IS DUAL SERVICE UNETHICAL?[1]

What is the appropriate response when outside counsel is asked to sit on a client company's board of directors? Some commentators have argued that the potential risks of dual service so far outweigh any benefits that may accrue that the appropriate response is always, "No."[2] There are, however, significant advantages to having a corporation's counsel serve on its board of directors. Lawyers, particularly corporate lawyers, are well-positioned to make valuable contributions to a board's decision-making process by steering the board away from problems as business decisions are being developed and considered, long before "legal advice" is sought.

There are potential pitfalls. When parties decide to proceed because the benefits seem to outweigh the risks, understanding these pitfalls may enable the corporate client and its lawyer to avoid them. So long as lawyer-directors and their clients understand the issues that may arise, a flat prohibition on ethical principles seems unwarranted.

A recent draft report of an American Bar Association Task Force on the Independent Lawyer[3] discouraged dual service, and concerns with such dual service have been expressed for some years.[4] Despite such concerns, there are few reported instances in which dual service presented a problem. Thus, the concerns may be more theoretical and philosophical than practical. A recent opinion of the American Bar Association Standing Committee on Ethics and Professional Responsibility[5] notes that the Model Rules of Professional Conduct do not prohibit dual service. That position is consistent with the views expressed below.

The Advantages of Dual Service

As a result of their training and experience, lawyers are perceived by management as good candidates for directorships. The fact that a lawyer-director is held to a higher standard of care (that required of an ordinarily prudent lawyer-director, rather than that required of an ordinarily prudent person[6]) indicates a view that lawyers have unique capabilities as directors. "Because of the relatively high risk of liability, the lawyer-director has a great incentive to know the business of [a]corporation...."[7] The combination of early appreciation of potential pitfalls and high incentive to know the business of a corporation places the lawyer-director in a unique position of being both able and highly likely to alert the company to problems early in their development. The lawyer-director, like other directors, has not only the opportunity, but also the obligation, to be fully informed about the business and affairs of the corporation and to render legal advice as problems first arise. In addition, however, a lawyer appreciates the legal

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[2] See, *e.g.*, Dennis R. Block, George F. Meierhofer Jr. & Daniel L. Wallach, "Lawyers Serving on the Boards of Directors of Clients: A Survey of the Problems", Prentice Hall Law & Bus. Insights, April 1993, at 3 (Westlaw, Law reviews, texts and periodicals database, printout at 18); Monroe Freedman, "You CAN Do It, But You Shouldn't," American Lawyer, Dec. 1992, at 43; Craig C. Albert, The Lawyer-Director: An Oxymoron?, 9 Geo. J. Legal Ethics 413 (1996); Martin Riger, "The Lawyer-Director -- A Vexing Problem," 33 Bus. Law. 2381 (1978).

[3] Task Force Draft Report [check status and reference]

[4] See Footnote 2, *supra*.

[5] ABA Formal Opinion 98-410 entitled "Lawyer Serving as Director of Client Corporation"

[6] See *Escott v. BarChris Constr. Corp.*, 283 F. supp 647 (S.D.N.Y. 1968)

[7] See Mundheim, Should [the]Code of Professional Responsibility Forbid Lawyers to Serve on Boards of Corporations For Which They Act as Counsel, 33 Bus. Law. 1507, (1978) at 1508

ramifications of alternative courses of action and is therefore well positioned to make valuable contributions by elucidating risks and benefits a board might otherwise overlook in its deliberations. In this sense, the lawyer is able to guide a board around potential pitfalls before "legal advice" becomes necessary. "Since he has access to the board he can give his warnings at an early stage."[8] While one commentator, Professor Wolfram, asserts that "a comparable increase in knowledge can be gained through attendance at board meetings without the lawyer's becoming a full legal member of the group,"[9] some dual service lawyer-directors have found that when a lawyer is not a member of the board, many companies do not feel the need to have the lawyer present at every meeting. Moreover, a lawyer speaking as a board member speaks not merely as an advisor, but as an equal. Conversations with lawyer-directors confirm that, as an equal, their views are given greater weight and consideration than those views were given when the lawyers attended board meetings in their legal capacity, not as members of the board. As a result of the lawyer-director having greater credibility with members of the board of directors than the lawyer who is not a director, the views of the lawyer-director are often more readily accepted by management and the board.

Also potentially important, is the fact that dual service strengthens the relationship between the corporate client and its outside counsel, which benefits both lawyer and client.

