In-House Ethics:
Important Questions

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Overall Responsibility

- "A law firm . . . shall make reasonable efforts to ensure that all lawyers in the firm conform to these Rules." Rule 5.1(a), NY R. Prof. Conduct.
- "Paragraph (a) applies to lawyers who have managerial authority over the professional work of a firm. This includes … lawyers having comparable managerial authority in a law department of an enterprise or government agency." ABA Model Rule Comment.

Model Rule 5.5 – Unauthorized Practice of Law

- ABA Model Rule creates safe harbors for certain types of practice by lawyers not licensed in that state:
  - Services undertaken in association with an admitted lawyer who actively participates in the matter
  - Provides legal services in or reasonably related to ADR proceedings that do not require *pro hac vice* admission if services are reasonably related to lawyer's practice in jurisdiction where licensed
  - Legal services arise out of or are reasonably related to lawyer's practice where licensed
  - Permits services provided solely to the lawyer's employer or its affiliates by a non-admitted lawyer licensed in another state, provided the services are not services for which the jurisdiction requires *pro hac vice* admission or permission (a.k.a. In-House Counsel exception).

Rule 5.5 : Unauthorized Practice of Law; as adopted in New York.

- (a) A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction.
- (b) A lawyer shall not aid a non-lawyer in the unauthorized practice of law.
- Note: New York chose not to adopt any of the ABA Model Rule 5.5 safe harbor provisions for temporary practice by non-admitted lawyers, nor did it adopt the In-House Counsel exception.

In-House Counsel and UPL Consequences

- Using the title "General Counsel" without local licensure, and without qualification, is the unauthorized practice of law. *See In re Application of Stage*, 692 N.E.2d 993 (Ohio 1998).
- Possible consequences of unlicensed In-House counsel:
  - Unauthorized Practice of Law – criminal sanction.
  - Complaint of Unauthorized Practice of Law to jurisdiction in which In-House Counsel is licensed.
  - Lose Ability to Claim Attorney-Client Privilege. *See Fin. Tech. Int'l, Inc. v. Smith,* 49 Fed. R. Serv. 3d 961 (S.D.N.Y. 2000) *declined to find that communications with unlicensed house counsel were privileged because although house counsel had passed NY bar exam, he had not completed bar application paperwork and was not licensed in any other state.*

Is a Lawyer Lawyering?
Why it Matters.

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Why Lawyering Matters

- "When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding." Rule 4.3 NY R. Prof. Conduct.
- NY City Bar Assn Op 2009-02 – duty to clarify role applies even if there will be no material prejudice to unrepresented person.
- *Is company employee L, who has a law license, and is conducting an internal investigation, bound by Rule 4.3?*
- *What if L is employed within the HR department, but notes "lawyer" or "J.D." on his or her business card?*

Why Lawyering Can Matter: Application of Professional Ethics Rules

- "If a rule requires as a condition precedent that there be an attorney acting in a representative capacity and there was no representation, then it would not be appropriate to recommend a violation of that rule." Dismissed Complaint by Minnesota Office of Lawyers Professional Responsibility, 2007.
- Certain Rules of Professional Conduct begin with the preface "In representing a client . . .." (e.g., Rules 4.2 and 4.3).

Is it Lawyering?

- I'm not a Lawyer: An interviewee alleges that L violated Rule 4.3(b).
  How will L show she was not acting as a lawyer?
- I am a Lawyer: Plaintiff seeks to discover L's report of the investigation. *How will L show she was acting as a lawyer, so as to protect the attorney-privilege?*
- *Can't have it both ways.*
- *Illustrates need to clarify lawyer's role in organization.*

Lawyering: Certain presumptions

- "There is a presumption that a lawyer in the legal department or working for the general counsel is most often giving legal advice, while the opposite presumption applies to a lawyer . . . who works for the Financial Group or some other seemingly management or business side of the house." *Boca Investerings Partnership v. United States*, 31 F. Supp. 2d 9, 11-12 (D.D.C. 1998).
- *What does L's job description say? What is L's title? To whom does L report?*

In-House Counsel

What about Non-Compete Agreements?

