

Ethical Issues for Business Lawyers

Lawyer-Directors: Just a Bad Idea

By C. Evan Stewart

One of the biggest country hits of 1978 was “Mamas, Don’t Let Your Babies Grow Up to Be Cowboys.”¹ Substitute “Lawyers” for “Babies” and “Directors” for “Cowboys,” and you will get the theme of this article.

Is It Ethical?

First off, and as Richard Nixon used to say, let me make one thing perfectly clear: It is not unethical for lawyers to serve as directors of public companies. Indeed, it is not necessarily unethical for a lawyer to serve as a director of a corporation which is also a client. ABA Model Rule 1.7(a)(2) sets forth the guiding principle: a lawyer runs afoul of her ethical obligations if “there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client.” Comment 35 to that Rule more specifically addresses the lawyer / director / two-hats issue:

A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such 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 or should cease to act as the corporation’s lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at a board meeting while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer’s recusal as a director or might require the lawyer and the lawyer’s firm to decline representation of the corporation in a matter.

In 1998, the ABA went further in providing guidance with ABA Formal Ethics Opinions 98-410.² The opinion answered “yes” to the “may lawyers serve as directors of corporate clients” question, subject to a number of caveats. The key ones are that a lawyer seeking to wear two hats should: (i) sufficiently inform management and the board about his or her dual roles; (ii) make clear that he or she will be required to recuse him or herself when faced with a conflict of interest (e.g., choosing outside counsel on a matter); and (iii) recognize there may be circumstances in which he or she should decline to act in his or her role as counsel (e.g., where there may be potential liability arising out of a board decision).

Later that same year an ABA task force went further.³ While recognizing there “is no *per se* rule of professional ethics that prohibits any lawyer—inside or outside—for a corporation or other organization from also serving on its board of directors,” the task force sought to discourage the practice because “the risks may prove to be significant in certain circumstances” (e.g., potential waiver of the attorney-client privilege, the creation of conflicts of interest, possible coverage gaps at the intersection of malpractice insurance and corporate D&O policies, undermining the lawyer’s professional independence, exposing lawyers to increased liability risks).⁴

But Is It Smart?

The first danger identified by the ABA—waiver of the privilege—is a real one. Numerous courts have held that, because a lawyer / director has fiduciary duties to the shareholders, there would be no privilege as to certain communications between the lawyer’s firm and the corporation.⁵ Attempting to navigate through these dangerous shoals by erecting information barriers has not proved uniformly successful.⁶ And beyond this issue is the related concern that a lawyer’s legal duties may be in conflict with his or her director duties and thus create some unfortunate (and unforeseeable) consequences.⁷ The insurance coverage issue is also no academic matter, as the WorldCom directors (which included outside legal talent) discovered, much to their individual financial detriment.⁸

As if the foregoing were not enough to dissuade lawyers, one would think that greater exposure to increased liability would close the deal. As it is, directors’ legal and regulatory exposure has been ratcheted up tremendously over the past decade (and more).⁹ And even before that it was clear that lawyers who serve as directors do so with a

bullseye on their chests—i.e., lawyers are held to a higher standard of care.¹⁰

The first real jurisprudence on heightened lawyer liability came in *Escott v. BarChris Construction Corp.*¹¹ Analyzing whether a lawyer-director (who also was an outside lawyer to the company) could successfully assert the due diligence defense under Section 11(b) of the Securities Act of 1933, the court accepted the individual's representations that he was not aware of any material problems in the company's prospectus. The court nonetheless found that there were certain matters of which someone of the lawyers' expertise and experience should have been aware, which constituted clear red flags or were at least discoverable upon a non-audit like investigation (e.g., overstatement of the value of contracts, loans to the corporation by its officers). As such, the lawyer-director was held liable for his failure(s) to act.¹²

Several years later this liability trap was further "clarified" in *Feit v. Leasco Data Processing Equipment Corp.*¹³ Once again the legal issue was what met the due diligence defense safe harbor for purpose of Section 11(b). As a broad principle, the court opined:

What constitutes "reasonable investigation" and a "reasonable ground to believe" will vary with the degree of involvement of the individual, his experience, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions. . . . Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the Registration statements than outside directors. . . . Each must undertake that investigation which a reasonably prudent man in that position would conduct.¹⁴

Applying that standard to the lawyer-director in the hot seat, the court held that his responsibility came near to being a "guarantor of accuracy" for the securities filing.¹⁵ Subsequent courts have followed the *BarChris* and *Feit* courts as to lawyer-directors' higher standards to uncover fraud or wrongdoing.¹⁶ Other related liability hooks include lawyer-directors being held to be "controlling persons" under Section 20 of the Securities Exchange Act of 1934,¹⁷ as well as a law firm being held to have fiduciary obligations to corporate shareholders by dint of one of its partners serving on the corporation's board of directors.¹⁸

Conclusion

Notwithstanding the many obvious downsides mentioned above, a number of lawyers still clamor for the honor and glory of being a corporate director.¹⁹ This seems to stem from some notion that we lawyers may in fact be smarter than our business clients, that we really are "the best and the brightest," etc.²⁰ Unfortunately, that sort of hubris shows how really smart people can be really dumb sometimes.²¹ On this subject, perhaps lawyers should just remember (and act upon) Mom's advice!