The Potential Pitfalls

Pitfall #1: Risk of Loss of the Attorney-Client Privilege

From the company's perspective, one of the most serious risks of dual service is possible loss of the attorney-client privilege relating to communications between corporate client and counsel both inside and outside the board room.

Understanding when the attorney-client privilege applies can reduce the risk of losing the privilege. Not all communications between attorney and client are privileged. In order to assert the privilege, four fundamental factors must be present:

> The communications must originate in a confidence that they will not be disclosed;
>
> This element of confidentiality must be essential to the full and satisfactory maintenance of the relation between the parties;
>
> The relation must be one which, in the opinion of the community, ought to be sedulously fostered;
>
> The injury that would inure to the relation by the disclosure of the communications must be greater than the benefit thereby gained for the correct disposal of litigation.[10]

If these four conditions are present, an eight-step analysis must be applied to determine whether the privilege should be recognized, as follows:

Where legal advice of any kind is sought;

From a professional legal adviser in his capacity as such;

The communications relating to that purpose;

Made in confidence;

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[8] See *id*, at 1508

[9] Wolfram, Charles W., <u>Modern Legal Ethics</u> § 13.7 at 739 (1986), at 740

[10] *Radiant Burners, Inc. v. American Gas Ass'n*, 320 F.2d 314 (7th Cir.), *cert. denied*, 375 U.S. 929 (1963), quoting 8 John Henry Wigmore, Evidence in Trials at Common Law Secs. 2290-92 (John T. McNaughton, rev., Little, Brown & Co., 1961 and Supp. 1991).

By the client;

Are in his instance permanently protected;

From disclosure by himself or by the legal adviser;

Except the protection be waived.[11]

Other formulations of the attorney-client privilege are variations on these themes.[12]

Attorneys and their clients prize the attorney-client privilege. The judiciary does not; it considers the privilege an obstacle to investigation of the truth, although essential to the working of the system. Accordingly, even when all four factors are present and the eight-step analysis indicates the privilege should be recognized, it is strictly construed, that is, construed "within the narrowest possible limits consistent with the logic of its principle."[13]

When a company's outside counsel serves as a director, it may be more difficult for the company to establish that the advice being rendered was "legal" in nature, as opposed to business-related advice. In addition, it may be more difficult to establish that the confidentiality requirement relating to privileged legal advice has been met, particularly if directors are not warned in advance that what they might be hearing or reading is legal advice, as opposed to business advice, and reminded to treat it accordingly.

The risk of waiver is, no doubt, enhanced if those to whom the legal advice is rendered perceive it to be "business" advice, and treat it as such. Such treatment may occur inadvertently, as, for example, by disclosing the legal advice to fellow corporate employees who have no "need to know" because the information concerns matters beyond the scope of their duties to the corporation.[14]

It is clear that business advice is not protected, and legal advice that is incidental to business advice also may not be protected.[15] A lawyer who gives both business and legal advice may risk having a court take an “all or nothing” approach. Under this approach, a court first determines whether the lawyer is primarily a lawyer or primarily a businessperson. If the court determines the lawyer to be primarily a businessperson, no attorney-client privilege attaches to any of the lawyer’s communications with the client company.[16] The preferred approach, however, seems to be a case-by-case analysis, where the court determines what type of advice is being sought, and permits assertion of the attorney-client privilege for legal but not business advice.[17]

Pitfall #2: Perceived Risk of Loss of Independence under the Business Judgment Rule

Whether a lawyer who serves on the board of directors of a corporation that regularly engages the lawyer’s firm to perform services is, for purposes of the business judgment rule, an “independent” director, is likely to be viewed as a question of fact.

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[11] Id, at 319.
[12] See e.g., *United States v United Shoe Machine Corp*., 89 F. Supp. 357 (D.Mass. 1950), *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 609 (8th Cir. 1977) and *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981)
[13] See *Radiant Burners, supra*, at 323
[14] See *Upjohn supra*, at 389.
[15] See *United States v. International Bus. Mach. Corp*., 66 F.R.D. 206 (S.D.N.Y. 1974)
[16] See *In re Robinson*, 125 N.Y.S. 193 (N.Y. App. Div. 1910)
[17] *Zenith Radio Corp. v. Radio Corp. of Am*, 121 F. Supp. 792 (D. Del. 1954)

For example, in considering, on a motion to dismiss, whether a demand on a board of directors was futile and therefore unnecessary under Chancery Rule 23.1,[18] one court's assessment included consideration of the fact that the board included a defendant director who also served as the corporate defendant's outside counsel. The court noted that the director's law firm allegedly earned close to $1 million in revenues in representing the corporate defendant, found that "[r]ealism ... requires one to acknowledge the possibility that a partner at a small firm bringing in close to $1 million in revenues from a single client in one year may be sufficiently beholden to, or at least significantly influenced by, that client as to affect the independence of his judgment,"[19] and concluded that sufficient reasonable doubt of the board's independence had been raised to make granting a motion to dismiss inappropriate.