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Lawyering & Non-Compete Agreements

- "A lawyer shall not participate in offering or making: (a) a partnership, shareholder, operating, employment, or other similar type of agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement. . . ." NY R. Prof. Conduct 5.6.
- *May General Counsel include a non-compete in In-House Counsel employment agreements?*

Are Non-Competes Enforceable, Ethical?

- Employment agreements for in-house lawyers are subject to Rule 5.6 and may not include restrictive employment provisions or non-compete covenants. *See* New Jersey S. Court Advisory Comm. on Prof'l Ethics, Op. 708, 2006.
- WA and CT Ethics Opinions opine that in-house counsel may be required to sign a non-compete agreement but the non-compete is only enforceable if lawyer obtains a non-lawyer position with a competitor. Lawyer is free to provide legal service to a competitor per Rule 5.6. *See* Washington Bar Op. 2100 (2005); Connecticut Bar Association Op. 02-05.

Who, Within the Corporation, Is Protected from Communication by Plaintiff's Counsel?

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Communication with a Person Represented by Counsel

- "In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order." Rule 4.2, New York Rules of Professional Conduct.

Employees of Organizations and Rule 4.2, ABA Comment 7

- In the case of a represented organization, this rule prohibits communications with a constituent of the organization:
  - who supervises, directs or regularly consults with the organization's lawyer concerning the matter or
  - who has authority to obligate the organization with respect to the matter or
  - whose act or omission in connection with the matter may be imputed to the organization for purposes of civil or criminal liability.

Rule 4.2 and Former Constituents (Employees)

Comment 7 to ABA Model Rule 4.2:

- Consent of the organization's lawyer is not required for communication with a former constituent.
- If a constituent of the organization is represented in the matter by his or her own counsel, the consent by that counsel to a communication will be sufficient for purposes of this rule.

Does Rule 4.2 Protect In-House Counsel from Direct Contact by Adverse Counsel?

- Probably Not -- "Model Rule of Professional Conduct 4.2 generally does not prohibit a lawyer who represents a client in a matter involving an organization from communicating with the organization's inside counsel about the subject of the representation without obtaining the prior consent of the entity's outside counsel." *See* ABA Formal Op. 06-443, entitled "Contact With Inside Counsel of an Organization Regarding a Matter When the Organization is Represented by Outside Counsel."

What if In-House Counsel was a Participant?

- What if the contacted in-house counsel is “a part of a constituent group of the organization” as described in Rule 4.2 Comment [7] as, for example, when the lawyer participated in giving business advice or in making decisions which gave rise to the issues which are in dispute?
- Other Rules may also limit opposing counsel’s ability to inquire, especially as to communications that might be privileged. Rule 4.4(a) prohibiting means of obtaining evidence that violates the rights of a third party.

New Rule 3.3

Confidentiality

And

Candor to the Tribunal

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Rule 1.6 (a) Client Confidentiality

- "Confidential information" consists of information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested to be kept confidential.
- "Confidential information" does not ordinarily include (i) a lawyer's legal knowledge or legal research or (ii) information that is generally known in the local community or in the trade, field or profession to which the information relates.

Candor to the Tribunal
Rule 3.3

- Known, Know or Knows – denotes actual knowledge of the fact in question. A person's knowledge may be inferred from circumstances.
- Requires lawyer to disclose information to the tribunal even if protected by Rule 1.6 (confidentiality rule that includes attorney-client privilege information) when:
  - The lawyer **knows** a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding;
  - The lawyer **knows** false testimony or evidence is being offered in a court proceeding;
  - Necessary to correct **material** false testimony or evidence that was offered by the lawyer and the lawyer later comes to **know** of its falsity.

Candor to the Tribunal
Rule 3.3: Other new Issues.

- Permits, but does not require, lawyers to refuse to offer evidence **believed to be false**, except where the evidence is the testimony of a criminal defendant.
- New Rule 3.3(d) imposes obligation upon lawyer in an *ex parte* proceeding to disclose all material facts known if necessary to enable court to make informed decision, even if facts are adverse to client.

What New Developments Are There in the Law Regarding Unauthorized Retention and Inadvertent Production of Confidential Documents?

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Intentionally Obtaining or Retaining Privileged Documents Violates Rule 4.4.

- Rule 4.4(a): Respect for Rights of Third Persons:

  "In representing a client, a lawyer shall not . . . use methods of obtaining evidence that violate the legal rights of such a [third] person."