Endnotes

1. This song, by Waylon Jennings and Willie Nelson, spent four weeks at No. 1 on Billboard's Hot Country Singles chart (replacing *Don't Break the Heart That Loves You*, by Margo Smith, and being replaced by *Ready for the Times to Get Better* by Crystal Gayle). Jennings and Nelson won a Grammy award for the song (Best Country Vocal Performance by a Duo or Group).
2. See 14 Law. Man. Prof. Conduct 105 (1998). For other Bar authorities offering guidance for lawyers serving on clients' board of directors, see also Oregon Ethics Op. 1991-91 (1991), New York State Ethics Op. 589 (1988), Maryland Ethics Op. 87-29 (1987), Illinois Ethics Op. 86-14 (1987) and New Hampshire Ethics Op. (7A) (1982). For a view that the "two hats" should never be worn, see Albert, *The Lawyer-Director: An Oxymoron?*, 9 GEO. J. LEGAL ETHICS 413 (1996); Mundheim, *Code of Professional Responsibility Forbids Lawyers to Serve on Boards of Corporations for Which They Act as Counsel*, 33 BUS. LAW. 1507 (1978). For the contrary view, see Straub, *ABA Task Force Misses the Mark: Attorneys Should Not Be Discouraged from Serving on Their Corporate Clients' Board of Directors*, 25 DEL. J. CORP. L. 261 (2000).
3. See 14 Law. Man. Prof. Conduct 183 (1998).
4. The American Law Institute has issued an advisory opinion similar to that of the ABA's task force. See RESTATEMENT OF THE LAW GOVERNING LAWYERS § 135 cmt. d (2000).
5. See, e.g., *AOC Ltd. Partnership v. Horsham Corp.*, 1992 Del. Ch. LEXIS (Del. Ch. 1992); *Deutsch v. Logan*, 580 A.2d 100 (Del. Ch. 1990); *Securities and Exchange Commission v. Gulf & Western Ind., Inc.*, 518 F. Supp. 675 (D.D.C. 1981); *Valente v. PepsiCo, Inc.*, 68 F.R.D. 361 (D. Del. 1975); *U.S. v. Vehicular Parking Ltd.*, 52 F. Supp. 749 (D. Del. 1949). Some of the issues inherent in this area are highlighted by the ongoing criminal and civil litigations involving AIG. In one manifestation, two former senior AIG officers and directors under indictment (who also have civil disputes with their former company) were allowed by the Appellate Division, First Department, to inspect privileged legal memoranda that were prepared for AIG during their tenure on the board of directors. See *Indicted Directors Entitled to See Legal Memos*, *New York Court Rules*, BNA SECURITIES REGULATION & LAW REPORT 327 (March 3, 2008).
6. See, e.g., *American Steamship Owners Mutual Protection & Indemnity Association, Inc. v. Alcoa Steamship Co.*, 232 F.R.D. 191 (S.D.N.Y. 2005). Corporate boards relying instead on the so-called "self-evaluation" privilege to protect communications should be skeptical (at best). See *Beam v. Martha Stewart*, 845 A.2d 1040 (Del. Sup. Ct. 2004). See also C. E. Stewart, *Self-Critical Analysis: An Emerging Privilege?* N.Y.L.J. (December 17, 1992).
7. See, e.g., Ohio Supreme Court Bd. of Commissioners on Grievances and Discipline, Op. 2008-2 (June 6, 2008) (lawyer's service as a director bars lawyer's firm from suing corporation); *FDIC v. Mmahat*, 907 F.2d 546 (5th Cir. 1990) (lawyer/director held to have improperly urged board members to approve "risky" loans in order to generate fees for his law firm); *Harrison v. Keystones Coca-Cola Bottling Co.*, 428 F. Supp. 149 (M.D. Pa. 1977) (lawyer/director

disqualified because he was a co-defendant with the corporation); *Cottonwood Estates Inc. v. Paradise Builders Inc.*, 624 P.2d 296 (Ariz. 1981) (lawyer disqualified from representing corporation where he had to testify as to board actions). One company recently solved the conflict issue by firing the law firm and keeping the lawyer on as a director. See A. Efrati, *Showdowns Highlight Lawyers-as-Directors Risks*, (June 7, 2007) (reported on WSJ.com on law and business and the business of law).