The outcome was also unfavorable to defendant corporation's position in *Feit v. Leasco Data Processing Equip. Corp*.,[20] but the process by which the court reached its decision indicates that an analysis was made of the specific facts and a conclusion reached in light of those facts. In that case, the court found that a lawyer-director "was so intimately involved in this registration process that to treat him as anything but an insider would involve a gross distortion of the realities of Leasco's management," and therefore concluded that he was a management director rather than an outside director.[21]

The conclusion that whether a lawyer-director is an "inside" or "independent" director is a question of fact is supported by the ABA's *Corporate Director's Guidebook*,[22] which states that a lawyer-director may be an "affiliated non-management director" depending on a number of factors, including the materiality of the relationship to the corporation or to the director.

Pitfall #3: Risk of Perceived Diminished Ability to Exercise Independent Judgment in Either Capacity

According to Professor Wolfram, the dual-capacity relationship "is a decided threat to the professional independence of counsel."[23] He reasons as follows:

> The lawyer puts his or her own legal advice to the vote of the rest of the board under circumstances in which the pressures are inevitably great to conform to the board's preferred, business-dictated conception of legal obligations. The board's probable preference for collegiality and deference to management prerogatives and the will of the board's majority clashes with the lawyer's duty to act on occasion as the corporate nag, or conscience. What is good for business and what the law requires may be very different things, but the need to draw this distinction is particularly great for a person who purports to draw upon both kinds of expertise and make both kinds of judgments.[24]

While diminished independence is a potential pitfall, most lawyer-directors see their function as a director as giving business, not legal advice, and would strongly disagree that their legal advice is put to the vote of a board. As to the concern that legal advice (presumably outside the board room) would be impacted by pressure to conform to a preferred business strategy, a lawyer's obligation is to render the legal advice deemed appropriate, regardless of whether it is management's preferred course of action.

Similarly, a director has an obligation to withstand pressure from officers and even other directors who hold opposing views, and to render advice in light of the director's own experience

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[18] *Steiner v. Meyerson*, C.A. No. 13139 (Del. Ch. July 18, 1995)
[19] Id., slip op. at 24-25
[20] *Feit v. Leasco Data Processing Equip. Corp.*332 F. Supp. 544, (E.D.N.Y. 1971)
[21] *Id* at 575-76
[22] ABA, Corporate Director's Guidebook, reprinted in 33 Bus. Law. 1591, 1620 (1978)
[23] C. Wolfram, Modern Legal Ethics, Sec. 13.7, at 739
[24] *Id*. at 739

and convictions, even if such advice involves voicing unpopular views. Both lawyer and non-lawyer directors face such pressures, however. There is nothing unique about dealing with those pressures when serving in a dual capacity. It has even been argued that because lawyers face such pressures in a variety of situations when dealing with clients, they are more able and skillful than others at resisting such pressures and expressing unpopular views that deserve a board's attention and consideration.[25]

Pitfall #4 - Conflicts of Interest

Situations may arise where a lawyer's interests as outside counsel to a corporate client may conflict with his interests as a director. In such situations, the lawyer may be unable to fulfill either role. Such a conflict may, for example, arise when the board is evaluating the advisability of hiring another law firm to do work that the lawyer-director's firm has been doing. The example, however, has a limited application, because the board of directors does not typically address issues such as retention of outside counsel and appropriateness of legal fees. When such conflicts do arise, it is advisable, and may in some instances be mandatory, for the lawyer-director to abstain from voting on the matters in question, and to be excused from participation in discussions regarding them.

Pitfall #5 - Possible Disqualification of the Lawyer-Director to Serve as the Corporation's Lawyer

When individual members of a board of directors are sued, conflicts of interest among individual members may include conflicts of interest between the lawyer-director and other directors' interests. While again, the possibility of conflicts of interests among board members is not unique to conflicts involving lawyers serving in a dual capacity, the consequences for both the lawyer and the client corporation may be more significant than for conflicts among other board members. For example, if all of the members of the board are individual defendants in a shareholders' derivative suit, but the lawyer-director's interests conflict with those of other directors, the lawyer-director (and his firm - see discussion below) may be disqualified from representing the corporate client.

