ETHICS: FIDUCIARY DUTIES OF IN-HOUSE COUNSEL

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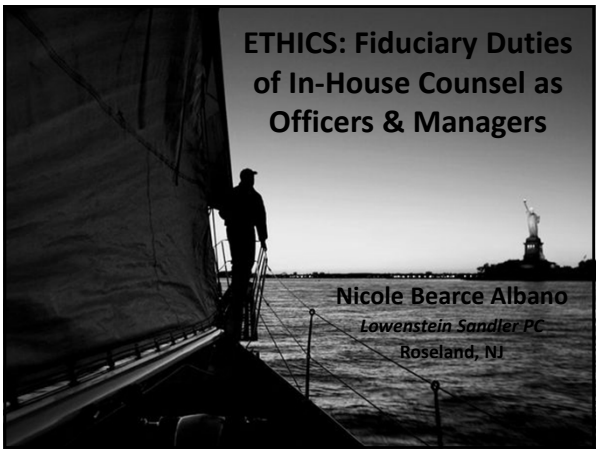

Consider the Context of the Preceding Decade…

Raises Questions About Management's Duties to Shareholders and Consumers

tyco TOYOTA LEHMAN BROTHERS ENRON WORLDCOM The Walt Disney Company

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Recent trends in the fiduciary duty/ corporate governance arena arise in the face of …

- **Changing economic landscape**
- **Increased power for shareholders in areas historically reserved to management**
- **Expanded role of government**
- **Environment of intense scrutiny**

Companies face a winding path with continued protections …

- Recent case law remains protective of boards and accords deference to their business judgment and sound governance principles
  - even in "bet the company" cases
  - provided there are reasonable and adequate risk management systems in place

… but also increased scrutiny

- That said, there has been (i) increased judicial scrutiny of:
  - Special Litigation Committees
  - Settlements in Shareholder Derivative Suits
- and (ii) inclusion of innovative governance reforms in settlement agreements (*See, e.g., Merck Shareholder Derivative Litigation* - (settlement approved in March 2010)
  - May be "pivotal moment in the corporate governance arena" (NY Times, Apr. 2, 2010)
  - Intended to create more transparency, to ensure scientific integrity, and to safeguard drug and patient safety, as noted by the presiding judge
  - Professor at Rutgers Business School paid by plaintiffs to help draft the settlement terms
  - Hiring chief medical officer, charged with monitoring product marketing and safety
  - Tasks board members for first time with safeguarding research ethics and drug safety
  - Calls for two new committees: one to look after product safety and another to address risks to the company

Courts' continued attention on fiduciary duties, though typically focused on directors

- 2009 & 1Q/2Q of 2010: continued activity for litigation focused on fiduciary duties, particularly on public company directors
- Many of those cases focused on the duties of a seller's board of directors, though at least one (*In re Dow Chemical*) in the context of acquiring company
- Generally, Delaware courts remained protective of the "business judgment rule"
- Maintained high bar to findings of "bad faith" and personal liability (*e.g.,* 2009 *Lyondell* decision)
  - an "extreme set of facts" – involving the complete and utter failure of the directors "to even attempt to meet their duties" – would be necessary to support claim that disinterested directors intentionally disregarding duties
  - Breach of good faith component of duty of loyalty requires much more egregious conduct than that necessary for breach of duty of care

"Massive Losses Happen"

- *In re Citigroup Inc. Shareholder Derivative Litigation* (Del. Ch. 2009)
  - Court held that complaint failed to plead claim for director oversight liability with particularity and conclusorily alleged liability should ensue merely because Citigroup incurred substantial losses
  - "[T]he mere fact that a company takes on business risk and suffers losses – even catastrophic losses – does not evidence misconduct, and without more, is not a basis for personal director liability."
    - Subprime-related derivative suits in Del and NY did not survive motion to dismiss
    - ERISA claims related to subprime market also dismissed
    - Executive compensation claims proceeding