Intentionally Obtaining or Retaining Privileged Documents Also Subjects an Attorney to Sanctions.

- *Arnold et al. v. Cargill Inc.,* 2004 WL 2203410 (D. Minn. Sept. 24, 2004, Dec. 4, 2007).
- Plaintiff class action counsel approaches a former high level Cargill HR employee to obtain investigative information. Former employee tells counsel he has Cargill documents relating to prior discrimination claims.
- Plaintiffs' counsel does not caution former employee about attorney-client privilege, takes possession of documents, is tardy in notifying defense counsel, and then retains copies after documents are returned.
- Plaintiffs' firm disqualified as class action counsel and denied fees. Ethics complaint against firm's senior partner results in discipline.

Ethical Duties and Inadvertent Disclosure

- Rule 4.4(b): "A lawyer who receives a document relating to the representation of the lawyer's client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender."
- ABA Formal Opinion 05-437, based on new Rule 4.4(b), supersedes ABA Formal Op. 92-368, which stated:

  "A lawyer who receives materials that on their face appear to be subject to the attorney-client privilege or otherwise confidential, under circumstances where it is clear they were not intended for the receiving lawyer, **should refrain from examining the materials, notify the sending lawyer and abide the instructions of the lawyer who sent them**."

Court Rules and Inadvertent Disclosure

- **Evidence and Waiver: Fed. Rule Evidence 502 (Sept. 2008):**

  Provides there is no waiver of privilege or work product, if production of privileged documents was inadvertent, and "reasonable steps to prevent disclosure" were taken, and "reasonable steps to rectify" the disclosure are taken.

- **Inadvertent Disclosure in Discovery: Fed. R. Civ. Procedure 26(b)(5)(B):**

  Provides that a party who in discovery produces privileged or work product materials may notify the recipient. The recipient must "promptly return, sequester, or destroy" the materials; must not use or disclose; and must attempt retrieval. The recipient may promptly present the material to the court for determination.

Conflicts of Interest: New Terminology

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Changes to Conflict Rules Terminology

- **Informed Consent – agreement obtained after the lawyer has explained the material risks and reasonably available alternatives (Rule 1.0(j)).**
- **Confirmed in Writing – requires either signature of person giving informed consent, or confirmation in "writing" promptly transmitted by the lawyer to the person confirming an oral consent. (Rule 1.0(e)).**
- **Writing - "Writing" or "written" denotes a tangible or electronic record of a communication or representation, including handwriting, typewriting, printing, photocopying, photography, audio or video recording, and e-mail. A "signed" writing includes an electronic sound, symbol or process attached to or logically associated with a writing and executed or adopted by a person with the intent to sign the writing.**

When May Former Counsel Be Disqualified For Knowing Too Much?

"Playbook Conflicts"

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The Issue

- *Attorney F formerly represented Company C in many matters, whether as in-house or as outside counsel. F is now representing Plaintiff P in a lawsuit against C. Can C obtain a disqualification order against F?*

Rule 1.9: Duties to Former Clients

- (a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.
- NY Law – Substantially Related: *T.C. Theatre Corp. v Warner Bros Pictures, 113 F. Supp. 265 (S.D.N.Y.1953*): "[t]he former client need show no more than that the matter embraced within the pending suit wherein his former attorney appears . . . are substantially related to the matters or cause of action wherein the attorney previously represented him, the former client."

Playbook Disqualification Denied

- *Bloom et al. v. St. Paul Travelers Companies, Inc.*, 806 N.Y.S.2d 692 (N.Y App. Div. 2005).
- "No evidence that the legal issue at the heart of the present action is essentially the same as any of the various legal issues" to which the lawyers had provided counsel to Travelers in the past.
- Reason: Focus of new dispute involved a policy change eliminating underinsured coverage that occurred after counsel ceasing to represent Travelers on uninsured and underinsured matters.

Playbook Denied: Former In-House Counsel

- *Jamaica Public Service Co. Ltd v. AIU Insurance Co.,* 92 N.Y.S.2d 631 (Ct. App. 1998).
- In-House counsel's prior representation was not substantially related to the post-separation litigation against AIU.
- Reason: Former in-house counsel's position involved representation limited to Canadian lawyers' professional liability coverage. In-House responsibilities did not involve litigation or coverage disputes such as those involved in current representation adverse to AIU.