Another problem may arise where a lawyer-director is subject to being called as a witness, because the Model Rules of Professional Responsibility preclude a lawyer called as a witness from serving as counsel,[26] and the rule is likely to be enforced in appropriate circumstances.[27] A related problem is the potential for lack of objectivity, which is heightened when the lawyer is also a corporate officer.[28]

The Model Rules also require a high degree of objectivity by a lawyer when representing a client. If a court finds that such objectivity is "highly unlikely" to exist, as for example in connection with an action for corporate mismanagement by the corporation and its board of directors, a court may disqualify counsel from representing that corporate client.[29]

Pitfall #6 - Loss of Insurance Coverage because the Lawyer-Director "Falls Between the Cracks"

Corporations typically carry director and officer liability insurance policies for their officers and directors, and lawyers or their law firms typically carry professional liability ("malpractice") insurance. The "D&O" policies cover losses suffered as a result of officers' and directors' wrongful acts in their capacities

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[25] *See e.g*., Dominic Bencivenga, *Should Attorneys Serve on Corporate Boards*?, 3 L. Firm Partnership & Benefits Rep. (Leader) No. 7, at 9 (Aug. 1997)

[26] Model Rule 3.7 provides, "[a] lawyer shall not act as advocate at a trial in which the lawyer is likely to be a necessary witness". *See als*., *Cottonwood Estates, Inc. v. Paradise Builders, Inc*., 624 P.2d 296 (Ariz. 1981) (en banc), involving a lawyer who was also a corporate officer, and was disqualified on the basis that he was called to testify and therefore property disqualified from serving as the company's counsel in the matter.

[27] See, for example, *Cottonwood Estates, Inc. v. Paradise Builders, Inc.*, *supra*.

[28] *Id.,* at 302-03.

[29] See e.g., *Harrison v. Keystone Coca-Cola Bottling Co.*, 428 F. Supp. 149 (M.D. Pa. 1977).

as officers or directors.[30] Professional liability insurance covers losses suffered as a result of "malpractice." Between the two, a lawyer-director might reasonably anticipate that any malfeasance would be covered by one policy or the other, as each policy covers claims arising out of services in the defined area of coverage. Both types of policies, however, generally have a variety of exceptions to coverage, including, for example, fraud and other intentional acts of bad faith, and these exceptions, together with the descriptions of coverage of each policy, may result in losing key areas of protection.

For example, a malpractice insurance carrier may deny coverage on the grounds that the claim did not arise out of the practice of law, that is, rendering professional services as a lawyer. Thus, in a case in which the plaintiff gave the insured lawyer $15,000 to invest for plaintiff and the money disappeared, when plaintiff sued the lawyer and his insurer, the insurer informed plaintiff that the policy did not cover the transaction that was the subject of the lawsuit, and the court upheld the insurer's position.[31] There is, however, case law to the contrary. A more recent case held that where an attorney accepted funds from a client and disappeared, the malpractice insurance was held to cover the loss, and plaintiff recovered from the insurer. The fact that the funds entrusted to the insured lawyer resulted from a legal proceeding in which the lawyer had represented the plaintiffs may have made a difference, as may the fact that the policy involved in the latter case expressly included fiduciary services.[32]

Both a lawyer and the lawyer's firm may be disadvantaged by the fact that lawyers may be held to high standards, particularly where an insurer claims absence of coverage under an exclusion for dishonesty. Where, for example, a lawyer who was also chairman of a bank encouraged ill-advised loans so his firm could earn fees, and a substantial loss in bad loans was suffered by the bank, a court held that the lawyer and his firm were liable for $35 million. The court also held that the lawyer had acted as the bank's chairman, not as a lawyer, and therefore could not have committed legal malpractice as a matter of law. As a result, both the lawyer and his firm were found to have breached their fiduciary duties, and neither was covered by their malpractice insurance.[33]

Pitfall #7 - The Lawyer-Director's Firm May be Deemed to Owe Fiduciary Duties to Persons Other than the Firm's Clients

Where a law firm represents one entity that may owe fiduciary duties to another entity, the presence of a firm's partner on the board of the first entity may cause a court to find that the firm also represents the interests of the second entity, thereby imposing on the firm fiduciary duties to the second entity. If a conflict arises between the two entities, the second may be able to argue successfully that no attorney-client privilege applies to preclude the second entity from obtaining discovery of communications between the firm and the first entity. Moreover, even if the requirements of the attorney-client privilege are met, the privilege may be deemed not to apply where the lawyer-director owes fiduciary duties to shareholders.[34]

Problems may also arise when a partner sits on the board of a subsidiary of a corporate parent that the firm represents. Attorneys, and their firms, generally undertake representation of corporate clients and their subsidiaries anticipating that conflicts are unlikely to arise. Where, however, an attorney serves two clients having common interests and each party communicates to the attorney, the communications are not

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[30] See generally K. Valihura & R. Valihura, Jr., <u>A Delaware Perspective On Advancing Directors' And Officers' Litigation Expenses</u>, Vol. 12, No. 1, Bank & Corporate Governance Rptr. (March 1994).

