INSIDE: PROFESSIONAL CONDUCT UNDER SARBANES-OXLEY

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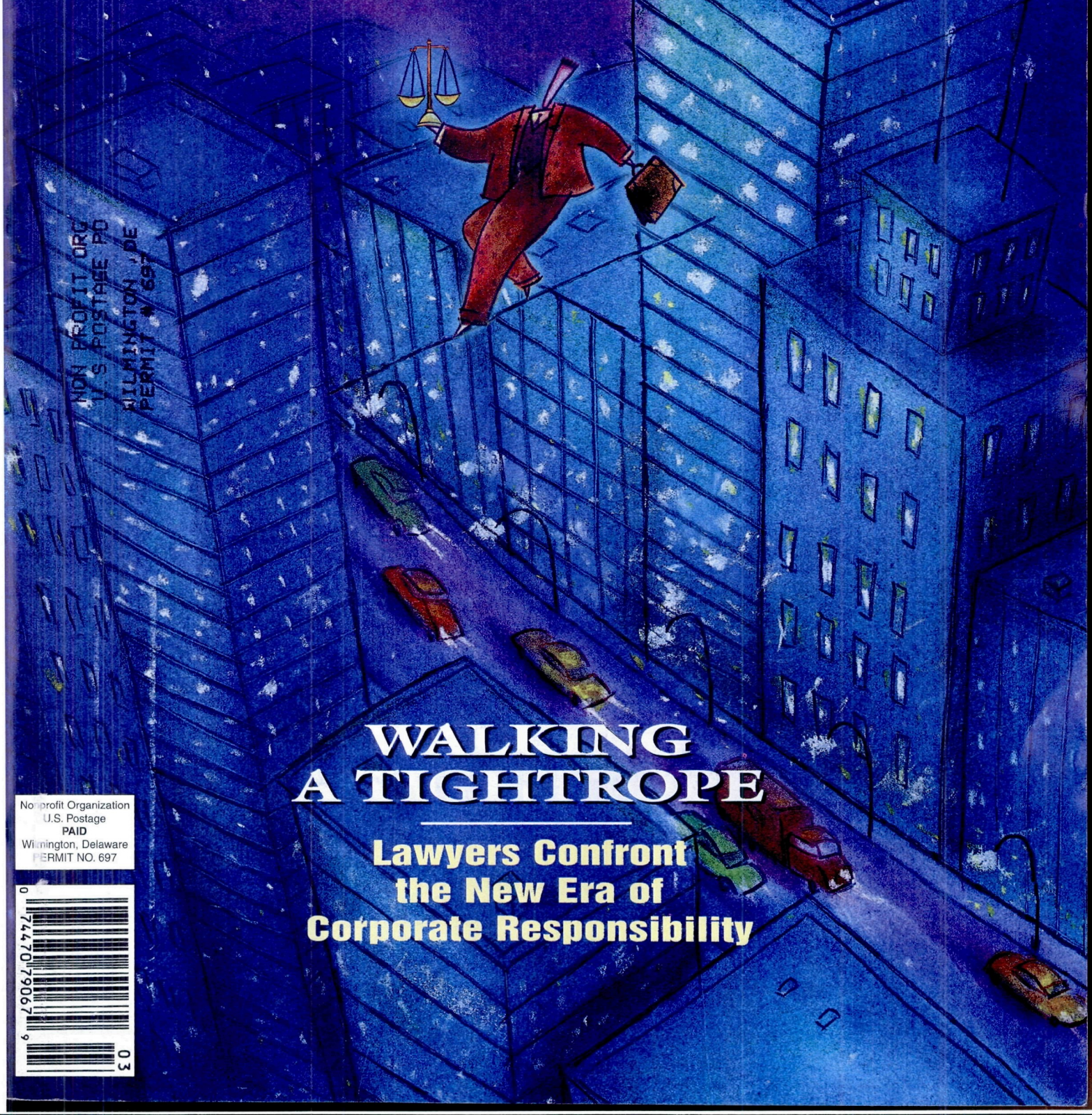

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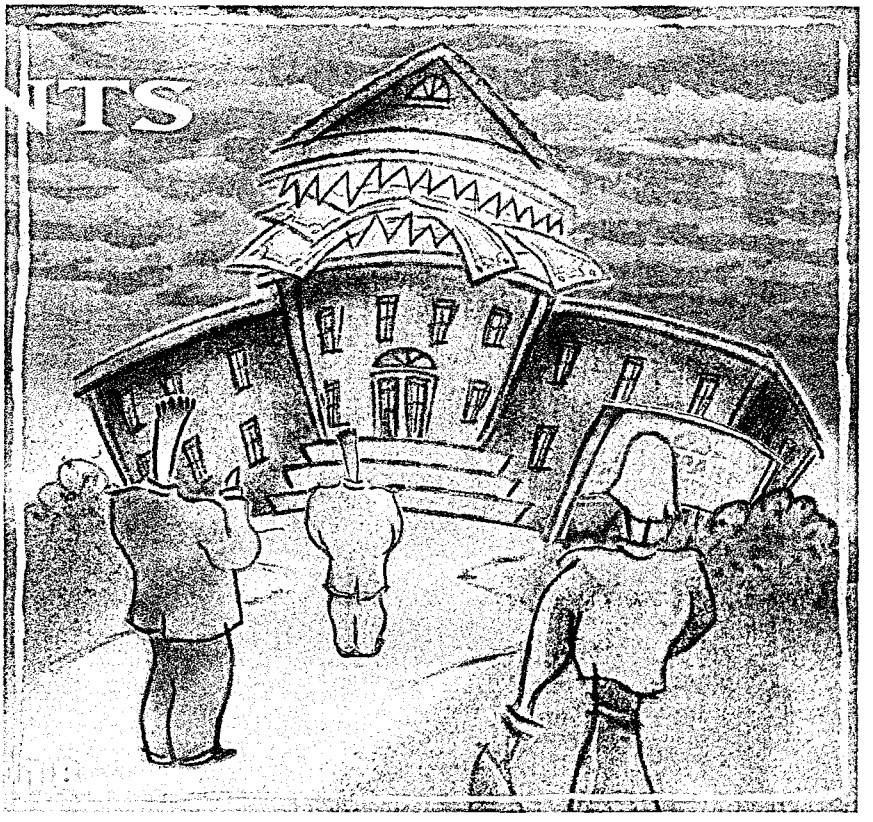

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This issue of *Delaware Lawyer* focuses on corporate responsibility. While tales of corporate irresponsibility normally last but a news cycle of three-to-four days, the topic has been "front page" since at least the third quarter of 2001. In the argot of news reporters, this story has "legs." Indeed, more than eighteen months since we first read of Enron (in fact Enron was preceded by Global Crossing and Waste Management), the news breaks, feature stories, follow-ups, side bars, columns, editorials, "perp walks" and investigative accounts continue. Only the names change, as WorldCom, Tyco, Adelphia, and now HealthSouth are added to the story lines.

These actions spawn reactions. Congress has passed the Sarbanes-Oxley Act, the SEC seeks to implement it, stock exchanges amend their rules, the ABA has created a high-profile Task Force on Corporate Responsibility, and ethics precepts change.

Lawyers perceive themselves walking a tightrope — hence the title of this issue. Our contributors emphasize the practical — the "nuts and bolts" of Sarbanes-Oxley in an article by Charles McCallum, the changing world of in-house counsel by Harold Barron (himself a former General Counsel at Bendix and Unisys), a peek behind the curtain at the ABA's Task Force on Corporate Responsibility by its reporter, our own Larry Hamermesh, and a reassessment of the Private Securities Litigation Reform Act by the nationally-known Gregory Joseph. David McBride, my co-editor, bookends this issue with a perspective uniquely engaging and thought provoking.

Thanks to all of our authors. They make this issue a "keeper," even if the topic is — to borrow a phrase from the late Rodney Layton — "[l]ike the proverbial pig on ice, we don't know where it will stop."

Hon. Thomas L. Ambro

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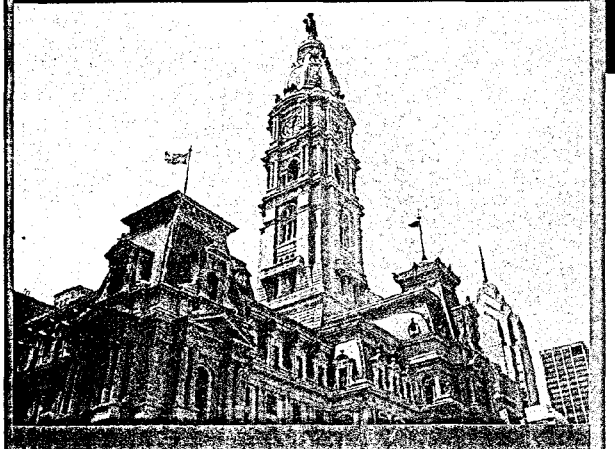

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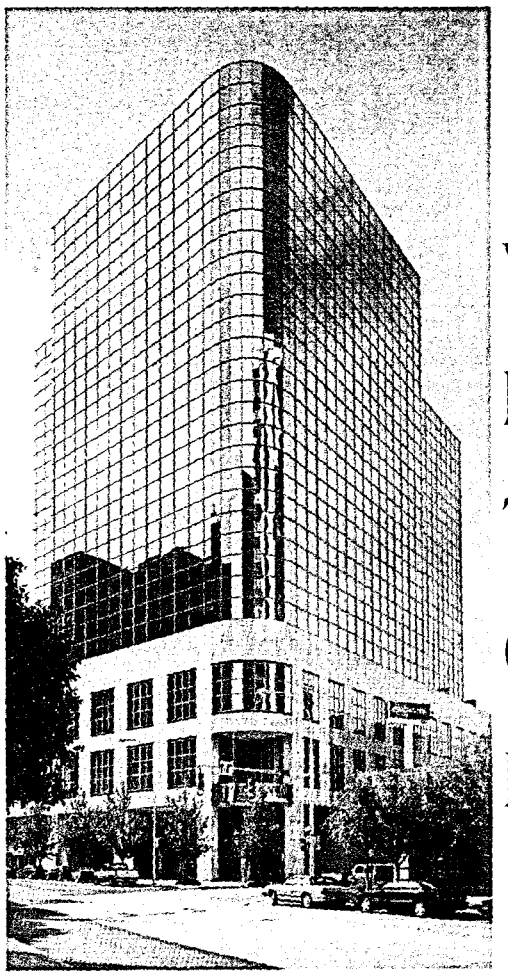

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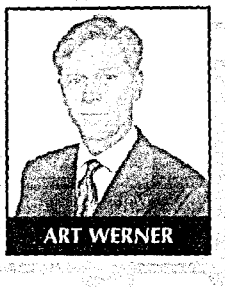

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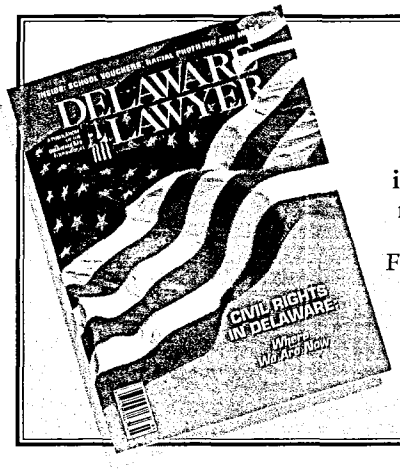

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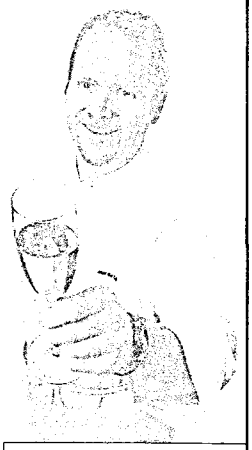