Resounding Affirmation of Business Judgment Rule

- *In re Dow Chemical Company Derivative Litigation* (Del. Ch. 2010)
  - Dismissed shareholder claims, stating directors' decision was proper exercise of business judgment and plaintiffs could not challenge simply because unhappy with outcome
  - Plaintiffs focused principally on the "substantive content" of the directors' decision rather than the decision-making process
  - Citing to *Citigroup*, reiterated that business judgment rule prohibits second-guessing of the merits of a business decision
  - NO HEIGHTENED SCRUTINY standard of business judgment applicable to "bet-the-company" decisions
  - Neither the stakes of a decision nor its appearance in hindsight has bearing on protections of business judgment rule

Fiduciary Duties of Officers … An Uncertain Future

- "Corporate law's treatment of officers is like the weather: everybody talks about it but nobody does anything about it."
- Corporate statutes typically say relatively little about officers, in contrast to numerous provisions addressing directors and shareholders
- Case law on fiduciary duties of officers is also surprisingly sparse

Important doctrinal questions remain unanswered

- Does the business judgment rule apply to corporate officers?
- What precisely are the contours of an officer's duty of care and duty of good faith?
- What is the standard of care applicable to corporate officers?
- If officers are agents of the corporation, do they owe fiduciary duties to shareholders or only to the company itself?
- May officers consider the interests of non-shareholder constituencies in the same manner and degree as directors?

Lack of sharp focus on discrete fiduciary position of the corporate officer

- Officers appear to be under-advised about fiduciary duties – and about their own personal liability exposure – in a way that may enhance risk-taking on their part
- By contrast, outside directors are frequently told about their duties and liability exposure by lawyers, trade press, D&O insurers, etc. and may overestimate their risk of actual liability, leading to risk aversion
- Directors & officers may misunderstand risk, but in opposite ways
- In-house counsel face challenges in role of advisor in this context
  - they themselves may be business managers and more likely to assume multiple roles
  - financially dependent on corporate client for livelihood
  - depending on business organization, may lack access

Directors' & Officers' Liability

- D&O policies are designed to protect companies and their directors & officers from liabilities taken by those individuals in their corporate capacities
- D&O insurers continue to face the choice of providing coverage or rescinding coverage when confronted with corporate executive guilty please and shareholder suits alleging fraud
- Influx of declaratory judgment and rescission actions, particularly in the context of misrepresentations or omissions in insurance applications
  - applications typically require financial information, e.g., annual reports, financial statements, corporate bylaws, claims history
- D&O carrier's decision to rescind policy: coverage deemed never to have existed and realities of funding defense costs and settlement or judgment loom large

Lack of sharp focus on discrete fiduciary position of the corporate officer

- ***In re Walt Disney Co. Derivative Litigation*** **(2005)**
  - **plaintiffs sued General Counsel and CEO in their capacities as directors *and* as officers**
  - **legal nature of the fiduciary claims pressed at trial against Sandy Litvack and Michael Eisner as officers was essentially the same as claims made against them as directors**
  - **on appeal, while counsel changed course and argued for a stricter standard, the Delaware Supreme Court admonished that it was too late**
  - **survey of law firm analyses following the decision showed notable failure to address officer-specific fiduciary duty implications**

Limited Guidance Relating to Corporate Officers as a General Matter

- ***Gantler v. Stephens*** **(Del. Supreme 2009)**
  - **Matter of first impression that court addressed explicitly whether officers owe fiduciary duties identical to those of directors**
  - **Court did not mention the BJ rule in analysis applicable to claims against officers, but did so regarding the claims against directors**
  - **Rather than apply the usual analytical framework requiring plaintiffs to overcome presumptions of BJ rule, the court found the allegations against the officers "state a claim that they breached their fiduciary duties as officers"**
  - ***Gantler*** **addressed duty of loyalty issue and neither duty of care nor officer oversight responsibilities**
    - **Consider *Caremark* doctrine application to director oversight liability**
  - **Issue of ordinary negligence versus gross negligence standard in the care context not raised before the court**

Murky Guidance Where Intersection of Roles as Officer and In-House Counsel

- ***Miller v. McDonald, et al.*** **(D. Del. Bankr. 2008)**
  - **Bankruptcy Court (relying on decisions of Delaware Chancery and Delaware Supreme Court) denied motion to dismiss *Caremark* claims against officer of World Health, who was also the in-house general counsel and NOT a director**
    - ***Caremark*** **articulates necessary predicates for director oversight liability, including**
      - **(i) directors utterly failed to implement any reporting or information system or controls; or**
      - **(ii) having implemented such a system or control, consciously failed to monitor or oversee its operation thus disabling themselves from being informed of risks or problems requiring their attention.**
  - **The officer/in-house general counsel was on the management team (as vice president of operations) when the president of the company committed fraud and other actions/omissions that led to the bankruptcy filing of the company**