[31] *Smith v. Travelers Indem. Co.*, 343 F. Supp. 605 (M.D.N.C., 1972).

[32] *Continental Cas. Co. v. Burton*, 795 F.2d 1187 (4th Cir. 1986), at 1190.

[33] *FSLIC v. Mmahat*, 97 B.R. 293, (E.D. La. 1988), *aff'd*, 907 F.2d 546 (5th Cir. 1990), *cert. denied*, 499 U.S. 936 (1991).

[34] See *Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990), involving a rather complex set of facts in which a firm's partner was a member of a the board of directors of a subsidiary and the firm represented the parent against certain minority shareholders of the subsidiary in connection with a merger. The court found that the firm owed fiduciary duties to the subsidiary and its minority shareholders, and refused to apply attorney-client privilege to prevent their discovery of communications between the firm and the parent company.

privileged in a subsequent controversy between the two clients. Thus, when conflicts do arise, the risk of loss of the attorney-client privilege relating to communications between attorney and parent corporation (or attorney and subsidiary) is significant. Such loss may, for example, arise in connection with mergers and acquisitions, when minority shareholders are challenging the adequacy of the proposed purchase price and seek discovery of communications between attorney and client (the parent or majority shareholders) regarding appropriate prices to be paid.[35] In such cases, conflict of interest and attorney-client privilege issues are likely to be raised where it is advantageous to minority shareholders to take the position that a lawyer-director of a majority shareholder also owes fiduciary duties to the minority shareholders.

Problems may arise even when a lawyer serves as a director of a company to which the lawyer's firm does not provide legal advice. For example, In *Valente v. PepsiCo, Inc.*,[36] the general counsel of PepsiCo, a majority shareholder of Wilson Sporting Goods Co. ("Wilson"), served as a director of Wilson. In such dual capacity, the court found that he owed fiduciary duties to Wilson, including the minority shareholders of Wilson, who were suing PepsiCo, as well as to PepsiCo. The fact that Wilson did not have an attorney-client relationship with him was deemed "of no import"[37] in evaluating the situation. Later, a partner of Mudge, Rose, Guthrie & Alexander ("Mudge, Rose"), outside counsel to PepsiCo, replaced the general counsel of Wilson on Wilson's board of directors. The court found that the Mudge, Rose partner also owed Wilson and its shareholders fiduciary duties and that "Mudge, Rose, as his partnership, carried those same obligations."[38] This left not only the individual partner, but also his law firm as a whole, owing fiduciary duties to Wilson.

A related set of issues arises in connection with defining the corporate client, and state statutes that permit directors to consider the interests of other constituencies in addition to a corporation's shareholders.[39] Some commentators have suggested that state statutes that permit directors to consider the interests of various constituencies in fulfilling their fiduciary duties may provide a basis for barring lawyers from serving as directors of their corporate clients whose internal affairs are governed by such statutes. One commentator suggests that "one could ... argue that constituency statutes, by their very nature, illustrate the differences between the responsibilities of directors and lawyers, as lawyers are expressly prohibited by the ethical rules from considering the interests of corporate constituents."[40] The rationale underlying this view is that lawyers are prohibited by the ethical rules from considering the interests of corporate constituents.[41] The better view, however, appears to be that even under these statutes, directors owe their allegiance principally to the corporation and not to any particular constituent group and, thus, that the allegiances of lawyers and directors are largely consistent and the potential for conflict is not enhanced under these statutes.

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[35] See for example *AOC L.P. v. Horsham Corp.*, C.A. No. 12480 (Del. Ch. May 4, 1992), also involving a dispute in connection with the fairness of a merger arrangement.
[36] 68 F.R.D. 361, 368-69 (D. Del. 1975)
[37] *Id* at 368
[38] 68 F.R.D. at 369
[39] By way of an example, the corporate constituency statute of Pennsylvania provides: "A director of a business corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation...." and also provides that in discharging their duties, the board: "may, in considering the best interests of the corporation, consider to the extent they deem appropriate: (1) the effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located. See *Norfolk Southern Corp. v. Conrail, Inc.*, C.A. No. 96-CV-7167, transcript at 642 (E.D. Pa. Nov. 19, 1996) (bench ruling).
[40] *See*, e.g., *Albert*, *supra* at 427
[41] *See* Model Rules, Rule 1.13 cmt. (constituents of an organizational client are not the clients of the lawyer).