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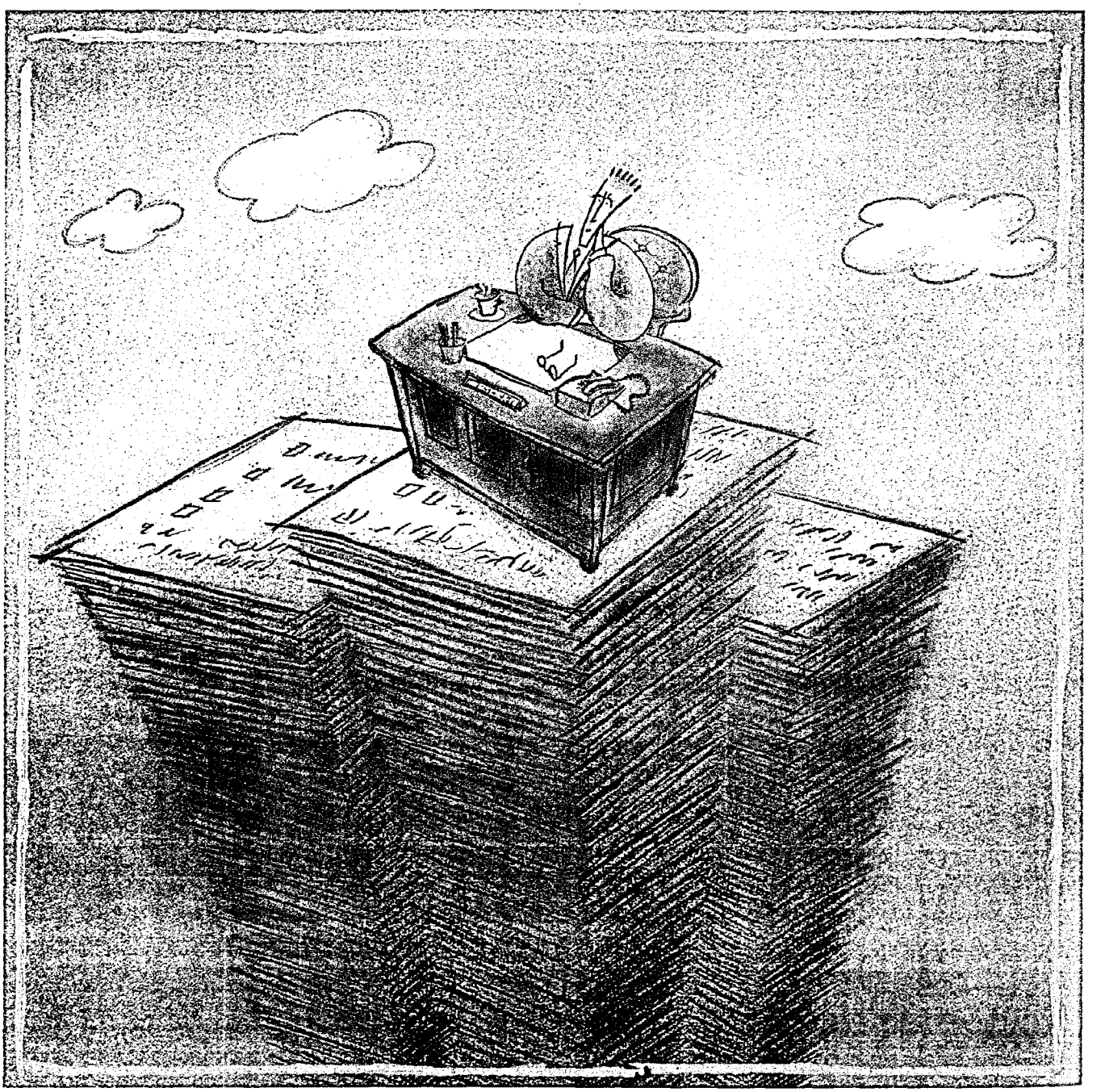
SOME PRACTICAL ASPECTS OF COUNSELING IN THE NEW CORPORATE GOVERNANCE ENVIRONMENT



Lawyers who counsel publicly held corporations are in a unique position to make important contributions to corporate governance and responsibility. The so-called "perfect storm" of Enron, WorldCom, etc., has produced a flood of new laws and regulations relating to corporate responsibility, with more to come. There is, of course, the need for all corporate counsel, whether inside or outside, to know the specifics of the new laws and regulations and to counsel clients on them. Since there is a plethora of materials already published on those subjects, this article focuses on practical considerations of complying with these new laws and regulations.

It has been said that good corporate counsel must have five key attributes — namely, courage, strength, wisdom, passion and vision. The situation at hand will surely test all five. In many ways, corporate governance has always been, like politics, something of the art of the possible. What was done with respect to the way a corporation was governed was largely up to the chief executive officer of the corporation. As we have seen, there has been a wide variance in the practice of corporate governance. Now, the bar has been raised for all companies. New minimum standards have been specified and broadly published. For listed companies, certain best practices will be mandated across the board, at least on paper. Chief executive and chief financial officers face increased potential liabilities. They and their boards of directors are looking to their corporate counsel for guidance. Such guidance should go beyond simply advising about compliance with the new laws and regulations. Corporate counsel must also step back and view the corporation's whole corporate governance structure and process and give a more thorough and realistic view of whether the process in place will function so as to meet the spirit as well as the letter of the new laws and regulations. The key will be in the execution, not in the mere drafting of written policies and procedures.

The first step should be to look at the whole corporate responsibility and governance process and the structure in place under which the board fulfills its role to govern responsibly. If your client's board is one of the minority that has yet to adopt guidelines on significant corporate governance issues, this is a good place to start. Having in place guidelines for board structure and composition, operation of the board and its committees, board methods of monitoring performance, board conduct of officer appointments, evaluations and succession planning, board evaluation of its own performance, and board oversight of the effectiveness of corporate compliance programs, is essential. It is too late to start to get the board organized to function effectively when an issue or problem confronts it. Guidelines set the stage for appropriate governance. Without them, precious time and thoughtful wisdom may be lost when the significant corporate governance principles that can be settled in advance by the guidelines have to be confronted in a crisis situation.

Having such guidelines in place will also help answer some of the questions that must be addressed under the new laws and regulations. For example, when will executive sessions of the board be conducted? Who will act as chair of such sessions? What record will be kept of such sessions? Will corporate counsel attend such sessions?

The last question raises some significant issues for corporate counsel. The often-cited ideal relationship of corporate counsel, particularly in-house counsel, to the client corporation is one where counsel is a respected and valued member of the corporation's management team. At the same time, the board of directors of the corporation must have confidence in such counsel so that the board is comfortable that his or her advice, particularly in troublesome situations, is objective and candid as well as accurate. Will participation in executive sessions of the board affect how the rest of the management team views corporate counsel? Surely, there are matters to be discussed in executive sessions where the presence of corporate counsel would be beneficial to the board. In addition, there may well be good reason to formally and carefully document what occurs in an executive session. The proper answer may depend on the particular counsel, the corporation and the existing relationship between counsel and the board.

Boards should be encouraged to use corporate counsel in all its deliberations, whether in executive session or not. Boards should understand that corporate counsel operate under the long-standing provision of state codes of professional responsibility which provide that a lawyer employed or retained by a corporation represents the entity as distinct from its directors, officers or employees. Thus, it is clear that corporate counsel is professionally required to place the interests of the corporation above those of its management. Often, this makes corporate counsel the embodiment of the legal and ethical conscience of the corporation. Boards should receive and value this point of view in their deliberations. Because of the new law and proposed regulations, there is currently vigorous debate about what specific actions corporate counsel should be required to take in fulfillment of this long-standing provision. However, the basic duty remains unchanged.

The wisdom of the corporate counsel will certainly be tested in connection with participation in executive sessions of the board. First, candor is demanded of corporate counsel in such sessions. Then, once outside of the boardroom, to the extent corporate counsel must act on the information gained, he or she must do so with the utmost diplomacy and skill, since it is necessary for an effective corporate counsel to be able to play both roles — counsel to the board and member of the management team — to be effective.

There are, of course, some matters to be discussed in an executive session that would be inappropriate to be heard by any member of the management team, including corporate counsel. Corporate counsel should not take any umbrage at being excluded from any such executive sessions of the board. Rather, this presents an opportunity for corporate counsel to inquire discreetly whether there was any subject discussed or action taken which might be important to document in the minutes of the meeting.

Independence is a consistent theme that emerges from the new laws and regulations. Independence of board members and board committee members is being demanded and new standards of independence have been established. Here, it is not only with the corporation's compliance with the letter of

the laws and regulations, but also their spirit, that corporate counsel will be judged. Undoubtedly, there will be facts and circumstances not contemplated by the laws and regulations where corporate counsel will have to weigh in. The wisdom and vision to see how those might be viewed in hindsight and the courage and strength to address them before they become an issue will be the hallmark of effective corporate counsel.

The new laws, existing regulations and the proposed revised listing standards spell out quite specific new independence standards for certain committees of the board. Here again, compliance with the letter of the law may not be sufficient. How the committees function in practice is an integral part of the test of independence. Corporate counsel is in an excellent position to see how the board committees function and can give continuing counsel on whether the processes in place meet the spirit of independence demanded by the new laws and regulations. The tasks set out for the audit committee present a test of independence at almost every turn. Corporate counsel should be alert to the maintenance of the independence of the audit committee in its dealings with the independent auditors, the internal auditors and management and counsel against slipping into old, perhaps more comfortable, ways that might compromise independence.

Similarly, a new standard of independence is being demanded of the compensation committee of the board. Although corporate counsel does not often get involved in hiring compensation experts and making presentations about compensation to the committee, he or she should stay aware, with the help of the chief executive officer and the human resources professional, of the processes being employed. Corporate counsel is in the unique position of being able to give a judgment of how such processes will appear in hindsight. As we have seen, perceptions become reality. Again, it is the spirit of the new laws and regulations that corporate counsel should keep in mind.

While there has been plenty of focus on board committees, there seems to have been too little discussion of the role of the full board in committee matters. The board does not discharge all of its duties simply by establishing a committee and selecting its members. First, let us remember that it is the full board that selects the committees of the board and that the board's selection process and criteria may be subject to scrutiny. Second, the board is entitled to, and should receive, regular reports from each board committee on its activities. If this ever has been treated as a perfunctory matter, that clearly should no longer be the case. Just as the board should properly discuss and question matters which the management puts before it for approval, the board should discuss and question the work of its committees. Corporate counsel can render advice on these processes as well.

It is the job of a director to ask the hard questions and test to see if the answers are thoughtful. Management needs to be counseled to expect and value this important role of the board and its committees.

The need for discussion and questioning of board committee actions provides a good example for corporate counsel to use in conditioning management to a new level of scrutiny of management proposals brought to the board. It is the job of a director to ask the hard questions and test to see if the answers are thoughtful. It is not a bad thing for a new idea or issue to arise in such a discussion. It should be viewed as a healthy result of good corporate governance. Management needs to be counseled to expect and value this important role of the board and its committees, and corporate counsel is often in the best position to do so.

It is typical for boards to grant management authority to operate the business within set parameters. Often, this takes the form of a schedule of approvals for such things as mergers and acquisitions, divestitures of lines of business, capital expenditures, purchases and sales of property, compensation, licenses, and a whole host of other matters. The schedule generally delegates to management certain limited dollar levels of authority. Actions that would exceed the stated dollar limits are those for which management must first seek board approval. These limits on authority deserve at least an annual review and regular reports of delegated activity should be made. Adjustments may be desirable for a whole host of reasons, including changes in the business or the management of a particular part of the business. Corporate counsel should suggest this review.

Independence of corporate counsel has become a more prominent issue as well. Regular corporate counsel must be vigilant in determining those matters where they cannot and should not render advice. The classic case seems to be where there is an investigation of a matter involving potential wrongdoing that may affect a director, officer or senior manager of the corporation. In such a case, regular corporate counsel would be wise to use other counsel who will be able to do the job at hand without worrying about damaging existing relationships with other members of the management team and thus the ability of regular corporate counsel to continue to be an effective member of that team. Similarly, where counsel is asked to review such a matter in which they, individually or as a firm, had prior involvement, using other counsel for such review eliminates the issue of whether the review will be independent and unbiased.

Another role that corporate counsel may be in the best position to fulfill is to orchestrate the continuing education of the board about the business of the corporation. Directors must not only be independent; they must be properly knowledgeable. In most corporations, corporate counsel prepares an orientation program for new directors and gives each director a manual of key information and basic documents about the corporation. This is where the education process begins but must not end, particularly in light of the new laws and

regulations. It is really up to management to make sure that the board understands the business of the corporation and the key business and financial levers that may affect it. The annual strategy reviews that boards typically engage in as a normal part of their oversight responsibilities will be far more meaningful if the board understands what really makes the business tick. The knowledge that the board should have is akin to a risk assessment of the business of the corporation. The board needs to know what can happen, beyond general economic conditions, that can affect the results of the business. In addition, the board should have an understanding of the opportunities that may have positive effects on the corporation's business.

These matters tell the story for each corporation of what it takes to be successful. They will, taken as a whole, spell out the differences between success and failure. As a participant in board processes, corporate counsel can take a broad view of what knowledge is being imparted to the board on an ongoing basis. Working with the chief executive officer and the chief financial officer, corporate counsel can help assure that the relevant ongoing information is provided to the board and that the board has an opportunity to digest and discuss it. In this connection, the board should also receive reports directly from the leaders of the various business units of the corporation. Appearances by these executives before the board should help the board better understand the business of the corporation. It will also give the board an opportunity to get to know and assess the people running the business units. This continuing process is necessary so that the board can perform the required task of effective oversight of the business of the corporation.