Playbook Conflict Found - Disqualified

- *Ullrich et al. v. The Hearst Corp.,* 809 F.Supp. 229 (S.D.N.Y. 1992).
- Former in-house counsel leaves Hearst and then becomes primary outside counsel on employment matters. After dispute with Hearst over hourly charges, counsel begins representing former Hearst employees.
- Counsel disqualified in all three cases because the allegations did not allege isolated acts unconnected to continuing management policies, but instead that actions were motivated by management's discriminatory animus, a subject which counsel had likely consulted with management about in the recent past.

"Playbook Conflicts" ABA View on Former In-House Counsel

- "General knowledge of the strategies, policies, or personnel of the former employer is not sufficient by itself to establish a substantial relationship . . .."
- "If the legal department were divided into specialized areas of practice such as tax, patent, and securities law, there would be no presumption that the general counsel has knowledge of any specific matter dealt with by any practice area."
- *See* ABA Formal Ethics Opinion 99-415, "Representation Adverse to Organization by Former In-House Lawyer."

Questions

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Managing the General Counsel/Compliance Officer Relationship

By Michael W. Peregrine and Joshua T. Buchman, McDermott Will & Emery, Chicago, IL

Creating—and preserving—an effective working relationship between the General Counsel (GC) and the Chief Compliance Officer (CCO) should be a key leadership priority for hospitals and health systems. This is particularly the case given the new anti-fraud compliance challenges arising in a post-healthcare reform environment. While no applicable "best practices" exist, the federal government has provided enough guidance to inform leadership decisions on designing appropriate relationships. The ultimate goal is a conflict-free management structure that facilitates the board's ability to exercise oversight of the organization's legal/compliance profile. The failure to achieve such a structure may compromise the credibility of the compliance program and, potentially, result in increased organizational risk.

Given recent developments, *objective* structuring issues for organizational leadership include, but are not limited to, (a) whether the GC/CCO positions should be separated and held by different persons, or combined and held by the same person; (b) the specific job description for each position, noting the areas of appropriate overlap and avoiding "gaps" in coverage; (c) relevant reporting relationships to corporate officers and to the board; (d) preservation of the attorney-client privilege; (e) the impact of the Rules of Professional Responsibility; and (f) communication and coordination between the two positions.

Equally important are the more *subjective* structuring issues that may arise given the different "skill sets" required for the positions and the different roles they are expected to perform. These include intangible factors such as the interpersonal relationship between the General Counsel and the Compliance Officer—which should include both mutual personal respect, and respect for each other's specific areas of responsibility. A cohesive GC/CCO relationship is a hallmark of the most effective health system compliance programs.

Leadership's attention to these issues is made more important by emerging regulatory focus on the compliance implications of quality of care deficiencies, and government's application of "responsible corporate officer" theories. How should the General Counsel and Compliance Officer respond to such concerns? Ultimately, it should be part of the governing board's *Caremark*[1] responsibilities to assure that the GC/CCO relationship is properly structured and managed.

Topics for leadership consideration, and possible approaches, include the following:

Core Duties

Any examination of the GC/CCO relationship should begin with a basic understanding of core duties and responsibilities attributed to the respective positions—and how they interface in connection with corporate compliance. Lack of clarity can be a recipe for disfunction.

The General Counsel: At its most basic level, the term "General Counsel" refers to the lawyer who has general supervisory responsibility for the legal affairs of the corporation.[2] In this role, the General Counsel provides legal advice to corporate officers, board members, and other organizational constituents.[3] The scope of this advice often includes internal topics such as corporate governance, and external topics such as corporate transactions, litigation/dispute resolution, and regulatory compliance.[4] The American Bar Association (ABA) believes the General Counsel should have *primary responsibility* [emphasis supplied] for assuring the implementation of an effective legal compliance system under the board's oversight.[5] The General Counsel's ethical responsibility is to the corporation, and not to constituents (e.g., officers, directors, other agents) with whom he/she may communicate in connection with representing the corporation.[6]