In the context of a preliminary injunction motion, one court has observed that the duty imposed on directors by the Pennsylvania statute "is to the corporation, not necessarily to the shareholders."[42] If that is the case, the concerns discussed above appear not to be justified.

Pitfall #8 - Ethical Limitations

As stated above, there are no ethical prohibitions against a lawyer serving as both lawyer and director for a corporate client. "The 1969 ABA Model Code of Professional Responsibility says nothing on the subject, and the 1983 ABA Model Rules of Professional Conduct apparently permit it."[43] The 1999 Edition of the Model Rules specifically refers to the possibility of dual representation and a possible requirement of consent in connection with it.[44] There are, however, ethical rules that may limit such dual service.

In the deliberations preceding the adoption of the Model Rules, "consideration was given to a flat prohibition" but that proposal was rejected in recognition of the "situations in which a lawyer's membership on the board can be a positive benefit to the corporate client."[45] Conflict of interest considerations are discussed in the commentary to Model Rule 1.7, which cautions that certain risks are inherent in such dual service and notes that the two roles may conflict. It cautions further that:

> The lawyer may be called upon to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director.[46]

There are also rules regarding “business transactions” within the meaning of Model Rule 1.8,[47] but the commentator concedes that he has found no authority indicating that taking a paid position as a director of a corporate client amounts to a “business transaction” within the meaning of Model Rule 1.8. Thus, although the argument remains available, research to date reveals no case in which it has been used to support a finding of unethical behavior in undertaking such a dual role.

Pitfall #9: Increased Liability Risks for the Lawyer-Director under the Federal Securities Laws

As indicated above, lawyer-directors may face greater liability risks under the federal securities laws than non-lawyer directors because they are held to the standard of care required of an ordinarily prudent lawyer-director, which is a higher standard of care than that required by an ordinarily prudent person, which is the standard required of a director who is not a lawyer.

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[42] *See Norfolk Southern Corp. v. Conrail, Inc.*, C.A. No. 96-CV-7167, transcript at 642 (E.D. Pa. Nov. 19, 1996) (bench ruling).

[43] *See* Wolfram, *supra* at 739; Geoffrey C. Hazard, Jr., <u>Is It Smart To Sit On a Client's Board?</u>, Nat'l L.J., Jan. 23, 1989, at 13

[44] See ABA Model Rule 1.13(e), Model Rules of Professional Conduct, American Bar Association Center for Professional Responsibility, 1998 Edition

[45] Hazard, *Id*.; <u>see also,</u> Monroe Freedman, <u>You CAN Do It, But You Shouldn't</u>, American Lawyer, Dec. 1992, at 43 (commenting that the Kutak Commission which drafted the Model Rules "declined even to consider a rule that [Freedman] had proposed in 1980 that a lawyer shall not serve as an officer or director of a publicly held company that is a client of the lawyer, of the lawyer's partners or associates, or of any firm or attorney with whom the lawyer has an of-counsel relationship").

[46] Model Rule 1.7 (commentary

[47] Freedman, *supra*, at 43

The higher standard has been applied in connection with liability under Section 11 of the Securities Act of 1933 (the "'33 Act") in the well-known *BarChris*[48] case. In *BarChris*, the court held the lawyer-director to a very high standard of independent investigation of an allegedly false and misleading registration statement because of his peculiar expertise and access to information. The lawyer-director had assisted in the preparation of the registration statement, and the court acknowledged holding him to a higher standard than it believed could be fairly expected of a non-lawyer-director who had no connection with the work. As a result, the lawyer-director was held liable for failure to meet the (higher) standard applicable to him.[49]

Similar risks are inherent in connection with possible liability under the Securities Exchange Act of 1934 (the "'34 Act"). In *Blakely v. Lisac*,[50] the court found a lawyer-director liable under the anti-fraud provisions of Section 10(b) of the '34 Act, on the grounds that he "knew or should have known of the misleading financial information in the prospectus which he should have investigated" because his "role was `beyond a lawyer's normal one,' and he is held to an even higher standard of care."[51]