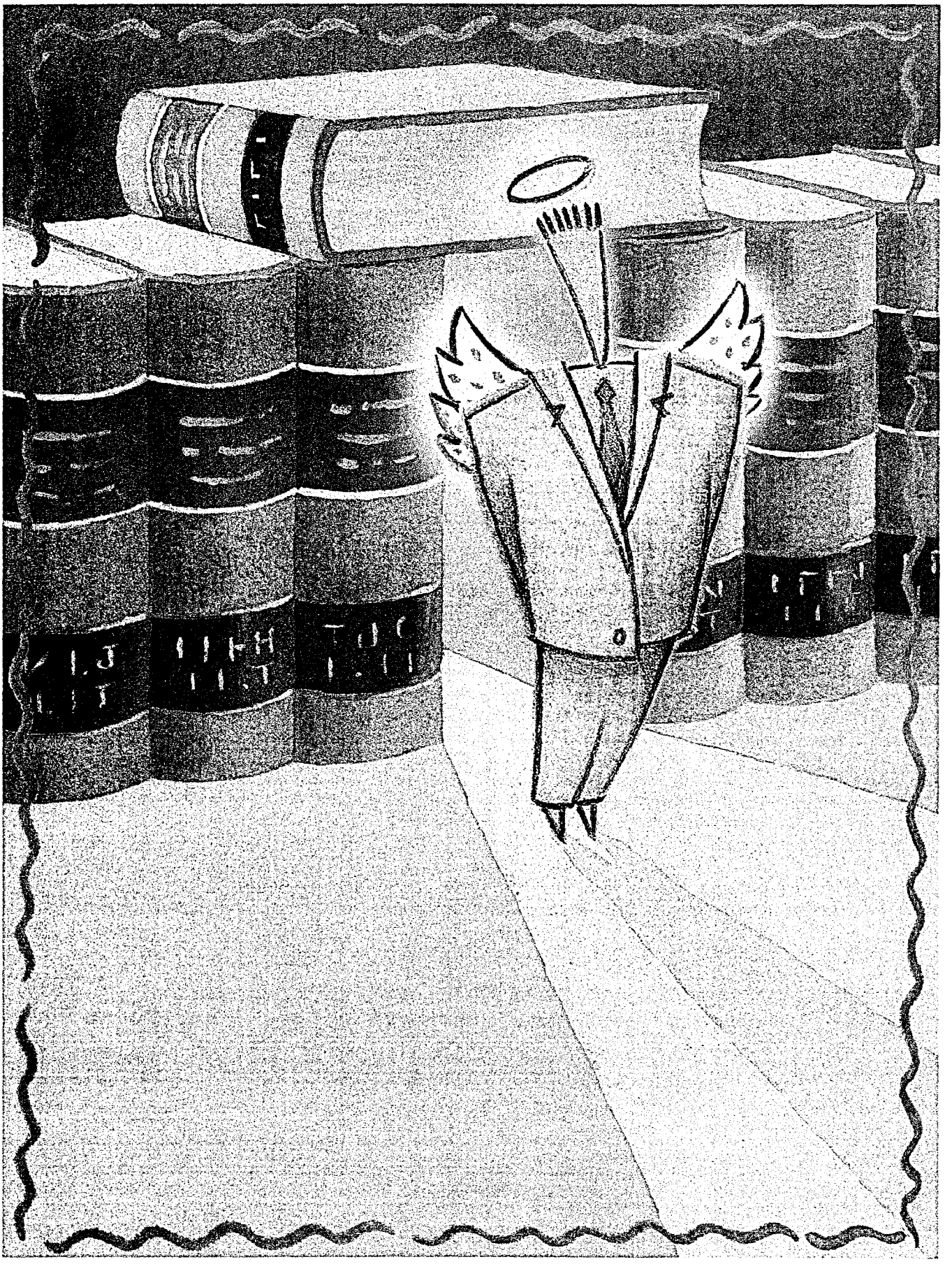
In many ways, corporate counsel also plays the role of the "ears" of the corporation. With new mandates to have more effective compliance programs and so-called hotlines, frequently corporate counsel will be the first to hear about a potential problem. Heightened awareness is certainly called for on the part of corporate counsel. However, the first thing corporate counsel should do is to examine the established processes for receiving and handling information that comes in this way. How are letters addressed to the board and specific directors and officers handled? Are they forwarded to the addressee? If a response is appropriate, how is it prepared and reviewed? If there is an existing hotline, is it adequate to handle the special requirements of financial personnel within the corporation? Should there be a separate hotline for financial personnel? Are the calls to the hotline logged in properly? Who makes the decision of how they are to be handled? Does that person understand the financial nuances that might be raised as a result of the new laws and regulations? Should the whole hotline process be outsourced to a firm that specializes in that function? In essence, corporate counsel must examine every aspect of the way incoming information is handled and ask whether, in hindsight, the methodology and processes used will be viewed as reasonable and effective.

Corporate counsel is also a key player in the writing of corporate codes of conduct as well as in the communication of what those codes mean in the everyday business life of the corporation's employees. Indeed, under the proposed revised New York Stock Exchange listing standards, the specified codes of conduct must also be applicable to the directors of the corporation. It has long been established as a matter of law and not just best practices that it is not sufficient simply to write the codes and put them in the drawer. Whether for Federal Sentencing Guidelines or corporate governance purposes, effective delivery and communication of the codes must be ongoing and visible. Training is the accepted means of delivery and communication, but it needs to be tailored to the situation. There are many considerations and no one plan fits all corporations or even all units of a single corporation. For example, whom do you train? How often should you train? What does the training consist of? Who does the training? Are they capable of delivering the message and answering questions that may arise during a training session? Has the training been customized for different personnel? How is the training documented? Does it give employees an opportunity to report conflicts of interest or other issues of concern? How are the reports dealt with? The issues are plentiful, but deserve careful attention. Again, it is corporate counsel that can take the lead and view the process as a whole to test how it will be viewed in hindsight.

How can we tell if the job is being done well? Perhaps there is no single event or time when corporate counsel can put the task aside and rest. Constant vigilance is required. There is one tool available, however, which can give periodic indications of how the corporation's governance processes are working. This involves having the board do an annual self-evaluation questionnaire. To be effective, the responses to the questionnaire must be anonymous. This can easily be accomplished by having the completed questionnaires sent to an outside counsel or someone at the corporation's independent auditor who is not involved in the corporation's audit. That person then consolidates the results of the questionnaire, including written comments, without attribution, and provides the consolidated report to management. Such a questionnaire can cover key topics relating to the operation of the board and board accountability. It must be tailored to the particular corporation and can cover other topics as well. It opens up a new line of communication. If it is done right, any director who is unhappy about anything can let it be known. While management may not know which director made such a comment, management will learn about the issue raised and can deal with it. It's a good safety valve for the board and for management.

There are, of course, many other practical aspects to counseling in the new corporate governance environment which cannot be covered within the confines of this article. Corporate counsel should study each provision of the new laws and regulations and consider how best they might be implemented and how that implementation will appear to various potential audiences in hindsight. Some say that the new laws and regulations and the issues described above make corporate counsel into a new breed of risk manager. There is some validity to that notion, but it should be considered only as a slight shift from the traditional role of corporate counsel — helping business achieve its goals through lawful means. If it means anything, it should mean not a diminution in attention to detail, but a higher level of awareness of how particular actions will affect the standing and reputation of the corporation.◆

The views expressed in this article are solely those of the author.



Charles E. McCallum

THE SEC STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS UNDER THE SARBANES-OXLEY ACT

The massive corporate frauds uncovered in 2002 (Enron, WorldCom, *et al.*) focused attention on, among other things, the roles perceived to have been played by the inside and outside lawyers to those corporations. Losses suffered by investors and employees resulted in Congressional hearings and the enactment of the Sarbanes-Oxley Act.[1] In the course of Congressional debate, Senator Edwards proposed an amendment that eventually became Section 307 of the Act, directing the Securities and Exchange Commission ("Commission") to issue rules

> 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.

On November 21, 2002, the Commission issued a release proposing and inviting comment on rules defining standards of professional conduct for attorneys.[2] After receiving extensive (167 letters) comments the Commission on January 29, 2003, issued its final rule (the "307 Rules").[3] At the same time the Commission issued a release extending the time for comment on the "noisy withdrawal" provisions of the original Proposed Rule and proposing an alternative approach for comment.[4]

Who is Subject to the 307 Rules?

The 307 Rules apply to an attorney appearing and practicing before the Commission in the representation of an issuer. Attorneys "appearing and practicing before the Commission"[5] are defined to include, in addition to attorneys directly transacting business with the Commission and its staff, or representing an issuer in connection with Commission administrative proceedings or investigations,[6] attorneys who:

> (1) provide federal securities law advice regarding or in connection with the preparation of any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; or
>
> (2) advise an issuer whether federal securities laws or regulations require that any information, statement, or opinion be filed with or submitted to, or incorporated into any document to be filed with or submitted to, the Commission.

This definition clearly excludes from the application of the 307 Rules lawyers who prepare documents with no intention or notice that they will be filed with the Commission, even if they are subsequently in fact filed. It also seems to exclude non-securities lawyers who prepare documents knowing that they may or will be filed with the Commission, but do not, expressly or impliedly, advise as to the requirements of the securities laws with respect to such documents or their contents.

Attorneys whose activities might otherwise constitute "appearing and practicing before the Commission" but are not undertaken in the course of providing legal services pursuant to an attorney-client relationship are not subject to the Rules. For example a CEO or CLO[7] who happens incidentally to be an attorney but does not render legal services to the issuer would not be subject to the Rules. On the other hand, the mere fact that an attorney is not in the issuer's legal department does not exempt that attorney from compliance with the 307 Rules. An attorney in an issuer's tax department who advises the issuer as to the requirements of the securities laws with respect to legal opinions used in the issuer's securities filings would be subject to the Rules.

In order to avoid unfairness to foreign legal counsel the 307 Rules exempt from their coverage "non-appearing foreign attorneys."[8] These are attorneys admitted only in a juris-

diction outside the United States who meet two requirements. First, they do not hold themselves out as practicing, and (except in consultation with U.S. counsel) do not give advice concerning, federal or state securities laws. Second, any activities of such foreign attorneys that might otherwise constitute appearing and practicing before the Commission must either be incidental to and in the ordinary course of their practice outside the United States, or be undertaken only in consultation with U.S. counsel.

"In the representation of an issuer" means "providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer."[9] For purposes of this definition, the term "issuer" is defined as including "any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer."[10] This means that services performed by an attorney who is employed or retained by an issuer's non-public subsidiary, but who in accordance with an umbrella representation agreement or understanding is in a position to invoke the attorney-client privilege for communications involving the parent, are performed in the representation of an issuer. This is likewise the case if the attorney employed or retained by the subsidiary is assigned work for use in connection with a Commission filing by the parent issuer.

The Reporting Up Obligation

The 307 Rules impose reporting duties on an attorney appearing and practicing before the Commission in the representation of an issuer who becomes aware of evidence of a material violation by the issuer or by any of its officers, directors, employees, or agents.[11] The attorney must report such evidence to the issuer's CLO, or to both its CLO and its CEO.

"Material violation" means a material violation of federal or state securities laws, a material breach of fiduciary duty under federal or state law, or a similar material violation of any federal or state law.[12] "Evidence of a material violation" means "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is occurring, or is about to occur."[13] The Commission's release states that the circumstances to be weighed include, among other things, the attorney's professional skills, the attorney's background and experience, the time constraints, the attorney's familiarity with the client, and the presence or absence of an opportunity to consult with other attorneys. The release states that "reasonably likely" means more than mere possibility, but less than "more likely than not."

Upon receiving such a report, the CLO must cause such inquiry into the evidence as the CLO reasonably believes appropriate.[14] If the CLO determines that there is no material violation, then the CLO must so advise the reporting attorney. Unless the CLO reasonably believes that there is no material violation, however, he or she must "take all reasonable steps to cause the issuer to adopt an appropriate response" and must so notify the reporting attorney.

Unless the reporting attorney reasonably believes that the CLO or CEO have provided an appropriate response to the report within a reasonable time, the reporting attorney must take the report up the corporate ladder to the issuer's audit committee or some other board committee consisting entirely of non-employed directors, or if there is no such committee then directly to the board of directors.[15] An "appropriate response"[16] is a response as a result of which the attorney reasonably believes either (1) that there is no material violation, or (2) that the issuer has adopted appropriate remedial measures, or (3) that the issuer (with the consent of the board or an appropriate committee of the board) has retained or directed an attorney to review the evidence and either has substantially implemented any remedial recommendations of such attorney, or has been advised that such attorney may ethically assert a colorable defense in any proceeding or investigation relating to the reported evidence.

As previously noted, the reporting attorney must take his or her report up the corporate ladder unless the attorney "reasonably believes" that there has been a timely and appropriate response. "Reasonably believes" means that the attorney believes it and that the circumstances are such that the belief is not unreasonable.[17] The release states that in determining whether the attorney's belief is reasonable it is appropriate to consider such circumstances as the amount and weight of the evidence, the severity of the apparent violation, and the scope of the investigation into the report. While an attorney may not accept unquestioningly the assurances of the issuer's officers, the release states that the attorney may rely on "reasonable and appropriate factual representations and legal determinations of persons on whom a reasonable attorney would rely."

If the reporting attorney receives what he or she reasonably believes is an appropriate and timely response, then the attorney is not required to do anything more with respect to the report.[18] Otherwise, however, the attorney must explain to each person or entity to whom the report was given why the response is not timely or appropriate.[19] An attorney who reasonably believes that he or she was discharged for reporting evidence of a material violation may, but is not required to, so notify the issuer's board or any committee of the board.[20]

The reporting obligations under the 307 Rules are similar to those imposed on attorneys for organizational clients by the ABA Model Rules of Professional Conduct.[21] Under Model Rule 1.13, if an attorney "knows" that an officer, employee or other person associated with an organizational client is engaged in action, intends to act, or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that might be imputed to the organization, and is in either case likely to result in substantial injury to the organization, then the attorney is required to "proceed as is reasonably necessary in the best interest of the organization." This may include "referring the matter to higher authority in the organization, including, if warranted . . . the highest authority that can act on behalf of the organization."

The Commission intentionally set the reporting-up trigger in the 307 Rules ("aware of evidence of a material violation") lower than that in the Model Rules, which require actual knowledge of a potential or ongoing violation. The Model Rules also give the attorney discretion in deciding what action is required, while the 307 Rules, following the Congressional mandate, prescribe a precise course of action and

give no discretion to the attorney as to whether and how to report.

The Qualified Legal Compliance Committee

An alternative reporting regime is available under the 307 Rules if the issuer has a Qualified Legal Compliance Committee (QLCC).[22] A QLCC is a board committee (it may be the audit committee or some other existing board committee) that has three or more non-employed (directly or indirectly) directors, including at least one member of the issuer's audit committee, and that has established procedures for the confidential handling of reports of evidence of material violations. The QLCC must be given authority and responsibility to determine whether an investigation is necessary regarding any report of a material violation and, if it so determines, (1) to so notify the audit committee or the full board, (2) to initiate an investigation conducted either by the CLO or outside attorneys, and (3) to retain such additional expert assistance as it deems necessary. The QLCC must also have responsibility and authority, at the conclusion of any such investigation, (1) to recommend that the issuer implement an appropriate response, (2) to inform the CLO, CEO, and board of the results of the investigation and the remedial measures to be adopted, and (3) to take all other appropriate action, including notifying the Commission in the event the issuer fails in any material respect to implement a response recommended by the QLCC.