Since the Sarbanes-Oxley era, the General Counsel also has been regarded as the "guardian of the corporate reputation," with an important role in promoting the appropriate "tone at the top"/corporate culture of integrity that is so critical to supporting rigorous legal compliance.[7] The General Counsel also is expected to share with its internal constituents the perspective of a counselor, providing advice based not solely on the "letter of the law" but also on ethical concerns and how particular corporate actions may be interpreted by third parties (e.g., public, media, regulators).[8] Implicit in this "guardian" role is the expectation that the General Counsel is well-positioned to "push back" on executive leadership in the context of controversial legal issues.[9] The General Counsel also is expected to serve as a "bridge" to the board on legal risk matters.[10]

Compliance Officer: The role of Compliance Officer is somewhat unique within a corporate organization. The Compliance Officer is perceived as a neutral finder of fact, expected to perform duties that transcend the practice of law, with specific responsibility for uncovering legal or ethical misconduct within the organization.[11] Consistent with the provisions of the Federal Sentencing Guidelines, the term "Compliance

Officer" generally refers to the corporate officer assigned overall responsibility for the organization's compliance program.[12] The GC and CCO typically have complimentary skills. For example, Compliance Officers historically have been recognized for their technical expertise in revenue cycle issues, coding, billing and reimbursement, internal controls, marketing, and responding to governmental inquiries. The primary responsibilities of the hospital Compliance Officer were first formally described in the Department of Health and Human Services (HHS) Office of Inspector General's (OIG's) 1998 "Compliance Program Guidance for Hospitals."[13] Additional refinement is contained in the 2004 OIG/AHLA publication, *An Integrated Approach to Corporate Compliance*:[14]

> (1) developing and implementing policies, procedures, and practices; (2) overseeing and monitoring the implementation of the program; (3) updating and revising the program, as appropriate; (4) developing, coordinating, and participating in a multi-faceted training and education program; (5) coordinating internal audits; (6) reviewing, responding to, and investigating reports of non-compliance; (7) serving as a resource across the organization on substantive compliance questions and issues; and (8) reporting directly to the Board of Directors, CEO, and president on compliance matters. In that process, the Chief Compliance Officer is expected to have a broad knowledge of the organization and operational matters and an awareness of applicable laws and regulations. Similarly, few individuals in the organization have the breadth of interaction with individuals at all levels of the organization: board, management, employees, and third parties, including federal and state government representatives.

More recent emphasis has been placed on the CCO's role as an "ombudsman," monitoring the organization's legal and ethical response to compliance issues as they arise.[15] At many organizations, this will include responsibility for applying the relevant Code of Conduct in addition to specific provisions of the compliance plan.

Differences and Overlap

Given these core duties, it is critical for organizational leadership to appreciate that the roles of GC and CCO differ in many instances, yet overlap in others. Only with this understanding can leadership effectively oversee the legal and compliance functions.

The generally accepted distinction perceives the General Counsel as the "legal defender" of the company, with responsibility for avoiding or limiting legal risks. The Chief Compliance Officer, on the other hand, is perceived as responsible not only for preventing misconduct, but also for identifying any legal or ethical misconduct that may have occurred.[16] The government views the Compliance Officer and the General

Any examination of the GC/CCO relationship should begin with a basic understanding of core duties and responsibilities attributed to the respective positions—and how they interface in connection with corporate compliance.

Counsel as serving the organization in fundamentally different ways. "[T]he lawyers tell you whether you can do something, and compliance tells you whether you should. We think upper management should hear both arguments."[17] While not every General Counsel may agree with these perspectives, they represent to many observers the prevailing view.[18] Yet, they can be a source of intra-organizational tension if not properly managed by the board.

Indeed, the post-Sarbanes "corporate responsibility" environment has led to a substantial refinement of the roles and expectations of the General Counsel, particularly as they relate to matters of governance, ethics, compliance, and professional responsibility. Similarly, the increased anti-fraud enforcement environment in healthcare has significantly enhanced the importance and scope of responsibilities of the Compliance Officer. All of these developments have contributed significantly to the effectiveness of corporate compliance programs. They also have increased the potential for confusion and overlap between the roles of the GC and the CCO. This is particularly the case with respect to responsibility for responding to government investigations and for matters of organizational ethics, culture, and integrity; both officers have legitimate claims to responsibility for these tasks. Ultimately, it is the responsibility of the governing board to resolve the potential for confusion or tension. This can be achieved in part by (1) clarifying respective roles and job descriptions; (2) establishing consistent reporting relationships for the CCO and GC; and (3) implementing appropriate protocols by which the CCO and GC can communicate and coordinate in a legally appropriate manner, without doing harm to the independence of their respective positions.