Intersection of Roles as Officer and In-House Counsel

- *Miller v. McDonald, et al.* (D. Del. Bankr. 2008)
  - NOT a "deepening insolvency" case, but rather involved fiduciary duty claim that alleged that even if the defendant did not commit any of the fraud and other abuses that led to downfall of company, he breached his fiduciary duty to make an effort to put monitoring systems in place that would have increased the likelihood the fraud perpetrated could have been detected sooner and/or could have been prevented sooner
  - Relied upon *Disney* litigation
  - Also relied upon Section 307 of the Sarbanes Oxley Act because publicly-held company and that section applies to lawyers

Intersection of Roles as Officer and In-House Counsel

- *Miller v. McDonald, et al.* (D. Del. Bankr. 2008)
  - According to the trustee's allegations, examples of failure by defendant officer to meet oversight responsibilities included material misrepresentations contained in SEC filings
  - Section 307 addresses professional responsibilities of attorneys and directs SEC to issue rules that "set[] forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers."
  - "[T]he Trustee appropriately asserts that [defendant officer] as the in-house general counsel and the only lawyer in top management of World Health during the relevant period, had a duty to know or should have known of these corporate wrongdoings and reported such breaches of fiduciary duties by the management."

Interesting Developments Outside Typical Partner-Officer-Director Realm

- Corporate Counsel
  - "[We] have a limited understanding of the place of general counsel, and more generally the legal department, inside the corporation."
    - Publicly Held Companies
      - Sarbanes Oxley Act
    - Closely Held Companies
      - may be subject to even greater scrutiny & liability given lack of public accountability

Sarbanes-Oxley: Responsibilities of Inside & Outside Counsel

- "Up-the-Ladder" Reporting: outside and in-house counsel who "appear and practice" before the SEC must report evidence of material violations of securities laws or breaches of fiduciary duty or similar violation by the company or any of its officers, directors, employees, agents
  - to the company's chief legal officer (usually the general counsel) and chief executive officer
  - if such report is not properly responded to by the adoption of appropriate remedial measures or sanctions, attorney must report the evidence to the audit committee (or other committee comprised solely of non-employees of the company) or to the full board
  - senior attorneys supervising other attorneys held responsible for their subordinates' compliance
  - attorneys who report directly to CLO not treated as subordinates
  - If violations reported by subordinates, supervisory attorney becomes obligated for up-the-ladder reporting

Some Statistics Related to In-House Counsel

- Between 1998-2001, SEC initiated civil enforcement actions against 12 inside counsel
  - Most of these directed at general counsel or most senior legal officer directly involved in preparation, approval and/or signing of allegedly false financial statements or representations included in SEC filings or other publicly disseminated documents
  - Most resolved by settlement
  - In nearly half of the actions, inside counsel were either barred or suspended from appearing or practicing before the Commission
- Between 1995-2001, Justice Dept brought 5 criminal actions against inside counsel for role in fraudulent securities schemes engaged in by other officers or employees

Some Statistics Related to In-House Counsel

- Between 2002-2009, SEC initiated enforcement actions against approximately 19 inside counsel
  - Most of these directed at general counsel or most senior legal officer directly involved in preparation, approval and/or signing of allegedly false financial statements or representations included in SEC filings or other publicly disseminated documents
  - Most resolved by settlement
  - In nearly half of the actions, inside counsel were either barred or suspended from appearing or practicing before the Commission
- In same timeframe (after establishing Corporate Crime Task Force), Justice Dept brought at least 8 criminal actions against in-house counsel for violations of securities laws

SIX GENERAL PRINCIPLES DERIVED FROM NONCRIMINAL SEC SANCTIONS

- The top lawyer is nearly always the target
- Inside lawyers who relied on outside counsel advice are seldom SEC targets
- Putting money in your pocket is not necessary to prompt SEC enforcement
- Disclosures, particularly omissions in disclosures, are usually the problem
- A generalist lawyer serving as general counsel must seek out sound advice or pay the price
- Your risk increases if you hold several corporate offices, your company failed, or you sat on a serious problem you could have taken to the Board.