There is also the possibility of exposure for violating Section 20(a) of the '34 Act because of the risk that a lawyer-director may increase the likelihood that his status will become that of a "controlling person", with the attendant increase in obligations imposed on such persons by that section. In *Cammer v. Bloom*,[52] the court found that allegations that one defendant "was a director, assistant secretary and [outside] attorney" for the corporate defendant were sufficient to survive a motion to dismiss a Section 20(a) claim, since "[i]t may be presumed for pleading purposes [that] a director, who was also corporate counsel and assistant secretary, in such a company would have at least some global responsibilities for, and interest in, corporate affairs."[53]

Pitfall #10: The Risk of Vicarious Liability for the Law Firm

As discussed above, it is possible that a lawyer may be deemed to be the firm's representative to the corporate client's board of directors. One commentator discusses three theories which, in his view, could result in imposition of liability for the law firm with which the lawyer-director is affiliated: (i) control person liability under Section 15 of the 1933 Securities Act and under Section 20(a) of the 1934 Securities Exchange Act, (ii) respondent superior theories and (iii) a "deputization" theory.[54]

He notes that the likelihood of a law firm incurring control person liability is remote because Sections 15 and 20(a) require some culpable conduct by the law firm before secondary liability will attach.[55] The likelihood of imposition of liability under a respondent superior theory is also remote, at least regarding alleged securities law violations, because "the principles of respondent superior are inappropriate to impose secondary liability in a securities violation case."[56] However remote, the possibility exists, and evaluation of its risk thus becomes relevant.

Some comfort on the issue is provided by the case of *Blau v. Lehman.*.[57] In that case, plaintiff alleged that the partnership had deputized the director (who was a member of the partnership) to represent the partnership's interests on the corporation's board of directors and that, by reason of his inside information, he caused the partnership to purchase stock of the corporation. The district court refused to impose Section 16(b) liability on defendant partnership, Lehman Brothers. The Court of Appeals affirmed,

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48 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 690 (S.D.N.Y. 1968)
49 *Id.*, at 689-90
50 *Blakely v. Lisac*, 357 F. Supp. 255, 266 (D. Or. 1972)
51 *Id.*, at 266
52 *Cammer v. Bloom*, 711 F. supp. 1264 (D.N.J. 1989)
53 *Id.*, at 1293-95
54 *Albert*, *supra* at 466
55 *Id.* at 468
56 See *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 884 (3d Cir. 1975)
57 *Blau v. Lehman*, 368 U.S. 403 (1962)

as did the United States Supreme Court. The district court had found, after trial, that Lehman Brothers purchased the stock solely on the basis of public information and without consulting the director who allegedly had been deputized. The Supreme Court noted that "Lehman Brothers would be a `director' of Tide Water, if as petitioner's complaint charged, Lehman actually functioned as a director through Thomas, who had been deputized by Lehman to perform a director's duties not for himself but for Lehman." The Court determined, however, that the factual findings below precluded such a holding.[58]

Of less comfort is a case involving allegations of insider trading and liability for short-swing profits under 16(b) against the president of Martin Marietta, who served on the board of Sperry Rand. In this case, the president-director was deemed to have been "deputized" by Martin Marietta to represent it on Sperry Rand's board, and the court held Martin Marietta responsible to Sperry Rand for short swing insider profits taken in violation of Section 16(b).[59] Although this case did not involve a lawyer-director, some commentators have suggested that the “deputization” reasoning could be applied to make a law firm liable.[60]

TIPS FOR AVOIDING THE PITFALLS

The first step in avoiding pitfalls is to identify them. The next is to remain aware, at all times, of those risks. The third step is to educate the client about the risks and pitfalls, and enlist the client’s assistance in instituting policies and procedures that will minimize the risks and maximize the benefits of having a lawyer-director if that is the choice the client makes.

Tip #1: Separate Business and Legal Advice

Not all discussions with counsel are attorney-client privileged. Corporate clients need to understand that fact, and understand when they are being given legal, and when they are being given business advice. Making the distinction requires attention of both counsel and client, and that awareness and attention can and should be reflected in verbal discussions and documents.

Board Meetings and Minutes of Meetings

An obvious risk-prone area is board of director meetings and minutes of those meetings. The lawyer-director should be responsible for identifying, in discussion, what advice is legal advice and what advice is business advice. In the absence of identification, discussions during meetings of the board of directors are likely to be seen as providing business advice, and thus not be protected by the attorney-client or work product privilege. The lawyer-director should ~~also~~ be responsible for reviewing draft minutes to assure that any legal advice provided during board meetings is identified as legal advice.