If the issuer has an existing QLCC, a reporting attorney may report evidence of a material violation directly to the QLCC. After doing so, a reporting attorney has no further reporting obligation and is not required to assess the issuer's response to the report or, if the response is not timely or appropriate, to so advise the QLCC. A CLO may refer a report of evidence of a material violation to a QLCC in lieu of conducting his or her own inquiry, so advising the reporting attorney. Thereafter the QLCC is responsible for responding to the evidence of a material violation.

Supervisory and Subordinate Attorneys

A "supervisory attorney" is an attorney who supervises or directs another attorney who is appearing and practicing before the Commission in the representation of an issuer.[23] The issuer's CLO is deemed to be a supervisory attorney. The release states, however, that not every partner in a law firm is a supervisory attorney, but only those who actually supervise and direct attorneys who are themselves subject to the 307 Rules. A "subordinate attorney" is an attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney.[24]

A supervisory attorney must make reasonable efforts to "ensure" that a subordinate attorney who appears and practices before the Commission in the representation of an issuer complies with the 307 Rules. This requirement applies even if the supervisory attorney does not personally appear and practice before the Commission. If a subordinate attorney appears and practices before the Commission in the representation of an issuer, all of that person's supervisory attorneys are deemed to appear and practice before the Commission in the representation of an issuer as well.

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A subordinate attorney discharges his or her reporting obligations under the 307 Rules by reporting evidence of a material violation to a supervisory attorney, who thereupon becomes responsible for compliance with those reporting obligations. If a subordinate attorney reasonably believes that a supervisory attorney to whom the subordinate attorney has reported evidence of a material violation has failed to comply with the reporting obligations, however, then the subordinate attorney may, but is not required to, report such evidence in accordance with the Rules.[25]

Sanctions and Discipline

If an attorney violates the 307 Rules, the Commission may pursue the civil penalties and remedies available to it for violations of the federal securities laws and, in addition, administrative disciplinary proceedings.[26] The Rules provide that an attorney who complies in good faith with the requirements of the Rules is not subject to discipline or otherwise liable under inconsistent standards imposed by any jurisdiction where the attorney is admitted or practices.[27] Attorneys practicing outside the United States need not comply with the requirements of the 307 Rules to the extent that compliance is prohibited by applicable foreign law. Finally, the Rules state that they are not intended to and do not create a private right of action based on an attorney's compliance or non-compliance with the requirements of the Rules, but instead that the Rules may be enforced exclusively by the Commission.[28]

The Chief Legal Officer

The issuer's CLO plays a central role in the process of compliance with the 307 Rules.[29] Evidence of a material violation is to be reported, in the first instance, either to the CLO or to both the CLO and the CEO. In either event, the CLO is responsible for undertaking such inquiry as he or she reasonably believes appropriate.[30] If the result of the inquiry is negative, the CLO must advise the reporting attorney of the basis for that conclusion. Unless, however, the CLO reasonably believes that no material violation has occurred, is occurring, or is about to occur, he or she must "take all reasonable steps to cause the issuer to adopt an appropriate response," and must advise the reporting attorney with respect to the steps taken. In lieu of conducting his or her own inquiry a CLO may refer a report of evidence of a material violation to a QLCC.[31]

As noted above, the CLO is deemed to be a supervisory attorney,[32] and cannot, according to the release proposing the 307 Rules, "avoid responsibility under the rule by claiming a lack of knowledge of, or supervision over, the actions of subordinate attorneys."

Confidentiality

An attorney appearing and practicing before the Commission in the representation of an issuer may, but is not required to, reveal without the issuer's consent confidential information relating to the representation to the extent the attorney reasonably believes necessary:

(1) to prevent a material violation that is likely to cause substantial injury to the financial interests or property of the issuer or investors;
(2) to prevent the issuer, in a Commission investigation or administrative proceeding, from committing or suborning perjury or perpetrating a fraud on the Commission by misrepresenting or concealing material facts; or
(3) to rectify the consequences of a material violation in the furtherance of which the attorney's services were used and that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors.[33]

This provision should be compared with Model Rule 1.6, which also permits information relating to the representation of a client to be disclosed in limited circumstances, including when the lawyer reasonably believes it necessary to comply with other law (the 307 Rules, for example) or a court order.[34] The ABA's Ethics 2000 Commission[35] proposed in 2001 that Model Rule 1.6 be amended to add further exceptions that would permit disclosure of information relating to the representation to the extent the attorney reasonably believes necessary to

- prevent the client from committing a crime or fraud that is reasonably certain to result in substantial financial injury to another and in furtherance of which the attorney's services are being or were used; and
- prevent, mitigate, or rectify substantial financial injury to another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the attorney's services were used.

While the ABA House of Delegates rejected the Ethics 2000 Commission's proposals, similar exceptions have been adopted in a majority of the states.

There are differences, however, between the 307 Rules and the Ethics 2000 proposals. First, Ethics 2000 would have permitted disclosure to prevent a crime or fraud only in circumstances in which the attorney's services were being or had been used in furtherance of that crime or fraud. Second, Ethics 2000 would have permitted disclosure only when the client's crime or fraud is reasonably certain to result in substantial financial harm, while the 307 Rules permit such disclosure when substantial financial harm is likely.

Investigations and Contested Proceedings

A major concern about the 307 Rules as initially proposed had to do with attorneys engaged to investigate evidence of a material violation or to litigate whether a material violation has occurred. Such attorneys are themselves subject to the 307 Rules as attorneys appearing and practicing before the Commission in the representation of an issuer.[36] It thus appeared that such attorneys would be compelled to report material evidence of a violation uncovered in the course of their investigation or defense preparations.

Agreeing that these concerns were legitimate, the Commission responded by substantially narrowing the circumstances when such attorneys would be required to report up the corporate ladder.[37] An attorney retained or directed by the CLO to investigate evidence of a material violation has no reporting duty if (1) the attorney reports the results of such investigation to the CLO and (2) except where the attorney and the CLO reasonably believe that there is no material violation, the CLO reports the results of the investigation to the board of directors, a QLCC, the audit committee, or another committee consisting solely of non-employed directors. An attorney retained or directed by the CLO to assert a colorable defense on behalf of the issuer in any proceeding

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not be mandatory.[39] Employed attorneys would not be required under the proposal to withdraw from the representation, but would be required to disaffirm documents they reasonably believed to be materially false or misleading.

This proposal goes beyond the statutory mandate but is not inconsistent with the Model Rules. Model Rule 1.16(a)(1) requires that an attorney withdraw from the representation of a

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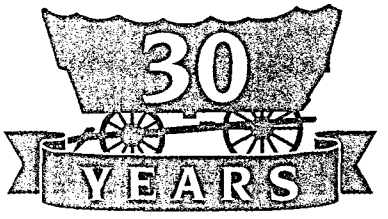

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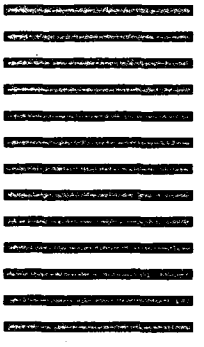

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relating to evidence of a material violation has no reporting duty so long as the CLO provides reasonable and timely reports on the progress and outcome of the proceeding to the board or one of such committees.

Both of these exemptions from the reporting requirements place a burden on the investigating or defending attorney to assure that the necessary reports are made by the CLO. If, however, the attorney is retained by a QLCC, either to investigate evidence of a material violation or to assert a colorable defense on behalf of the issuer in a proceeding relating to such evidence, then the attorney is relieved of all reporting responsibilities.

The Commission's "Noisy Withdrawal" Proposals

In its initial release proposing the 307 Rules, the Commission included a provision for, in the Commission's words, "noisy withdrawal." Under this provision, if there was no timely and appropriate response to an attorney's report of a material violation, and if the reporting attorney reasonably believed that the violation was ongoing or was about to occur and in either case was likely to result in substantial financial harm to the issuer or investors, then the reporting attorney would be required to withdraw from representing the issuer, to advise the issuer that the withdrawal was for "professional considerations," and promptly thereafter to so notify the Commission.[38] The withdrawing attorney would also be required under this proposal to disaffirm any portion of a document filed with or submitted to the Commission that the reporting attorney had prepared or assisted in preparing and reasonably believed was or might be materially false or misleading. If the material violation was not prospective or ongoing, but had already occurred, then "noisy withdrawal" and disaffirmation would be permitted but would not be mandatory.[39] Employed attorneys would not be required under the proposal to withdraw from the representation, but would be required to disaffirm documents they reasonably believed to be materially false or misleading.

This proposal goes beyond the statutory mandate but is not inconsistent with the Model Rules. Model Rule 1.16(a)(1) requires that an attorney withdraw from the representation of a

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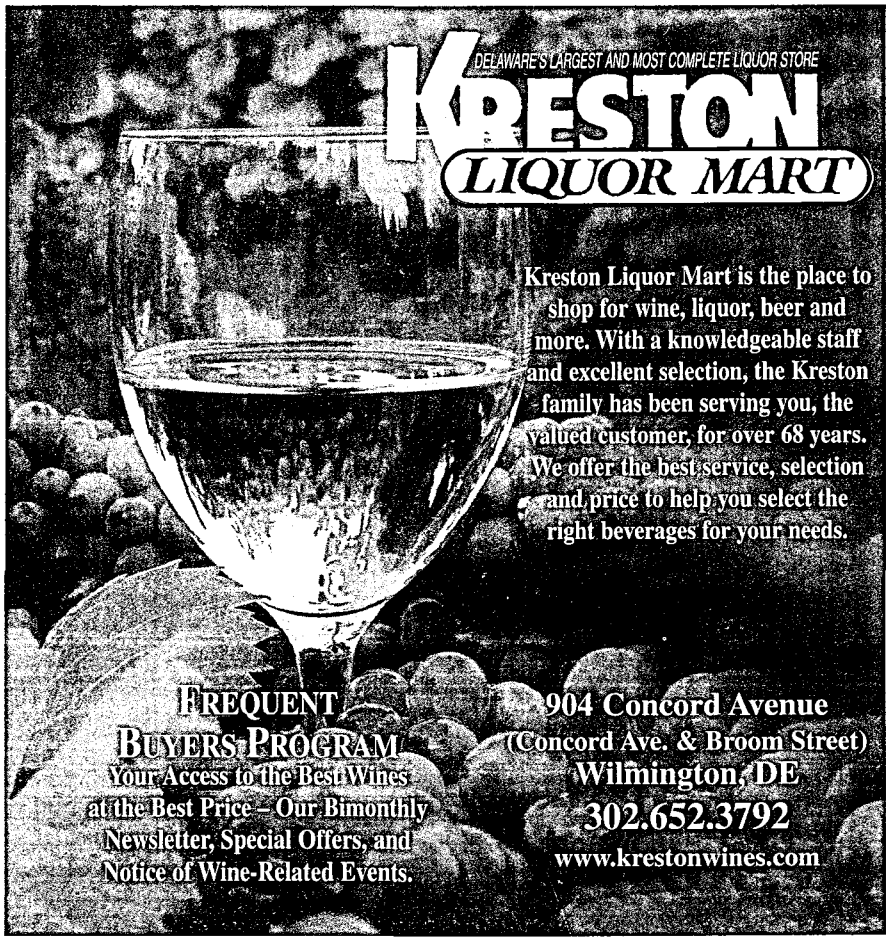

client if the representation "will result in violation of the rules of professional conduct or other law." The comments to Model Rule 1.2(d)[40] state that when an attorney learns that his or her engagement assists the client in criminal or fraudulent conduct the attorney must withdraw from the representation under Model Rule 1.16(a)(1), but that in some cases withdrawal alone might not be sufficient and the attorney may have to "give notice of the withdrawal and disaffirm any opinion, document, affirmation, or the like."[41]

In addition to extending the time for comment on its initial "noisy withdrawal" proposal, the Commission also proposed for comment an alternative proposal. Under the alternative proposal the withdrawing attorney would not be required to notify the Commission of his or her withdrawal or to disaffirm documents filed with the Commission, but would instead be required to notify the issuer in writing that he or she is withdrawing based on professional considerations.[42] The attorney would not under this alternative proposal be required to withdraw from a matter if prohibited from doing so by order or rule of a court or agency before which the matter is pending or otherwise having jurisdiction over the attorney.

Taking away with the other hand what it has given with the one, however, the the alternative proposal would require the issuer within two business days to report the attorney's withdrawal "for professional considerations" in a Form 8-K or other appropriate filing.[43] This alternative proposal doesn't solve the concerns voiced by the bar concerning the initial proposal. The lawyer's withdrawal still triggers, albeit indirectly, notification to the Commission of the lawyer's withdrawal for professional considerations. Indeed, the alternative proposal, by requiring that the lawyer's withdrawal be publicly reported (e.g., in a Form 8-K), provides for public dissemination of the fact of the lawyer's withdrawal, as opposed to the original proposal's requirement that it be reported to the Commission.

Practical Implications

Attorneys should explore the implications of the 307 Rules for their practices. Those practicing in law firms should consider whether their securities practices should be restructured so as to minimize the number of attorneys in the firm subject to the Rules. Firms should also consider implementing policies and procedures for more intensive continuing education of and oversight over those attorneys in the firm who are engaged in the securities practice. The firm's engagement letter for publicly held clients should be revised to reflect and make the client aware of the reporting obligations applicable to the firm and its attorneys. Securities practitioners should as well consider whether to advise their publicly held clients to create a QLCC (assuming the client can find directors willing to serve on it).