- John K. Villa, *Inside Counsel as Targets: Fact or Fiction?*, 40th Annual Institute on Securities Regulation (Nov. 2008)

SEVEN GENERAL PRINCIPLES DERIVED FROM SEC CRIMINAL PROSECUTIONS

- The criminal targets are the chief legal officers
- Big losses increase risk of prosecution
- Having outside counsel can make a big difference
- The crimes charged are often perjury and obstruction of justice
- Mere knowledge of conduct later deemed criminal is typically not enough
- Counsel are seldom charged where alleged fraud is complex and its propriety is debatable
- Prosecutors' true goal is to undermine the executive's advice-of-counsel defense

- John K. Villa, *Inside Counsel as Targets: Fact or Fiction?*, 40th Annual Institute on Securities Regulation (Nov. 2008)

"Entity Rule" - Rule 1.13 of the Professional Rules of Conduct

- Generally provides that corporate counsel represents only the corporation and not its individual constituents
  - May be difficult to apply in practice; sometimes authorized actions come from several sources
  - In-house counsel should keep paramount the entity's interests
  - Also includes "up-the-ladder" reporting as well as "reporting out"
- E.g., in close corporations: "ownership and management are usually identical or substantially overlapping, making it more difficult in practice to draw a line between individual and corporate representation." *ABA/BNA Lawyers' Manual on Professional Conduct § 91:2001 (2000)*
- Does not provide safe harbor for attorneys who fail to remain neutral and instead take sides in fights among shareholders for control of corporation. *Id.*

Fiduciary Obligations of Corporate Counsel to Close Corporations

- Can an attorney representing a closely held corporation be liable for breach of fiduciary duty to one of the corporation's shareholders?
- Issues often arise in the context of fights for corporate control
  - Typically involve situation where two or three equal shareholders
  - Is the corporate counsel liable to the ousted shareholder-director?

Fiduciary Obligations of Corporate Counsel to Close Corporations

- Courts have taken three different approaches

(1) The lawyer (or law firm) owe fiduciary duties to each of the corporation's shareholders

- Treat the close corporation as analogous to partnership
  - *See, e.g., Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler*, 309 N.W.2d 645 (Mich. Ct. App. 1981); *Schaeffer v. Cohen, Rosenthal, Price, Mirkin, Jennings & Berg P.C.*, 541 N.E.2d 997 (Mass. 1989)
- "[T]he corporate attorneys, because of their close interaction with a shareholder or shareholders, simply stand in confidential relationships in respect to both the corporation and individual shareholders."
- An attorney for a close corporation may well be in privity with the corporation's shareholders, despite the "corporate counsel" label – though no *per se* duty in every case

Fiduciary Obligations of Corporate Counsel to Close Corporations

- More recent cases have declined to extend the rationales of cases such as *Fassihi* and *Schaeffer*
  - *See, e.g., DeSantis v. Biehler*, 2007 WL 711567 (N.J. Super. Ch. Jan. 30, 2007); *Banco Popular N. Am. v. Gandi*, 184 N.J. 161 (2006); *Cortran Group, Inc. v. Dinnin*, 1999 WL 33453834 (Mich. App. Mar. 9, 1999)
    - *DeSantis* shareholder argued that CLO owed him fiduciary duty, as counsel for the business entity
    - *DeSantis* and *Cortran* courts noted majority view that lawyer representing organization does not owe fiduciary duty to constituent member of business entity
    - Emphasis that both invitation to rely and reliance are linchpins of attorney liability to third parties
    - Important factual issue was whether CLO advised shareholder, during merger process, to secure independent counsel

Fiduciary Obligations of Corporate Counsel to Close Corporations

(2) The lawyer (or law firm) owes fiduciary duties directly to ousted shareholder based on existence of attorney-client relationship