8. See Morgenson, *10 Ex-Directors From WorldCom to Pay Millions Using Their Own Money: Rare Sort of Concession Is Made in Settlement of Investor Lawsuit*, N.Y. TIMES, Jan. 6, 2005 at A1. See also *FSLIC v. Mmahat*, 1988 U.S. Dist. LEXIS 7136 (E.D. La. Jun. 29 1988), *aff'd sub nom. FDIC v. Mmahat*, 907 F.2d 546 (5th Cir. 1990) (jury found that neither a lawyer-director of failed savings and loan, nor his law firm, was covered by malpractice insurance or the D&O policy); *Continental Casualty Co. v. Smith*, 2003 U.S. Dist. LEXIS 50 (E.D. La. Jan. 2, 2003) (malpractice insurance did not cover lawyer-director). See generally Metzger & Chunias, *Two Years After Sarbanes-Oxley: Assessing the Impact on D&O Liability Insurance*, 37 SEC. & COM. REG. 99 (May 25, 2004); Rosenberg, Sigelko, Chaskin, Posner & McGhee, *Negotiating D&O Policies: Key Terms and Conditions*, 37 SEC. & COM. REG. 31 (Feb. 25, 2004).
9. See C. E. Stewart, *The Yin & Yang of Corporate Governance*, N.Y.L.J. (Oct. 11, 2005); R. C. Saver, *The Changing Dimensions of Director Liability Under the Federal Securities Laws*, BNA SECURITIES REGULATION & LAW REPORT 413 (Mar. 7, 2005); L. N. Silverman & S. L. Fisher, *Director Due Diligence After WorldCom*, 39 SEC. & COM. REG. 1 (Jan. 18, 2006); see also White, *Blame for Scandals Entering the Board Room*, WASHINGTON POST, at E1 (Jan. 7, 2005) ("What was once a gilded position offering hefty compensation for minimal work is becoming a more challenging job fraught with the risk of significant financial liability.").
10. This recalls the *Far Side* cartoon by Gary Larson in which two deer are conversing in the woods. One deer with a normal coat of fur says to the other deer, which has a large bulls-eye emblazoned on its chest, "Bummer of a birthmark, Hal."
11. 283 F. Supp. 643 (S.D.N.Y. 1968).
12. *Id.* at 690.
13. 332 F. Supp. 544 (E.D.N.Y. 1971).
14. *Id.* at 578.
15. In most instances, lawyer-directors wearing two hats will be deemed to be "inside" directors. See *Feit, supra*, 332 F. Supp. at 575-76, 578. In some limited circumstances, however, lawyers have evaded that bulls-eye. See *Counsel to Fund's Independent Directors*

May Also Serve as Disinterested Director, BNA CORPORATE COUNSEL WEEKLY 147 (May 8, 2002).

16. See, e.g., *Blakely v. Lisae* 357 F. Supp. 255 (D. Ore. 1972). A similar analysis has been used to hold directors with "specialized financial expertise" to a higher standard. See *In re Lernout & Hauspie Sec. Litig.*, 286 B.R. 33 (D. Mass. 2002); *In re Emerging Communications Inc. Shareholders Litig.*, 2004 Del. Ch. LEXIS (May 3, 2004); *In re WorldCom, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 93,137 (S.D.N.Y. Mar. 21, 2005).
17. See *Cammer v. Bloom*, 711 F. Supp. 1264 (D. N.J. 1989) (lawyer, who was a director, assistant corporate secretary, and outside counsel held a "controlling person" under Section 20). See also *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268 (S.D.N.Y. March 21, 2005) (review of "controlling person" liability).
18. See *Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990).
19. See E. Rosen, *Female Lawyers Set Sights on Yet One More Goal: A Seat on a Board*, N.Y. TIMES, Sept. 6, 2007, at C5; A. Peters, *Lawyers Get Back on Board*, FULTON COUNTY DAILY REPORT (July 19, 2007) (reported on Law.com's In-House Counsel); A. Efrati, *Showdowns Highlight Lawyers-as-Directors Risks* (June 7, 2007) (reported on WSJ.com on law and business and the business of law); J. Scheck, *Prominent Corporate Lawyers Didn't Stop Shady Options Deals*, THE RECORDER (August 28, 2006) (reported on Law.com's In-House Counsel).
20. See Mundheim, *supra* note 2 at 1515-16 (Remarks of Kenneth J. Bialkin: "Some of the best of us are not only damn good lawyers, but damn good businessmen; and to deprive the business community of the opportunity to use those people's services in both roles . . . would be a terrible mistake.").
21. The foregoing traps are, of course, exclusive of the extra responsibilities and liabilities imposed upon lawyers by Sarbanes-Oxley and the subsequent legacy of that legislation. See C. E. Stewart, *Regulating the Legal Profession: Sense or Nonsense?*, N.Y.L.J. (May 15, 2008); C. E. Stewart, *The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?*, BNA SECURITIES REGULATION & LAW REPORT (Feb. 18, 2008).

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