Separate Positions

Historically, many valid reasons have been advanced in support of combining the GC/CCO positions. These include the perception of substantial overlap between the responsibilities of the two positions; the desire to preserve the attorney/

client privilege for all legal and compliance matters; and economic efficiencies associated with limiting executive headcount. However, the government's preference has long been that the positions of Chief Compliance Officer and General Counsel be kept separate and staffed by different persons:

> The OIG believes that there is some risk to establishing an independent compliance function if that function is subordina[te] to the hospital's [G]eneral [C]ounsel, or comptroller or similar hospital financial officer. Freestanding compliance functions help to ensure independent and objective legal reviews and financial analyses of the institution's compliance efforts and activities. By separating the compliance function from the key management positions of [G]eneral [C]ounsel or chief hospital financial officer (where the size and structure of the hospital make this a feasible option), a system of checks and balances is established to more effectively achieve the goals of the compliance program.[19]

The OIG's position is reminiscent of Senator Charles Grassley's (R-IA) famous observation about the conflicts of interest he perceived as inherent when the Compliance Officer and General Counsel positions are held by the same person:

> Apparently, neither [name of company] nor [its General Counsel] saw any conflict of interest in her wearing two hats . . . General Counsel and Compliance Officer. As General Counsel . . . [she] zealously defended [the company] against claims of ethical and legal non-compliance . . . while as Chief Compliance Officer, she supposedly ensured compliance by [the company's] officers, directors and employees. It doesn't take a pig farmer from Iowa to smell the stench of conflict in that arrangement.[20]

This "position separation" perspective also is reflected in a series of recent HHS OIG Corporate Integrity Agreements with large health sector companies.[21] In these and similar matters, the company under review separated its General Counsel and Compliance Officer positions in response to government emphasis on removing the potential for conflict of interest from the compliance process.

Note also that in its proposed Medicare accountable care organization (ACO) regulations, the Centers for Medicare and Medicaid Services (CMS) requires that the ACO's Chief Compliance Officer be a person other than its legal counsel. This presages the position CMS may take when it promulgates provider compliance plan "core elements" as required by Section 6401 of the Patient Protection and Affordable Care Act. A related issue arises in the multi-hospital health system context. The typical "parent/subsidiary" corporate structure locates key system executives (e.g., the GC and the CCO) as employees of the "parent" or "holding company" so they can better serve the needs of the entire system. Yet, the government historically has encouraged a dual level of compliance management, i.e., "coordination with each hospital owned [or controlled] by the corporation or foundation through the . . . headquarter's [sic] compliance officer, communicating with parallel positions in each facility, or regional officer, as appropriate."[22]

Presumably, the job responsibilities of the "system" and "operating level" Compliance Officers are structured in a complimentary manner, to enhance reporting and reduce the potential for administrative inefficiency and overlap. Yet, an open issue is whether the position of "operating level" Compliance Officer may be combined with that of the General Counsel or other legal officer serving that affiliate entity. The government has not, to our knowledge, formally addressed the issue. It would seem that the equities of the "economies"/reduced headcount argument might be persuasive at this level . . . why require separation of the GC/CCO positions at the operating level when adequate separation and related controls are in place at the "headquarters company" level? This would particularly be the case if the operating company GC/CCO was required to report to both the parent company GC *and* CCO.

The government also has been sensitive to situations (e.g., smaller, rural, or financially distressed hospitals) where economic realities require the CCO responsibilities to be assumed by an officer with other significant responsibilities.[23] It is also aware that some hospitals use economic and efficiency issues as the basis for combining the CCO and GC positions.[24]

Organizations that maintain a combined GC/CCO position should have a thoughtful board-level discussion of the related compliance and governance issues. Is the practice illegal? *No.* Is it a compliance risk? *Maybe*—it could create a negative presumption by regulators, although "work-arounds" may mitigate some concerns. Does it make sense to change? *Yes*—absent financial considerations, "position separation" is clearly the more accepted practice in the current environment.