- **Based on two propositions that an attorney owes fiduciary duties to his client and that the existence of an attorney-client relationship is a question of fact**
  - **"Although, in the ordinary situation, corporate counsel does not necessarily become counsel for the corporation's shareholders and directors, [it may be] reasonable [in the close corporation context with a limited number of shareholders] for each shareholder to believe that the corporate counsel is in effect his own individual attorney." *Rosman v. Shapiro,* 653 F. Supp. 1441 (S.D.N.Y. 1987)**
  - **"….[D]espite the rule that the organization is the client, a lawyer-client relationship has nonetheless been formed between the lawyer and the constituent. This is more likely to happen when the entity is a close corporation or other small organization." *ABA/BNA Lawyers' Manual on Professional Conduct § 91:2001 (2000)***

Fiduciary Obligations of Corporate Counsel to Close Corporations

- **Nonetheless, Second Circuit has subsequently rejected the "reasonable reliance" test articulated in *Rosman*, in the context of privilege *(see International Bhd. of Teamsters*, 199 F.3d 210, 217 (2d Cir. 1997); *see also Mackenzie-Childs LLC v. Mackenzie Child LLC*, 262 F.R.D. 241 (W.D.N.Y. 2009))**
  - **Court noted little support in case law for alternative standard based on employee's "reasonabl[e] belie[f]" that he was being represented by corporate counsel on individual basis**
- **Likely to see similar limitation in context of fiduciary duties**

Fiduciary Obligations of Corporate Counsel to Close Corporations

(3) Rather than a direct fiduciary relationship, focus on whether the corporate counsel has aided and abetted breaches by one or more of the close corporation's shareholders of the fiduciary duties owed by them to the ousted shareholder

- **Consider whether the defendant lawyer/law firm assisted the shareholders knowing that the conduct was in violation of their fiduciary obligations**
  - ***See, e.g., Granewich v. Harding*, 985 P.2d 788 (Or. 1999)**
  - **Allegations that lawyer's actions fell "outside the scope of any legitimate employment on behalf of the corporation"**
  - **Left question unanswered when lawyer representing client may be liable for client's torts (*Reynolds v. Schrock*, 142 P.3d 1062 (Or. 2006)**

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Harvard Law School (J.D., 1997), cum laude; Vice President, Harvard Legal Aid Bureau; Executive Editor, Harvard Women's Law Journal

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Nicole Bearce Albano is an experienced litigator at both the trial and appellate levels, with a substantial part of her practice focusing on complex fiduciary duty cases. Nicole handles a diverse range of matters, including shareholder derivative and ERISA class actions in the corporate context; fiduciary duty disputes among members of partnerships, closely held corporations, LLCs and LLPs; conflict of interest challenges involving higher education and institutionally related foundations; as well as will contests, guardianship proceedings and contested accountings.

Nicole also counsels business owners who face the unfortunate circumstance of navigating business divorce (and aggressively handles related litigation when needed) -- matters that often involve claims of fiduciary breach as well as corporate governance conflicts, oppression claims, business tort actions, valuation disputes, nuanced contract interpretation, dissolution defenses, real estate matters and emergent/injunctive relief. Understanding that many clients strive to resolve their issues without judicial process and that business breakups can be particularly emotional and complicated, Nicole utilizes her skills honed from handling mediation, arbitration and myriad out-of-court negotiations. In that vein, she is a firm believer in the benefits of early conflict assessment and management, and serves as a Committee member of the International Institute for Conflict Prevention and Resolution (CPR).

Should resort to the courts become necessary or deemed the best strategic course of action, Nicole's experience has included all phases of fact and expert discovery, motion practice, jury and bench trials, and appellate arguments. Clients have complimented her "quick reaction" and "sharp questions" in the courtroom. She has appeared in the federal and state courts of New Jersey and New York, as well as the Chancery courts of New Jersey and Delaware. Nicole is passionate about advocating on behalf of her clients -- a drive that was kindled from the beginning of her legal career representing indigent clients as a student attorney while at Harvard Law School.

Nicole has been recognized as a "Rising Star" by New Jersey Super Lawyers for the past five consecutive years. She has been appointed to both the Class Action Committee and the Special Committee on Higher Education of the New Jersey State Bar Association, and is also an active member of the National Association of College & University Attorneys.