Corporate general counsel should consider whether their legal departments should be reorganized and what procedures should be put in place to facilitate compliance with these new obligations. Attorneys employed by an issuer, but not practicing law, will want to take care to avoid rendering even minor and incidental legal services. And of course, and this is presumably what the Commission intends to accomplish, all lawyers for issuers must become more sensitive to warning signs of material violations and less tolerant of conduct that sails dangerously close to the line. ◆

FOOTNOTES

1. The Public Company Accounting Reform and Investor Protection Act of 2002.

2. Release Nos. 33-8150; 34-46868; IC-25829 (http://www.sec.gov/rules/proposed/33-8150.htm).

3. Release Nos. 33-8185; 34-47276; IC-25929 (http://www.sec.gov/rules/final/33-8185.htm). The Final Rule constitutes 17 CFR Part 205.

4. Release Nos. 33-8186; 34-47282; IC-25920 (http://www.sec.gov/rules/proposed/33-8186.htm).

5. "Appearing and practicing before the Commission" is defined in § 205.2 (a). "In the representation of an issuer is defined in § 205.2 (g).

6. This includes not only an attorney defending a party in a Commission proceeding or investigation but also an attorney conducting an internal investigation on behalf of an issuer or a board committee as, for example, an attorney retained by the CLO or a QLCC to assist in the inquiry into a report of evidence of a material violation. As noted below, however, such an attorney has a limited reporting obligation.

7. The 307 Rules use the terms "chief executive officer (or the equivalent thereof)" and "chief legal officer (or the equivalent thereof)," denoted in this article as CEO and CLO respectively. The release proposing the 307 Rules states that "[w]here an issuer has no general counsel or chief legal officer, the 'equivalent' would be the chief executive officer . . ." References in this article to the CLO or CEO should be understood to include "or equivalent."

8. § 205.2 (a)(2)(ii). The term "non-appearing foreign attorneys" is defined at § 205.2(j).

9. § 205.2 (g).

10. § 205.2 (h).

11. § 205.3(b)(2).

12. § 205.2(i).

13. § 205.2(e).

14. § 205.3(b)(2).

15. § 205.3(b)(3). If the attorney reasonably believes it would be futile to report to the CLO and CEO, then the attorney may take the report directly to the board of directors in the first instance. § 205.3(b)(4).

16. § 205.2(b).

17. §205.2(m).

18. § 205.3(b)(8).

19. § 205.3(b)(9).

20. §205.3(b)(10).

21. Rule 1.13 of the ABA Model Rules of Professional Conduct ("Model Rules"). Other provisions of the Model Rules are relevant. Rule 1.2(d) prohibits an attorney from assisting a client to engage in conduct that the attorney knows is criminal or fraudulent. Rule 4.1 prohibits an attorney from knowingly failing to disclose a material fact to a third party when disclosure is necessary to avoid assisting the client's criminal or fraudulent act, unless disclosure is prohibited by Rule 1.6.

22. § 205.3(c). What is required to qualify a committee as a QLCC is set forth in § 205.2(k). A report may be made to a QLCC only if it was established prior to the date of the report.

23. § 205.4.

24. § 205.5. An attorney may well be both a supervisory attorney and a subordinate attorney. The Rules explicitly provide, however, that in-house attorneys who report directly to the CLO are not subordinate attorneys.

25. *Compare* these provisions with Model Rules 5.1 and 5.2. Under Model Rule 5.1 a supervisory attorney must make "reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance" that all lawyers in the firm comply with their ethical obligations, a less stringent burden than that in the 307 Rules. Model Rule 5.2, on the other hand, provides that a subordinate attorney is not relieved of responsibility for an ethical violation by having acted at the direction of a supervisory attorney, unless the supervisory attorney's direction was a reasonable resolution of an arguable question of professional duty.

26. § 205.6. Disciplinary proceedings may be brought notwithstanding that the attorney may also be subject to discipline for the same behavior in a jurisdiction in which the

attorney is admitted to practice.

27. § 205.6(c). § 205.3(d)(1) provides, in addition, that an attorney may use any records the attorney may have made in connection with fulfilling the attorney's reporting obligations under the 307 Rules in connection with any investigation, proceeding, or litigation in which the attorney's conduct with respect to such reporting is in question. The Commission intends this as an exception to the prohibitions of Model Rule 1.6, similar to the exception in Model Rule 1.6(b)(3).

28. § 205.7.

29. The release proposing the 307 Rules observes that "[t]he issuer's CLO . . . is in a position to conduct an internal inquiry when appropriate. Moreover, a CLO has a clear duty to protect the issuer – as opposed to its other officers and employees – in every possible way."

30. § 205.3(b)(2).

31. The QLCC must have been established, however, before the report of a material violation.

32. § 205.4(a).

33. § 205.3(d)(2).

34. Disclosure is also permitted under Model Rule 1.6 when the lawyer reasonably believes it necessary (1) to prevent reasonably certain death or substantial bodily harm, (2) to secure legal advice about the attorney's compliance with the Model Rules, or (3) to establish a claim or defense on behalf of the attorney in a controversy with the client, or a defense to a criminal charge or civil claim against the attorney based on the client's conduct, or to respond to allegations in a disciplinary proceeding.

35. ABA Commission on Evaluation of the Rules of Professional Conduct, chaired by the Hon. E. Norman Veasey.

36. An attorney engaged or directed to investigate evidence of a material violation is deemed to be appearing and practicing before the Commission (§ 205.3(b)(5)), while an attorney representing the issuer in a proceeding falls within the definition (§ 205.2(a)(1)(ii)).

37. §§ 205.3(b)(6) and 205.3(b)(7).

38. Proposed § 205.3(d).

39. The distinction between past and ongoing violations may, however, be illusory, because under the securities laws an unremedied past violation that has not been disclosed can constitute an ongoing violation.

40. Rule 1.2(d) provides that an attorney "shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . ."

41. Comment [10] to Model Rule 1.2. *See also* ABA Formal Opinion 92-366 (1992).

42. Alternative proposed §205.3.

43. In addition, the alternative proposal would permit, but not require, the reporting attorney to inform the Commission of the withdrawal if the issuer fails to file such report.

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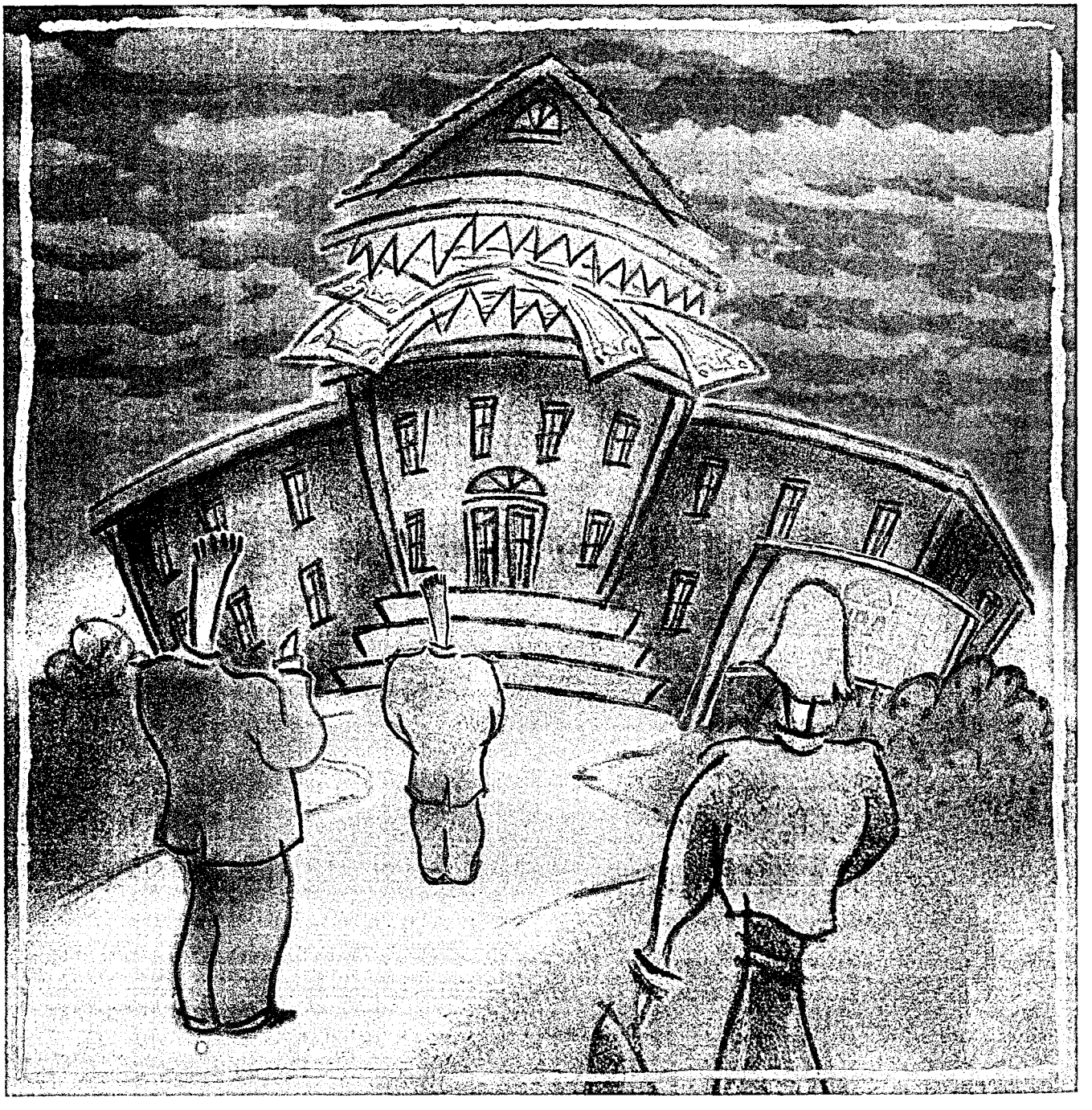
Lawrence A. Hamermesh

CORPORATE RESPONSIBILITY IN REAL TIME:

THE WORK (SO FAR) OF THE ABA TASK FORCE ON CORPORATE RESPONSIBILITY



As this issue of *Delaware Lawyer* reflects, the subjects of corporate responsibility and governance are vitally important to the State of Delaware and its bar in particular. One avenue through which the organized bar has most recently attempted to study and influence the debate on these subjects is the American Bar Association's Task Force on Corporate Responsibility, created last year in the wake of the collapse of Enron Corp.[1] The purpose of this article is to introduce members of the Delaware Bar to the past and continuing work of this Task Force.

Like the rest of my work with that group, this article is written in real time, and is not an historical analysis. From the moment of its creation, the Task Force has been forced to confront enormously complex questions within a framework of shifting facts, political currents and public fancies. Even as the Task Force's preliminary report was in advanced stages of drafting, WorldCom's financial fraud became public, and Adelphia's scandals emerged. At the same time, federal legislative efforts picked up steam — along with numerous profoundly important last-minute amendments — as they moved toward passage of the Sarbanes-Oxley Act of 2002 just days after the Task Force released its preliminary report.[2]

Even as this article is being prepared, the target is still moving; the Task Force's work remains incomplete. The Task Force is still evaluating reams of written statements and transcripts of oral presentations generated at public hearings this past fall in New York, Chicago and Palo Alto, and attempting to digest the significance of new SEC rules on the duties of lawyers in publicly held companies. Final recommendations are still being debated, and even the scope of those recommendations, let alone their specific content, remains unsettled.

Therefore, this article does not attempt to review substantive reform proposals in any detail (any reader interested in reviewing the Task Force's substantive recommendations should visit the Task Force's web site). Rather, this article examines the process by which the Task Force was created and has thus far approached its task — a process which itself sheds some light on the character and complexity of issues surrounding the governance of modern publicly held corporations.

Enron and the Explosion of Corporate Responsibility Reform

Perhaps we will never know why the collapse of Enron Corp. so deeply captivated public attention. Other large public companies had failed before, and securities fraud was not first discovered, let alone invented, in 2001. Perhaps the public outcry was fueled by the specter of (previously) loyal employees watching their retirement funds vanish, sinking under the weight of overconcentration in Enron's plummeting stock. Perhaps it was Enron's previously high public and political profile and persistent deregulatory zeal. Perhaps it was simply the sheer size of Enron's accounting misconduct: over a billion dollars in book value rarely disappears overnight, as it did on October 16, 2001, when Enron announced the fateful financial restatements that sent it spiraling into bankruptcy. Perhaps all of these factors, brewed together in the pot of imminent national elections anticipated to be closely contested, created the "perfect storm" of corporate scandal, public outcry and re-regulatory enthusiasm.

Whatever the causes of public consternation may have been, it became clear in the months following Enron's bankruptcy filing in December 2001 that the people and institutions who ordinarily contribute to responsible corporate behavior — CEOs, boards of directors, the SEC, state legislatures and courts, stock exchanges, accounting oversight boards and other self-regulatory organizations, and most notably for our readers, the organized bar — would be called upon to re-examine and reform the systems of governance of publicly held companies.

Creation of the ABA Task Force on Corporate Responsibility

The American Bar Association was thus in no position to sit on the sidelines of public debate. On March 27, 2002, the ABA's then president Robert E. Hirshon created a Task Force on Corporate Responsibility, charged with the duty to:

> examine systemic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States; and
>
> examine the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants, . . . in the context of the system of checks and balances designed to enhance the public trust in corporate integrity and responsibility.

To carry out this charge, President Hirshon appointed 11 prominent lawyers representing a wide range of experience and perspective — including a former SEC commissioner, former ABA president, senior in-house counsel, business court judge, law school dean, and nationally recognized corporate and securities counsel, such as the Chair of the Task Force, James H. Cheek, III of Nashville, Tennessee.[3] A significant perspective otherwise missing from the Task Force membership was that of our own State — a shortcoming addressed to some surely debatable extent by my appointment as reporter.