Additional protection may be obtained by instituting procedures to ensure that all directors are advised to restrict access to minutes and supporting documents as appropriate to assure confidentiality, and to assure additional precautions are outlined, as needed, if and when attorney-client privileged information is involved.

Documents

Mark all documents circulated to board members as "confidential" if they are, and as "attorney-client privileged" if they provide legal advice. Mark all documents circulated to board members as "work product of counsel" if they are.

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[58] 368 U.S. at 410

[59] *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970)

[60] <u>See</u> James H. Cheek, III, Howard H. Lamar, III & <u>Lawyers as Directors of Clients: Conflicts of Interest, Potential Liability and Other Pitfalls</u>, 22nd Annual Institute on Securities Regulation, Vol. 1 at 461, 499 (PLI Corp. Law & Practice Course Handbook Series No. 712, October 1990); see also Sam Harris, <u>The Case for the Lawyer-Director</u>, 30 Bus. Law. 58, 62 (1975).

Mark documents thoughtfully. Marking all documents "attorney-client privileged" or "work product of counsel" is likely to undercut, rather than fortify, successful assertion of either privilege. In general, effectively minimizing the risk that the attorney-client privilege will be inadvertently waived requires segregating legal advice and distinguishing it from business communications.

Educate clients regarding the applicable rules and maintain ongoing awareness.

Avoid intertwining legal and business advice in a single memorandum where possible. Where not possible, indicate clearly those parts of the document that provide legal advice and separate into paragraphs so the document can, if necessary, be produced in redacted form that excludes the legal advice.

Consider instituting internal procedures for gathering information and requesting documents that will support assertion of attorney-client privilege, including limited distribution, and document retention and destruction procedures. These should include procedures relating to voice mail and electronic communications. The latter pose particular risks because they feel like telephone calls and are therefore casually worded, but they are not, like telephone calls ephemeral. Rather, ~~but~~ because of corporate backup systems, email messages are likely to be long-lived.[61]

Tip #2: Guard against inadvertent waiver of privilege.

Maintain awareness, among attorneys and clients, that the privilege may be lost if the client does not continue to treat information as confidential *(e.g.,* when corporate employees attend a meeting outside the scope of their duties to the corporation).

Maintain awareness, among attorneys and clients, that the privilege may be lost if transmitted electronically in the absence of a secure system for assuring confidentiality of electronic communications and confidentiality of backup copies.

Maintain awareness, among attorneys and clients, that the attorney-client privilege belongs to the client, and may be lost for failure to distinguish between the corporation as client and individual officers and directors.[62]

Tip #3: Review D&O and Professional Liability Insurance Coverage to Reduce Exposure

Carefully evaluate the malpractice and D&O insurance of the lawyer-director to identify the scope of coverage of each, and assure that the activities of the lawyer-director do not "fall between the cracks."

Tip #4: Develop Law Firm Procedures to Authorize and Track Lawyers' Serving as Directors and the Organizations for Which They Serve

A law firm needs to know which of its lawyers serve as directors, the organizations for which they serve in that capacity, including subsidiaries and affiliates, and whether or not the firm or the lawyer performs legal services for that organization. In addition, firms need to develop and implement procedures for authorizing such service.. Such procedures should include methods of evaluating the likelihood that conflicts would arise that would adversely impact the lawyers' or firm's ability to function effectively in either capacity. The procedures should also assure that the lawyer-director is fully apprised of all of the potential pitfalls presented by such dual service and that the client is advised of these potential problems.

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[61] See, e.g., *Baxter Travenol Lab. v. Lemay*, 89 F.R.D. 410 (S.D. Ohio) and *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).
[62] Failure to make the distinction can also place counsel in the awkward position of having become attorney for the individual rather than the corporation.

Tip #5: Educate the Client

Prior to accepting dual service, the attorney has an obligation to become familiar with and educate the client about the risks, so that the client, with the attorney's help, can evaluate them and exercise informed judgment regarding whether or not accepting dual service is in the best interest of the client. Minimizing the risks associated with dual service requires enlisting the cooperation of the corporate client. No matter how skillful a lawyer-director may be, a lawyer-director cannot minimize those risks without educating and obtaining the assistance of the client.

Conclusion

There are advantages and disadvantages to dual service. Although dual service should not necessarily be encouraged, prohibiting the practice would be an extreme measure depriving a corporation of the opportunity to evaluate whether the benefits of dual service outweigh the risks. Rather than adopting a rule prohibiting the practice and restricting a corporation's freedom of choice, promoting awareness of potential pitfalls can assist the client in evaluating its options wisely.