knowledge of its individual employees and agents); *U.S. v. Bank of New England, N.A.*, 821 F.2d 844, 855 (1<sup>st</sup> Cir. 1987)(“collective knowledge”: . . . is the sum of the knowledge of all of the employees. That is, the bank’s knowledge is the totality of what all of the employees know within the scope of their employment); *see also Corporate Criminal Liability*, Am. Crim. L. Rev. 328, 333 (2002).

The various forms of electronic data that exist in a typical corporate environment, and the ease with which such data can be requested and required to be made available compound this problem.

## X. IT’S A TOUGH WORLD OUT THERE FOR ALL ATTORNEYS

These new cases and statutes along with the changing public opinion added to the burden of complying with the Disciplinary Rules of Professional Conduct makes it sometime hard to determine what the right conduct is in complicated situations.

Many lawyers in attempting to justify some course of conduct can find some disciplinary rule authorizing the very act preferred by the lawyer. It seems clear that some overriding approach to ethical decision-making is necessary in the practice of law as is necessary in all decision-making.

A lawyer needs some basic guidelines in truly seeking to avoid committing malpractice, grievable offenses, or acts lowering self-esteem. The following three questions and three suggestions may or may not help.

### A. Questions

#### 1. Who is the Client?

While this sounds simple, it is never simple. For the lawyer who represents a group of doctors who form a medical group and then form an HMO/PPO or get purchased by a hospital, the lawyer attempting to represent a party at each stage of the process invariably

runs into conflicts of interest. Not only must the lawyer continually identify his client in each transaction, but also he must effectively identify that client to the other parties involved in the transaction. There is usually a negative economic impact for clarifying this information and it is sometimes very hard to do. When compensation for the attorney comes from a source other than the client, the problem becomes extremely complicated and the lawyer must try to clarify for everyone to whom his duties are owed.

#### 2. What is the Fee?

What is the fee arrangement and who pays the fee are the first elements determining compensation for the lawyer. Written communication about who is responsible and the method for calculating fees are strongly recommended. The “no surprise” element seems to be the secret to success in this area; i.e., that is, when the last bill is sent out to the last person who is supposed to pay it, there is no surprise. It is the surprise bill received by the person responsible for payment that generates bad feeling and ill will, and results in grievance and malpractice claims. A lawyer’s inability to determine the fee and thus hesitancy in discussing the fee consistently results in trouble.

#### 3. Can I Clear the Conflicts?

The first step is to determine that representation does not violate any ethical standards set forth in the rules for conflicts of interest. Secondly, the attorney should identify any political conflicts of interest that may likely generate difficulty. This almost always includes personal inquiry of other lawyers in the firm because these conflicts will not surface in most conflicts systems. Political conflicts are simply relationships that involve family, friends, or civic connections that impact the firm. Third, the lawyer should consider any issue conflicts that might affect his representation. A lawyer does not want to take one side of an issue only to discover his major client’s need for the opposite position in subsequent litigation. Being sensitive to issue conflicts is a necessary self-protection instinct.

### B. Suggestions

#### 1. Good Ethics are Good Tactics.

It is important in any continuing litigation for a lawyer’s relationship with the court and opposing counsel to be a priority in delivering a high quality, low cost product to the client. A lawyer’s ethical decisions pursuant to the Texas Rules of Professional Conduct will result in more favorable treatment from the court and a better result for the client. It is difficult to adhere to this rule in the heat of litigation, but a

conscientious lawyer should recognize the long-term ethical conduct results in fewer instances of malpractice or grievable offenses and produces good results in most cases. When a litigation lawyer is faced with difficult choices and is uncertain of proper strategy, the ethical choice most always produces the best result.

2. Remember that the Client is the Principal.

Most lawyers understand the relationship between an attorney and client as a fiduciary relationship and that of an agent/principal. It is often easy for the lawyer to forget who is the principal. The control of the lawsuit belongs to the client, and it is the client who is *always* the principal. Designating the client as the principal enables the lawyer to lower the level or arrogance, increase the amount of communication and keep in perspective that the client, not the lawyer, owns the lawsuit.

3. Choose to Make Less Money.

This rule runs counter to human self-interest and is difficult to follow. In facing an ethical dilemma with a dollar value attached, a lawyer should at least analyze the choices to determine the economic impact of each choice. If there is a fee dispute, a lawyer should calculate the options that produce both the largest and smallest fees. In selecting the lowers fee option, a lawyer greatly reduces the likelihood of a malpractice or grievance claim. A lawyer will feel better about his profession if his image is tied up in something other than the size of fees being generated.

## XI. TREND TOWARDS PROFESSIONALISM

The recent trend of the ABA and some states such as Texas has been a focus on lawyer “professionalism” as a basis for regulating conduct, beginning with the commissioned ABA study on professionalism and resulting in the American Bar Association’s Creed of Professionalism and Pledge of Professionalism. Attached to this paper is a copy of the Texas Creed on Professionalism, one example of a state’s effort to address the problem of regulating attorney conduct by stressing the professionalism aspect.

What is “professionalism?” Professionalism has been defined as “that spirit, that ethic, those attributes that inspire in a practitioner a sense of purpose, instill a sense of learned authority, and foster both self and public respect.” Jordan, Lawyer Bashing for Fun & Sport: Do Vicious Barba Miss the Mark? 54 TEX. B. J. 752, 754 (1991). Schuwerk and Sutton suggest that “[p]rofessionalism and high ethical standards means more than being civil to other lawyers. They mean caring about the quality of one’s work. They also mean striving to bring about improvements in our profession through participation in organized bar

activities and participation in the affairs of the community through pro bono work and other public service.” Schuwerk & Sutton, *supra* at 1.

Perhaps professionalism is nothing more than a particular attitude about one’s own worth and the worth of others. Aristotle suggested that men acquire a particular quality by constantly acting in a particular way, that perhaps attitude is created by behavior: “. . . often the highest award for our toil is not what we get for it, but what we become as a result of our effort.” Jordan, *supra* at 756.

## XII. CONCLUSION

The profit-motive may in fact explain many grievances and lawsuits filed against lawyers. Certainly the fear of such filings can motivate some attorneys to comply with the Rules and the various state and county creeds of professional conduct. Many may be motivated as envisioned by Preamble 9 of the Rules:

Each lawyer’s own conscience is the touchstone against which to test the extent to which [the lawyer’s] actions may rise about the disciplinary standards prescribed by these rules. The desire for the respect and confidence of the members of the profession and of the society that it serves provides the lawyer the incentive to attain the highest possible degree of ethical conduct. The possible loss of that respect and confidence is the ultimate sanction. So long as its practitioners are guided by the principals, the law will continue to be a noble profession. This is its greatness and its strength, which permit of no compromise.