Reporting Relationships

Where the GC/CCO positions are held by separate individuals, a critical compliance management concern is the creation of appropriate access, and *vertical* reporting relationships, to both executive management and to the board.

HHS OIG's Compliance Guidelines emphasize the importance of providing the CCO with direct access to the governing body, the President/Chief Executive Officer (CEO), all senior management, and legal counsel.[25] Consistent with that view, the government's long-held position is that the Compliance Officer's reporting relationship to the board should be unrestricted and without "buffer."[26] The expectation is that the board should receive unfiltered advice from the Compliance Officer, without interference or interpretation by superior officers. The government has repeatedly expressed concern with the General Counsel serving as the Compli-

ance Officer's "direct report"; (e.g., the ability to review or edit reports prepared by (or otherwise influence) the Compliance Officer).[27] Hence, an arrangement whereby the Compliance Officer reports to the General Counsel would likely be considered problematic by the government. Given such a regulatory "red flag" status, a "Compliance Officer-to-General Counsel" reporting relationship is likely to present an unfavorable perception of compliance plan effectiveness.

Here, the government's view is consistent with the 2010 amendments to the Sentencing Guidelines that similarly call for the board to assure a "direct reporting relationship" between the Compliance Officer and the board.[28] The Guidelines define this as providing the Compliance Officer the "express authority to communicate personally to the governing authority promptly" on compliance issues including but not limited to the ability to report at least annually on the state of the compliance program.[29]

This dual executive management/board reporting relationship is consistent with established "best practices" and professional responsibility rules for the General Counsel.[30] It may thus be appropriate to model the CCO's executive management reporting relationship in a manner consistent with established best practices for the General Counsel. That approach is based on the premise that the proper reporting relationship should be consistent with the officer's senior status within the corporation. Accordingly, best practice for the General Counsel is a management reporting relationship to one of the highest ranking company executives, either the CEO or the officer carrying out the day-to-day duties of a CEO. This could be the Chief Operating Officer, as long as the General Counsel has ready and unrestricted access to the CEO and the legal department is perceived as operating at an appropriately senior level within organizational hierarchy. These best practices recommend *against* the General Counsel reporting to the Chief Financial Officer due to their overlapping roles with respect to business and transactional matters, financial reporting, and disclosure.

Following such an approach, it is plausible for both the General Counsel and the Chief Compliance Officer to report to the same member of the senior leadership team *while maintaining parallel reporting relationships* to the governing board or a committee thereof (e.g., audit or compliance).

A related component to the reporting relationship concern is establishing a "peer" relationship between the GC and CCO, both formally and informally. Thus, assuming the positions are separated, an important compliance management issue is the appropriate positioning of the General Counsel and the Compliance Officer within the executive hierarchy. Commentary, best practices, regulations, and the Federal Sentencing Guidelines are consistent on this point with respect to both the General Counsel and the Chief Compliance Officer. To be effective, both the GC and the CCO must be perceived as senior, influential, and respected officers of the corporation and members of its management team.[31] It is not necessary that both officers hold the same title (e.g., Vice President/Senior Vice President), as it is conceivable that differences in education, training, scope of responsibilities, and length of service may provide a legitimate basis for a distinction between the assigned titles. Such differences do not create unrestricted license, however. A material gap between the designated title for either position and the operational/financial sophistication of the organization may call into question the depth of the organization's commitment to an effective system of legal/compliance controls.

Given these core duties, it is critical for organizational leadership to appreciate that the roles of GC and CCO differ in many instances, yet overlap in others.

Communication Protocol

The government's prejudice against a Compliance Officer-to-General Counsel reporting relationship creates a significant barrier to the organization's ability to effectively coordinate its legal and compliance functions.[32] It is thus incumbent on corporate leadership (with specific input from the GC and CCO) to develop a communication protocol that supports board oversight of legal and compliance matters while respecting the government's concerns about transparency and conflict of interest.

No guidance of consequence has been provided by the government on this issue. Hospitals and health systems are thus "left to their own devices" to develop an appropriate coordination protocol. Experience suggests, however, that any such protocol should acknowledge two key government concerns:

(1) That Compliance Officers be completely independent; free to perform their duties in the interest of promoting compliant behavior (as opposed to avoiding legal liability, which the government perceives as the General Counsel's primary concern); and

(2) That not every action by the Compliance Officer be cloaked in the attorney/client privilege—a potential threat to transparency that the government believes is exacerbated by having one person perform both functions, or where the Compliance Officer reports to the General Counsel.