Defining the Task of the Task Force

Having been charged with the task of examining "systemic issues relating to corporate responsibility," a logical step for the Task Force at the outset of its work was to determine what "corporate responsibility" is. This question was easier asked than answered. From whose perspective should "corporate responsibility" be judged? From the perspective of stockholders? Investors dependent upon full and accurate disclosure of material corporate information? Employees dependent upon the corporation for their livelihoods and the value of their retirement savings?

All of these constituencies were deeply aggrieved by the Enron collapse, but it was important to identify the appropri-

ate focus of the Task Force's work in order to determine what steps to recommend. Ultimately, the Task Force settled on a partial definition of corporate responsibility as including — but not necessarily limited to — "behavior by the executive officers and directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders." The Task Force also recognized the importance, in defining corporate responsibility, of "ethical behavior beyond that demanded by minimum legal requirements."[5] No response to recent corporate crises can disregard the importance of the role of ethical norms and rely solely on legalistic regulatory changes.

A far more difficult task, however, also greeted the Task Force: given its charge to examine the "roles of lawyers, executive officers, directors, and other key participants" in our system of corporate governance, what aspects of that highly complex system of checks and balances should be studied? Clearly, the role of lawyers in corporate governance needed to be addressed, since the ABA has expertise and resources that uniquely enable it to examine that role. Other areas were less clearly capable of being addressed, although there was widespread public clamor for reform in all of them, including, for example: the role of and limitations on public accounting firms; regulation of employee benefit plans; the responsibilities of security analysts and credit rating agencies; regulation of accounting standards; adequacy of federal securities law disclosure requirements; and insider trading limits.

The effort to determine what areas of potential reform to focus on was shaped to some extent by constraints of timing. Like the proverbial infinite number of monkeys, a task force with unlimited time and resources could theoretically address every one of the corporate governance topics being publicly debated. No such task force existed, however: given the pace of reform efforts last spring — the obvious acceleration of Congressional activity, the explosion of SEC reform initiatives and the emergence of dramatic new proposals for listing standards for the New York Stock Exchange — it became apparent that the only way for the real world Task Force to have meaningful input into the debate in any of these forums would be to put forward some set of recommendations, albeit preliminary, within a few short months after its creation. And the only way to accomplish that goal, clearly, was to be modest in defining the subject matter scope of the Task Force's work.

Thus, many of the Task Force's early discussions resembled some form of triage: given the constraints of time and resources, a threshold task was to choose what subjects were peculiarly within the expertise of the Task Force and in what areas the Task Force and the ABA as a whole could have the greatest useful impact. Judged by these criteria, I believe that the Task Force chose well: as previously noted, it would have been unthinkable for the Task Force *not* to have addressed the role of lawyers as agents of corporate responsibility in the system of corporate governance, and, of course, the Task Force did resolve to examine that role. The other area selected was described by the Task Force as "internal corporate governance," namely the processes of, and allocations of responsibilities among, the board of directors and the senior officers of the corporation. The Task Force members brought a large fund of experience in corporate counseling to bear in evaluating this area and, needless to say in the wake of Enron et al., it was (and remains) an area of immense importance.

No response to recent corporate crises can disregard the importance of the role of ethical norms and rely solely on legalistic regulatory changes.

Identifying the Problem

Even with a more narrowly focused range of subjects to address, the Task Force had to answer one more threshold question: while the collapses of Enron, WorldCom and Adelphia, to name a few, unquestionably reflected major failures of corporate responsibility, what caused those failures? Who acted improperly, and how, and who missed what opportunities to prevent the failures, and why? Obviously, there can be no logic in recommending reforms unless and until some answers, however tentative, to these question are supplied.

Unquestionably, it made sense theoretically to await the outcome of full-blown investigations, civil and criminal trials and other enforcement or disciplinary proceedings, in order to assess blame in any individual case. It was clear to the Task Force, however, that in Enron or indeed in any case of corporate failure, the judgment of formal adjudications would be many months or even years in the making; therefore, the Task Force early on eschewed any effort to assess any individual's responsibility for failures at Enron or any other company. Similarly, it made sense theoretically to engage in extended empirical study of the performance of various participants in the corporate governance system to determine, with social scientific confidence (an oxymoron?), where breakdowns in the system occur. Again, however, such studies were impossibly utopian given the time and resources at hand. Necessarily, the Task Force relied on its principal resource — the experience of its members — in evaluating the causes of the recent corporate failures.

From that experience emerged two related conclusions. First, it was felt that "executive officers and other employees of public companies may succumb to the temptation of maximizing their own wealth or control at the expense of long-term corporate well-being."[6] Second, and because of such temptation, our system of corporate governance "has relied upon the active oversight and advice of ... outside directors, outside auditors and outside counsel."[7] In the view of the Task Force, however, "the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short."[8] Accordingly, the Task Force turned its attention to ways in which to make more effective such "active and informed stewardship" of corporate interests by independent corporate governance participants.

The Task Force's Preliminary Recommendations

As noted earlier, a number of the Task Force's preliminary recommendations focused on the composition of the board of directors and the composition, functions and powers of various of its committees. The recommendations drew almost no comment, let alone criticism, in public debates on the Task Force's preliminary report. This was not surprising, even though these recommendations involved dramatic departures from prior ways of doing business: the Task Force's recommendations drew heavily on similar recommendations being made for the New York Stock Exchange, by the Business Roundtable, by other corporate governance groups, and even in Congressional reform proposals.

Of far greater immediate interest to the legal profession were two other aspects of the Task Force's preliminary recommendations. First, it was suggested that corporate counsel — both in-house general counsel and outside counsel — be engaged much more directly and routinely in the process of calling attention to actual or potential violations of law by or breaches of duty to the corporation. Thus, it was recommended that corporate general counsel meet routinely with one or more independent members of the audit committee, outside the presence of other senior officers, and be prepared to discuss issues of legal compliance. By virtue of such a practice, private contact between the general counsel and independent directors to deal with serious legal compliance issues would not be viewed as a palace coup, and would therefore also be likely to encourage communication between senior operating officers and independent directors.

Likewise, it was recommended that upon retaining outside counsel, the corporation establish the understanding that outside counsel are to inform the general counsel upon observing violations of law or breaches of duty to the corporation. There has been no evident opposition to these recommended channels of communication, and they have already begun to be embraced by counsel and their corporate clients.

The other area of recommendations of particular interest to the organized bar involves proposals to amend rules of professional conduct for lawyers. In this regard, the work of the Task Force has been closely intertwined with recommendations of the Ethics 2000 Commission chaired by Chief Justice Veasey and the attorney conduct rules promulgated by the SEC on January 29, 2003.[9] Criticisms of some of the lawyers for Enron and Tyco resulted in some public call to enhance the role and obligations of corporate lawyers to identify, report and thereby prevent or rectify corporate fraud. Thus, it was natural that the Task Force would revisit the Ethics 2000 recommendations to enhance the lawyer's ability to disclose client information in order to prevent crime or fraud reasonably certain to result in significant financial injury to others (such as investors or employees) where the lawyer's services have been or are being used in furtherance of such crime or fraud. Although rejected in a controversial vote of the ABA House of Delegates in 2001, these recommendations are consistent with rules that exist in over 40 states (and have recently been recommended for adoption in Delaware).[10]

It was also natural for the Task Force to re-examine Model Rule 1.13, dealing with organizational clients and the lawyer's obligation to take action reasonably necessary to prevent injury to the organization when the lawyer knows of a violation of law or breach of duty by someone within the organization. The preliminary sense of the Task Force was that Rule 1.13 is somewhat restrictive and unduly discouraging to lawyers considering reporting corporate misconduct "up the ladder" — as opposed to reporting misconduct to someone outside the client — and it recommended that the lawyer's duty to take action under Rule 1.13 be triggered by misconduct of which the lawyer reasonably should know, as well as misconduct of which the lawyer has actual knowledge. This recommendation was the target of thoughtful criticism in public hearings. It remains to be seen how the Task Force responds to such criticism, and to the SEC's recent adoption of an "up the ladder" reporting obligation when a lawyer learns of "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[11]

In any event, the Task Force's proposals relating to the conduct of corporate lawyers are a reflection of the enormously important role of such counsel in our system of corporate governance. It is of course commonplace to ask "Where were the lawyers?" when corporate scandals surface, and to blame lawyers for failing to identify and avert crime or fraud. It is rarer, however, but surely at least as important, to help assure that lawyers are engaged and involved at the highest levels of corporate governance so that their talents and ethical precepts can be brought to bear in the first place.

It is hoped that out of all the negative publicity and crushing consequences of Enron and other recent corporate failures will emerge a renewed dedication on the part of the corporate bar, both inside and outside counsel, to promote the high standards of ethical conduct and compliance with law that are essential to the ultimate well-being of public companies, the investing public and our national and global economy. ◆

Professor Hamermesh is the Reporter for the ABA Task Force on Corporate Responsibility. This article is the author's own work, and does not represent the views of the Task Force or the American Bar Association.

FOOTNOTES

1. The Task Force's web site contains an extensive collection of written and oral testimony, legislative proposals, regulatory actions, position papers and other materials relevant to the ongoing public debate over corporate responsibility. *See* http://www.abanet.org/buslaw/corporateresponsibility/home.html

2. The Task Force's preliminary report is available on its web site, but can also be found at 58 BUS. LAW. 189 (2002).

3. Thus, the Task Force has been identified on occasion as the "Cheek Commission." The Task Force's web site identifies its members, whose ranks were subsequently increased by the addition of another former ABA president and a former justice of the North Carolina Supreme Court.

4. Task Force Preliminary Report, 58 BUS. LAW. at 191.

5. *Id.*

6. *Id.* at 193.

7. *Id.* at 193-194.

8. *Id.* at 194.

9. The work of the Ethics 2000 Commission, formally known as the Commission on Evaluation of the Rules of Professional Conduct, is available at http://www.abanet.org/cpr/ethics2k.html. The SEC rules adopted pursuant to Section 307 of the Sarbanes-Oxley Act of 2002 can be found at http://www.sec.gov/rules/final/33-8185.html.

10. *See* the Final Report of the Permanent Advisory Committee on the Delaware Lawyers' Rules of Professional Conduct, *available at* http://courts.state.de.us/supreme/.

11. 17 C.F.R. §205.2(e).

Gregory P. Joseph

REEVALUATION OF THE PRIVATE SECURITIES LITIGATION REFORM ACT IN LIGHT OF RECENT CORPORATE SCANDALS

There is no demonstrable correlation between any provision of the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the wave of corporate scandals that has rocked the nation over the past 18 months. Intentional fraud was illegal before the PSLRA, and corporate miscreants bent on criminal self-aggrandizement are scarcely focused on the nuances of pleading scienter or joint and several liability.

Nonetheless, the PSLRA was enacted to confer additional protection on defendants in securities fraud class actions, and it is having that effect. This article analyzes this phenomenon in the current environment and suggests statutory reforms — prospective reforms that would not affect any pending action — to address incongruities created by the web of the PSLRA, the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), and certain significant securities decisions.

Joint vs. Several Liability

The PSLRA eliminated joint and several liability unless "the trier of fact specifically determines that [the defendant] knowingly committed a violation of the securities laws." 15

U.S.C. § 78u-4(g)(2)(A).[1] Absent knowing misconduct, each defendant is liable only for its proportionate share of the judgment. § 78u-4(g)(2)(B)(i). If part of the judgment proves uncollectible, the extent of liability of each defendant is capped at 1.5 times its percentage of the judgment. § 78u-4(g)(4)(A)(ii). Therefore, only a defendant who is at least two-thirds responsible for the plaintiff's losses is liable for the full verdict, unless the defendant's misconduct was "knowing."

There is something wrong with this picture. As between the victim and a culpable defrauder, why should the victim be penalized simply because its loss was caused by actionable fraud that is not specifically found to be "knowing"? To be liable for securities fraud, the defendant must harbor a "mental state embracing intent to deceive, manipulate or defraud."[2] Although this mental state includes "recklessness," recklessness in this context means "'an extreme departure from the standards of ordinary care, which presents a danger of misleading the buyers or sellers that is either known to the defendant or so obvious that the actor *must have been aware of it*.'"[3] If the defendant "must have been aware of it," there is little reason to insulate him or her from the financial consequences of it.

The international accounting firms take credit for having secured enactment of the proportionate liability provision (indeed, the PSLRA as a whole), and they pride themselves on their exploitation of it. To begin with, they uniformly take the position that their culpability pales in comparison to that of the issuer of the financial statements (a position that may not survive the current wave of scandal). In all events, the accountants' misconduct, like that all of others, is a mere fraction of the total culpability.

Additionally, each of these giant accounting organizations markets and advertises itself as a unitary, worldwide firm, but when hauled into court protests that it is "really" composed of scores of legally distinct, unrelated entities. If a foreign affiliate has signed the audit opinion (and thus is a primary violator), that may, to a greater or lesser extent, insulate from liability partners and major affiliates in the U.S. and elsewhere who worked with the signatory and made the actual judgment as to compliance with U.S. GAAP (*see Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), discussed *infra*). In all of these circumstances, proportionate liability reduces victim compensation by curtailing the sums recoverable from the judgment-worthy defendants.

Accounting behemoths live by their worldwide brands, and they should account to the investing public that relies on those brands. Investment decisions are predicated on financial statements, and the *sine qua non* of investment in any significant issuer is a Big Four audit. The market is not focused on which affiliate of a Big Four firm does an audit — it simply looks for a Big Four imprimatur.

The doctrine of proportionate liability should be jettisoned. Outside of the class action context, common-law claims may be asserted, and joint-and-several liability prevails, rendering the limitation of the PSLRA moot. SLUSA, however, bars common-law claims in securities-fraud class actions. Consequently, the effect of SLUSA is to deprive most of the investing public of joint-and-several liability, and thus the prospect of full recovery in many cases, while preserving joint-and-several liability for large institutions and wealthy individuals whose direct losses are substantial enough to justify an individual (as opposed to a class) action. This is not equitable.

Even if retained, proportionate liability should not continue to apply as between multiple entities operating under the same brand name. Each constituent should be responsible for the collective losses incurred by the related entities. Further, it is difficult to appreciate the rational for a mere 1.5 uncollectible-judgment multiplier. At a minimum, the multiplier should be raised from 1.5 to at least 3. If someone is one-third or more at fault for a fraud, that party should be responsible for all ensuing damages if other culpable wrongdoers prove judgment-proof.

Aiding and Abetting Liability

In *Central Bank,* the Supreme Court held that, because § 10(b) does not expressly provide a civil remedy for aiding and abetting federal securities fraud, no such remedy may be judicially implied. *Id.*, 511 U.S. at 179, 182. As a result, only primary, not secondary, violators may be sued under § 10(b) and Rule 10b-5. *Central Bank* has spawned a Circuit split as to what constitutes primary liability, which is the critical issue now that secondary liability no longer exists.[4]

The proportionate liability provisions of the PSLRA, alone and in tandem with SLUSA, accentuate the victim impact of *Central Bank.* A defendant's proportionate liability under the PSLRA is reduced to the extent that culpability for aiding and abetting is not considered in assessing that defendant's "percentage of responsibility ... measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff."[5] If all defendants are judgment-worthy, this does not matter. Frequently, they are not.

To compound the inequity in this area, SLUSA again operates to eliminate any state law aiding and abetting claim in securities class actions, but not in individual securities action. Once again, the effect of SLUSA is to strip the class plaintiff of any aiding and abetting claim, while preserving the claim for large institutions and wealthy individuals who bring direct actions.

Congress should affirmatively address the question of a civil remedy for aiding and abetting a federal securities violation. There is much to commend a carefully-defined civil remedy. Alternatively, the state law aiding-and-abetting remedy that has been removed from class actions by SLUSA should be restored. There is no sound public policy reason to afford a civil remedy to the powerful and affluent victim but not the class victim.

RICO Bar

Section 107 of the PSLRA eliminated securities fraud as a predicate act under RICO, in the absence of a prior criminal conviction of the defendant. The prohibition of the PSLRA is broadly worded, forbidding the allegation of any RICO claim that is premised on "any conduct that would have been actionable as fraud in the purchase or sale of securities," 18 U.S.C. § 1964(c). That locution — "would have been actionable" — has been interpreted by the Third Circuit not only as barring RICO claims based on primary securities fraud (which is actionable by private investors) but also those based on aiding and abetting violations, on the ground that they remain "actionable" by the SEC.[6]

If ever there was a potent argument for the revival of securities fraud as a RICO predicate act, it is the number

and magnitude of recent confessions of criminality by corporate insiders snared in the web of recent scandal. It may be that no civil remedy will deter those intent on criminal profiteering. But the deterrent effect of RICO's treble-damage remedy should not be underestimated. The courts apply strict tests in judging the adequacy of securities and civil RICO allegations. If those tests are satisfied, the RICO claim should be permitted to proceed. Section 107 of the PSLRA should be rescinded.

Sanctions

The PSLRA mandates a Rule 11 review of every "complaint, responsive pleading, or dispositive motion," and contemplates the imposition of mandatory sanctions for any violation of Rule 11(b).[7] This is precisely the opposite of the rule that applies in every other case, as Federal Rule of Civil Procedure 11 was amended in 1993 for the express purpose of eliminating mandatory sanctions and instead confers on the district court discretion to sanction or not.[8]

The PSLRA also presumptively requires the imposition of an award of attorneys' fees and costs incurred as a result of any Rule 11(b) violation found.[9] (Once again, this is precisely the opposite of the rule in all other cases, in which attorneys' fees are disfavored unless the court finds the case to have been filed for an improper purpose.[10]) By far the greater burden falls on the plaintiff because, if the complaint is deemed — at the end of the case — to have violated Rule 11(b), then the plaintiff presumptively bears the expense of compensating the defendants for their entire cost of defending the action — in the words of § 78(c)(3)(A)(ii), "an award to the opposing party of the reasonable attorney's fees and other expenses incurred in the action."

This sanctions regime is one-sided. Even the presence of some non-sanctionable claims in a complaint is not necessarily a defense to the plaintiffs' being forced to pay the entirety of the defendants' fees and costs, as long as one sanctionable claim appears. The analysis as to whether the full weight of these mandatory sanctions is triggered is in fact quite complicated.[11] Moreover, it is unclear whether, in appropriate circumstances, the presence of a nonfrivolous claim against one defendant may keep frivolous claims against another defendant from being viewed as a "substantial" Rule 11 violation, nor whether the presence of a sufficiently meritorious state law claim might preclude a finding of a "substantial" violation if the federal securities claim lacks merit.[12]

All of this is unnecessary. There was never any showing that Rule 11 violations occurred disproportionately in securities cases, and there is no reason why the court should be burdened, as it currently is, with the obligation in every securities fraud action "to include in the record specific findings regarding compliance by each party and each attorney representing any part with each requirement of Rule 11(b)" (§ 78u-4(c)(1)).

It may be that no civil remedy will deter those intent on criminal profiteering. But the deterrent effect of RICO's treble-damage remedy should not be underestimated.

"Most Adequate Plaintiff" Provisions[13]

Although adopted in order to protect corporate defendants, the "most adequate plaintiff" provisions of the PSLRA have in fact redounded to their disadvantage. The operative theory was that an empowered plaintiff with a large interest in the corporation would control class action plaintiffs' lawyers and be more reasonable to deal with. Only an academic could have conceived such a notion.[14] Class action complaints — specifically, the amended complaints that follow appointment of the most adequate plaintiff — are now generally the subject of far more investigation than they were prior to the PSLRA (thus often making them harder to dismiss, despite the stricter pleading standards) and, to the extent that real institutions stand behind plaintiffs' lawyers, the cases are more expensive to resolve. There is nothing wrong with the Congressional policy choice to favor real plaintiffs over straw men, even if the result is not the one that was foreseen, but there is a practical problem with the statutory procedure.

The statute requires the judge to appoint, at the beginning of the action, a "lead plaintiff." The court must apply the same standards imposed by Federal Rule of Civil Procedure 23, but the PSLRA provides that "only ... a member of the purported class" may be heard in opposition to the "lead plaintiff" appointment. § 78u-4(a)(3)(B)(iii)(II). This effectively tasks the court with pre-judging the Rule 23 class certification decision at a time when, in most courts, the defendants may not be heard.[15] That is unfair to defendants. There is no principled reason why defendants should be precluded from being heard at the time the "most adequate plaintiff" is appointed. This will not force them to join issue on Rule 23 at that time. It may well be inefficient for the class issue to be heatedly litigated before the dismissal motion is decided and the contours of the case (if any) emerge. But there are cases when the fight is worth the candle, and the statutory preclusion should be removed.

Disproportionate Recovery

The PSLRA, in an effort to disincentivize professional plaintiffs, limits the recovery of the class representative to a share of any final judgment that is exactly "equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class." § 78u-4(a)(4). This proscription raises the question whether a plaintiff (*e.g.,* an institution) that continues to hold shares of the defendant corporation is precluded from seeking as part of a settlement corporate governance changes that would benefit all current shareholders, but not all class members (*i.e.,* those who sold their entire positions).[16]

It is difficult to see why corporate governance changes should be subject to arguments that they are off-limits because they confer on a class representative a "share" of the final judgment that is not enjoyed by all members of the class. Defendants need not agree to them, but sound corporate governance is good public policy, and the statute should be clarified to permit negotiation on this topic.

Pleading Falsity

The PSLRA requires plaintiffs to "specify each statement alleged to have been misleading, the ... reasons why the statement is misleading, and, if an allegation ... is made on information and belief" — as is virtually always the case — "state with particularity *all* facts on which that belief is formed" (§ 78u-4(b)(1)). "All facts" is both crystal clear and inherently ambiguous. No doubt a plaintiff may not conceal a fact on which an inference is drawn, but just what are those facts? Do they include work product and privileged information? Do they include the identity of a whistleblower, or is it only the whistleblower's title, job responsibilities, and access to information that is germane? Simply substituting "the" for "all" would permit the filing lawyer to decide which facts he or she is relying on, and to identify those facts, without generating the excessive litigation that "all" has produced.[17]

Pleading Scienter

The PSLRA raised the bar for pleading scienter, at least in most Circuits, and has produced a three-way Circuit split as to the precise meaning of the requirement, in § 78u-4(b)(2), that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[18]

Perhaps surprisingly, this provision would appear to be operating adequately, despite the Circuit split. The differences among the standards, as applied, is relatively nuanced, at least outside the Ninth Circuit (and even in the district courts there). Every Circuit appears to agree with the First that: "In the guise of tinkering with procedural requirements, Congress has effectively, for policy reasons, made it substantively harder for plaintiffs to bring securities fraud cases, through the 'strong inference' of scienter requirement." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999); *accord Helwig*, 251 F.3d at 553; *Green Tree*, 270 F.3d at 661; *Advanta*, 180 F.3d at 535. All securities fraud actions are fact-intensive and the standards (but for the Ninth Circuit's) are sufficiently similar that it is highly doubtful that the differences between them — as opposed to the judges who apply them — lead to different results. The conflicting interpretations are a matter for the Supreme Court to resolve; it is unlikely that any Congressional amendment could avoid creating new issues even as it attempted to resolve the current split.

Discovery Stay

The PSLRA imposes an automatic stay of discovery "during the pendency of any motion to dismiss,"[19] and it is a rare 10b-5 complaint that does not invite a dismissal motion. Because Rule 26(d) of the Federal Rules of Civil Procedure bars discovery prior to the parties' Rule 26(f) conference, this provision generally bars discovery from the inception of the action unless and until the complaint has been sustained.

There are three recurring problems under this provision. *First*, in complicated multi-party litigation, the court may issue a series of Rule 12(b)(6) decisions following a series of separate arguments, purely as a matter of judicial administration. May discovery begin prior to resolution of the last dismissal motion? There is little reason to bar all discovery once the complaint has been sustained against any defendant, at least insofar as document discovery from that defendant and third parties is concerned. *Second*, and similarly, once any aspect of a complaint has been sustained against a defendant, the fact that the court permits re-pleading against that defendant should not lead to a continuing discovery bar. *Third*, the "motion to dismiss" that Congress had in mind was the Rule 12(b)(6) motion on the merits, but by its terms the language extends to every Rule 12 motion, from venue to jurisdiction to a motion to strike. The language of the statute ought to be clarified to avoid needless litigation in this area.

Conclusion

The PSLRA was a product of its time. In light of intervening events, Congress has every reason to amend it. Even if it were reviewed as a change of direction, there is no embarrassment in that. As Churchill once remarked, "I have often had to eat my words, and I must confess that I have always found it a wholesome diet." ◆

Mr. Joseph represents both plaintiffs and defendants in pending securities and Racketeer Influenced and Corrupt Organizations Act (RICO) actions. None of the opinions expressed, or suggestions made, in this article bear in any way on any existing case.

See Footnotes on page 26.

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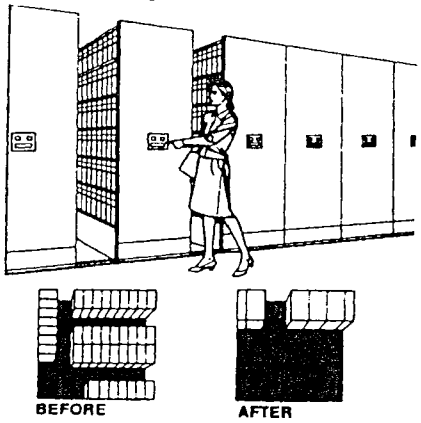

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FOOTNOTES

1. Because most securities fraud class litigation is filed under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), and Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. § 240.10b-5, this article cites to the 1934 Act provisions of the PSLRA. To the extent these provisions are paralleled in the Securities Act of 1933 (the "1933 Act"), the comments equally applicable.

2. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976).

3. This is the classic formulation of *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977). It is interesting to observe that §§ 105(c) and 602 of the Sarbanes-Oxley Act of 2002 each define the appropriate mental state for their respective purposes as "intentional or knowing conduct, including reckless conduct" (emphasis added). Thus, Congress is currently equating "knowing" and "reckless" behavior.

4. *Compare, e.g., In re Software Toolworks Sec. Litig.*, 50 F.3d 615 (9th Cir. 1995), *with Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) and *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001).

5. 15 U.S.C. § 78u-4(g)(3)(A)(ii).

6. *Bald Eagle Area Sch. Dist. v. Keystone Fin., Inc.*, 189 F.3d 321, 327-29 (3d Cir. 1999). *But see Renner v. Chase Manhattan Bank*, No. 98 Civ. 926, 1999 U.S. Dist. LEXIS 978 at *20 (S.D.N.Y. Feb. 2, 1999).

7. 15 U.S.C. § 78u-4(c)(1)-(2).

8. *See generally* Joseph, SANCTIONS: THE FEDERAL LAW OF LITIGATION ABUSE §§ 2(A)(4)(a), 15(C) (3d ed. 2000) ("SANCTIONS").

9. 15 U.S.C. § 78u-4(c)(3).

10. *See* SANCTIONS at § 16(B)(17)(a).

11. *Gurary v. Nu-Tech Bio-Med, Inc.*, 303 F.3d 212, 223 (2d Cir. 2002) ("the district court must first determine whether frivolous claims in violation of Rule 11 have been brought. If they have, the court must examine whether nonfrivolous claims have been joined and, if so, whether these claims — whatever their number — are of a quality sufficient to make the suit as a whole nonabusive and the Rule 11 violation not substantial. If no such weighty nonfrivolous claims are attached, the statutory presumption applies. The court must then determine whether the violation was *de minimis*, for, if it was, the presumption is rebutted. Alternatively, financial statements or other relevant evidence may establish that the full sanction award unjustly creates an unreasonable burden on the sanctioned party and that a partial award would not 'impose a greater burden on the party in whose favor sanctions are to be imposed.' § 78u-4(c)(3)(B)(i). In this situation, too, the presumption is rebutted and *full* sanctions are not warranted") (emphasis in original).

12. *Id.* at 224 & n.5.

13. 15 U.S.C. § 78u-4(a).

14. The source of the PSLRA was a law review article by two prominent and thoughtful legal scholars. Elliot J. Weiss and John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

15. The case law is split as to whether a defendant may be heard on the motion to appoint the most adequate plaintiff. Most defendants do not do so, in light of the uncertainty as to their standing.

16. This touches on the related question whether separate sub-classes are necessary for such "hold" and "sell" plaintiffs, since only "hold" plaintiffs would have any interest in such relief. *In re Cendant Corp. Litig.*, 264 F.3d 201, 244 n.25 (3d Cir. 2001); *In re Party City Securities Litig.*, 189 F.R.D. 91, 108-10 (D.N.J. 1999).

17. *See, e.g., In re Cabletron Sys.*, No. 01-1965, 2002 U.S. App. LEXIS 23372 (1st Cir. Nov. 12, 2002) (surveying the Circuits' differing views on the unidentified-sources issue in light of the statutory directive "all").

18. *Compare, e.g., In re Silicon Graphics, Inc., Sec. Lit.*, 183 F.3d 970, 978-79 (9th Cir. 1999) (requiring allegations of specific fact showing deliberate recklessness) *with* (i) *In re Advanta Corp. Sec. Lit.*, 180 F.3d 525 (3d Cir. 1999) and *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000) (holding former Second Circuit motive-and-opportunity test codified by PSLRA) and (ii) *Helwig v. Vencor, Inc.*, 251 F.3d, 540, 551 (6th Cir. 2001) (en banc), *Florida St. Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645 (8th Cir. 2001), *Nathenson v. Zonagen Inc.*, 267 F.3d 400 (5th Cir. 2001), *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999), and *Bryant v. Avado Brands*, 187 F.3d 1271 (11th Cir. 1999) (middle position — allegations of motive and opportunity may, but need not, suffice to state scienter).

19. 15 U.S.C. § 78u-4(b)(3)(B).

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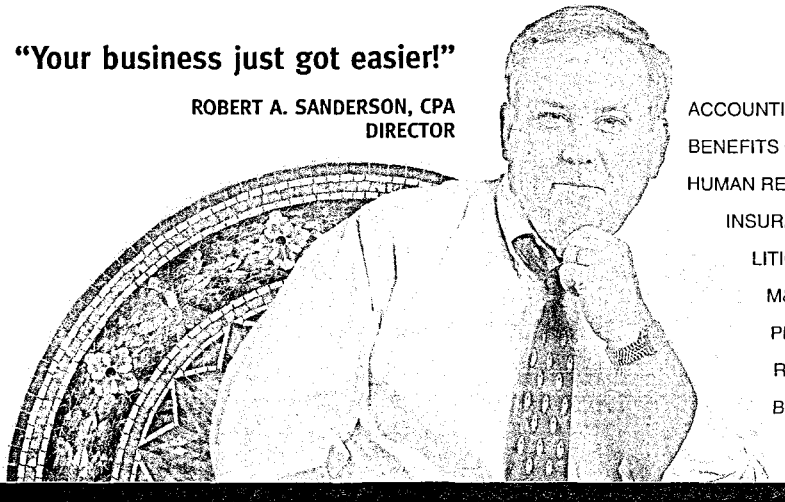

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(Continued from page 28)

of a law that catches you breaking the rules and punishes you. But a society that requires a policeman for its leaders is doomed at the outset.

I had a professor at Georgetown University, Carroll Quigley, who had a more elegant theory for this matter. Quigley opined that successful civilizations create social organizations that accomplish necessary societal ends. But over time, he said, these organizations become increasingly inefficient and ineffective. It seems that the people who man the organizations become more concerned about their selfish interests, and less concerned with their original mission.

In other words, I care more about money than the quality of lawyering I provide. Then all sorts of bad things happen, not the least of which is that my civilization is conquered by barbarians who dress badly and don't appreciate great art. If I marry Quigley and Stargatt, I discover that focusing on money instead of quality work leads to the decline of civilization. This is a heavy load for a lawyer like me, who still has problems making his computer work.

So what does any of this have to do with the musical *Chicago*? Well, as everyone knows by now, *Chicago* is the story of Roxie Hart, a sweet-faced murderer who will kill to get into show business. Her skillful lawyer shows her how notoriety, girlish looks and a few well-coached lies can be used to gain her fame and fortune. As one song puts it, Roxie's trial was the art of "razzle dazzle." Eventually, she reaches the pinnacle of success, closing with a number in which she thanks the audience because "I couldn't have done it without you."

In short, *Chicago* is the story of someone consumed by an ambition that has no objective other than fame, by whatever means and at whatever cost. But if all eras are populated with unprincipled people, why is one era characterized by a shared and ethical prosperity, and another with excess and fraud?

That brings us to *Chicago*'s second point. Maybe it's the audience. Roxie couldn't have done it without us — watching, admiring, applauding. The people who dance on our stages will reflect our values and priorities. We decide whom to applaud and whom to boo.

In recent years we have become increasingly obsessed with money, fame and power, and increasingly obsessed with — if not envious of — those who attain them. And we don't seem to care that much about how they got to the top. We applaud our Roxie Harts without asking whether they lie or cheat — the important point is their success. We even have "reality" TV where "average" people become "famous" by humiliating themselves or prevailing in an ethically suspect struggle for survival. And, periodically, many of us line up to buy a lottery ticket to paradise, believing that gambling is a worthy road to success.

Accuse me of being a hopeless romantic or maybe a pious prude. You might be right. But I cannot forget another thing Quigley said. He claimed that as Rome sank into decadence and dysfunction, it passed ever more laws articulating ever more rules. If you read the laws, you would see a wonderful society, committed to the highest ethical principles. But if the Romans had movies, they might have displayed a different reality.

In any event, my outlook has one major advantage — watching *Chicago* was a lot more fun than reading Sarbanes-Oxley. ◆

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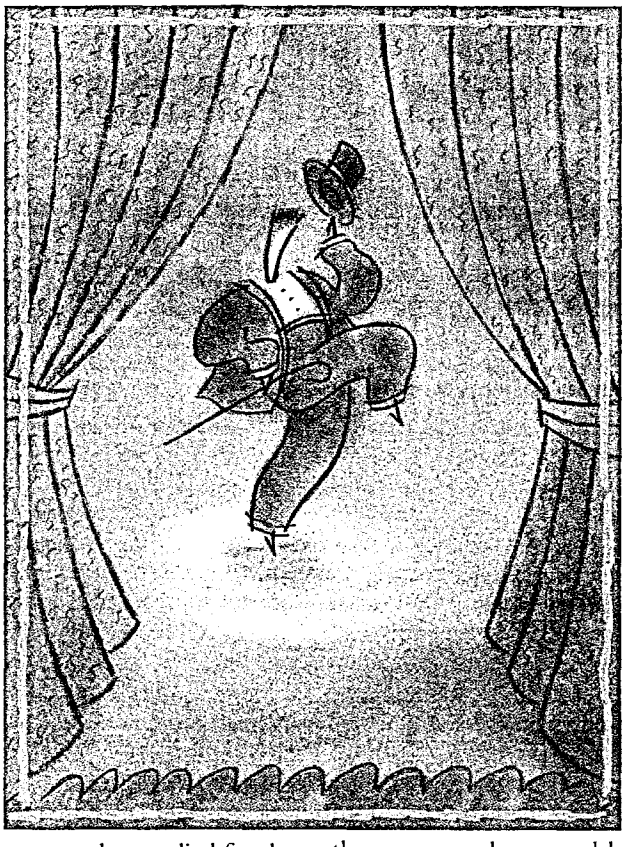
WHAT'S LAW GOT TO DO WITH IT?

And why the musical *Chicago* does have something to do with it.



With apologies to Tina Turner ("What's love got do with it?"), I admit that I have struggled with the question of what role the law has played in the corporate scandals that have consumed the headlines. Was there some deficiency in the law that led to these problems? Is reform of the law or enactment of new laws the answer?

I am in favor of new laws as much as the next guy — they certainly keep lawyers busy. And the legal reforms adopted in response to the scandals are changes for the better. But I fear that the substance of the law has never been the problem. The law as a tool for reform seems like a finger in the dike, trying to hold back the tide. In the end, the water always wins.

To those who direct blame for the scandals at the law, I have an easy rejoinder. The substance of corporate law applied for the last several years is fundamentally the same as that applied over the past 50 years. If anything, Delaware law has become more demanding of fiduciaries, what with *Revlon*, *Unocal*, *Blasius* and other cases that have imposed stricter scrutiny on directors.

Despite the occasional scandal, there was nothing like the systemic abuses that have accumulated over the past decade. It seems that while the standards articulated by the Courts have created greater scrutiny and higher aspirational goals, the conduct of the participants in the corporate world degenerated into what a recent book called "Pigs at the Trough."

On a purely cause and effect basis, the law was constant, but the behavior changed. Therefore the law could not be our causative factor. If it was not the law that caused the change, what did?

Some argue that the scandals are the product of unethical people behaving badly. This assertion certainly has some truth, but we have been graced with greedy people since the snake offered Eve the apple. Most of the time they don't run amuck, trashing securities markets and major corporations. Why now?

Others argue that the problem is capitalism itself and the greed it encourages. Yet only a few years ago we were congratulating ourselves that liberal democracy and free markets had resulted in the completion of a great historical trend toward self-fulfillment. Were we hallucinating? Is capitalism supremely flawed after all?

On the question of the merits of free market capitalism, there are undoubtedly a host of complex and insightful explanations and arguments. Those explanations are beyond my capability of understanding. So I am left with a more simple-minded observation. I think that in the past decade we got our objectives out of focus. Let me explain using something my partner Bruce Stargatt always said about practicing law and making money, which is the most direct experience I have had with the capitalist ethic.

Bruce said not to worry about the money — be a good lawyer and a good person, and the money would take care of itself. Our first objective should be to provide the best quality of service to our clients and the courts we serve, to meet their needs, to serve the ends of justice (whoa, what a phrase!). Our primary objective was ***not*** to amass the largest fortune possible.

This is not to say you could be indifferent to money or ignore the financial health of your practice. His attitude was a matter of emphasis, and it evidenced a trust that quality work and a job well done would be rewarded, at least most of the time.

This philosophy is not unique to lawyers. When businesses succeed in the long run, isn't it because of the quality of service or goods, and the ability to provide them with the greatest efficiency? What motivated Henry Ford or Thomas Edison? Was it the ambition to become rich, or was it to accomplish something "real" for which they could be proud?

The difference in motives is not immaterial. There are plenty of ways to become rich and not all of them require accomplishing a meaningful end. If your primary — or only — objective is to become as rich or powerful or famous as possible, there are no limits to what you will do to reach that end, short

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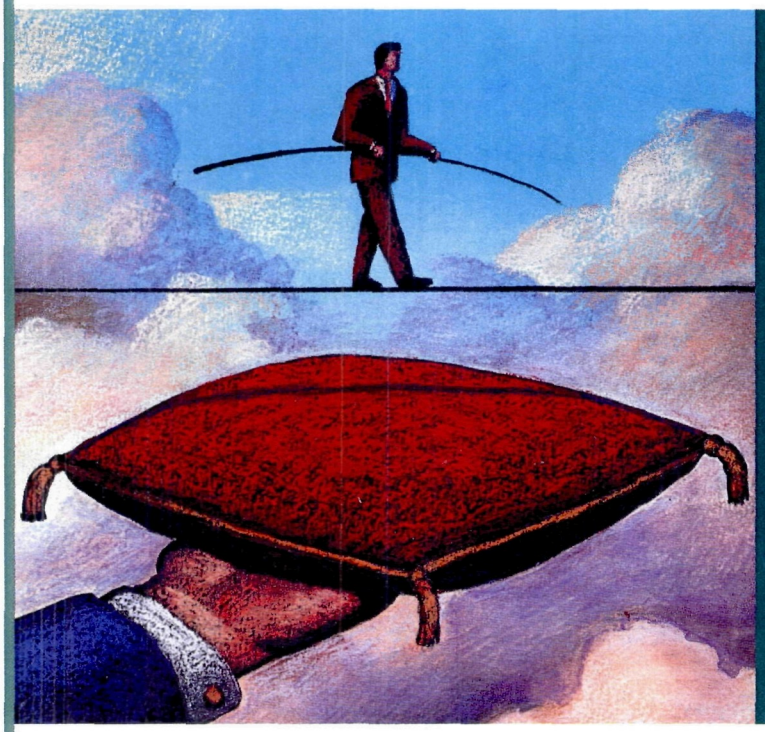

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