The government's prejudice against a Compliance Officer-to-General Counsel reporting relationship creates a significant barrier to the organization's ability to effectively coordinate its legal and compliance functions.

Accordingly, key elements of the communication protocol should include the following topics:

- Coordination of activities as necessary (including regular meetings) to advise the board on the corporation's legal and compliance profiles;
- Coordination (as appropriate) of respective presentations of the GC and CCO to the board and key committees to assure consistency and to avoid duplicate presentations;
- No restrictions on the CCO's ability to interact with government regulators;
- Authorization of the CCO to engage outside counsel with the understanding that the GC is to be involved (subject to conflict) with the scope and activities of such outside counsel and shall be provided with copies of all related legal advice;
- Coordination between the GC and CCO of all internal reviews and investigations commenced in response to regulatory or ethical concerns; and
- Shared GC/CCO responsibility for proposing and implementing revisions to the organization's compliance plan.

Appropriate assertion of the attorney/client privilege should be a key aspect of the communication protocol. The focus should not be on asserting a "blanket" privilege over all compliance matters. Rather, the CCO and GC should carefully document those communications they intend to come within the scope of the privilege (i.e., communication between client and lawyer for the purpose of seeking or giving legal advice). Some of these communications will be easy to identify, e.g., communication about litigation or responding to a government investigation. Other such communication will fall into a "grey area." Communication for which it may be more difficult to assert the privilege include those between the CCO and the GC about matters that do not relate to an identified legal exposure (e.g., about the general state of the compliance program, or updates thereto).

Action Items

Management of the GC/CCO relationship is an important component of the board's *Caremark* compliance plan oversight obligations. As such, it is a topic worthy of at least annual review by the board or its dedicated compliance committee. Specific steps that could be taken in this regard include:

- Where the GC/CCO positions are held by the same position, reviewing the prudence of this practice in view of recent developments and regulatory pronouncements.
- Where the positions are separated:
  - Clarify the job description for the two positions.
  - Establish appropriate executive, and "buffer-free" board, reporting relationships.
  - Assure appropriate "peer-level" hierarchal status.
  - Create an effective horizontal communications protocol. C

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Endnotes

1 *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch.1996); *see also Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106; 2009 Del. Ch. LEXIS 25.

2 ABA Task Force Report on Corporate Responsibility, 59 Bus. Law. 145, at 155 n.43 (2003) (ABA Task Force Report). If the corporation has no General Counsel, it should identify and designate a lawyer or law firm to act as General Counsel. *Id.*, at 161 n.63.

3 *Id.; see also*, Deborah A. DeMott, *The Discreet Roles of General Counsel*, 74 Fordham L. Rev. 955 2005-2006 (DeMott).

4 Demott, *supra* note 3.

5 ABA Task Force Report, *supra* note 2, at 161.

6 *Id; see also*, American Bar Association Model Rules of Professional Conduct Rule 1.13(a).

7 Benjamin W. Heineman, Jr., *Imagination at Work*, The American Lawyer (April 2006) (Heineman, *Imagination at Work*) at 73; *see also* New York City Bar, *Report of the Task Force on the Lawyer's Role in Corporate Governance*, November 2006 (NYCBA Task Force), at 98-100.

8 NYCBA Task Force, *supra* note 7.

9 *Id.*

10 *Id.*

11 Erica Salmon-Byrne and Jodie Frederickson, *The Business Case for Creating a Standalone Chief Compliance Position; Ethisphere,* May 25, 2010 (Ethisphere Article).

12 United States Sentencing Commission Guidelines Manual § 8.B2.1(b)(2)(B) ("Specific individuals within high-level personnel") and (C) ("Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program"). "High level personnel" is defined as "individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization"; e.g., a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance. Guidelines Manual § 8.A1.2 (Application Note 3(B)).

13 OIG Compliance Program Guidance for Hospitals, 63 Fed. Reg. 8987 (Feb. 23, 1998). (OIG 1998 Guidance).

14 *Available in* the AHLA/OIG's The Healthcare Director's Compliance Duties: A Continued Focus of Attention & Enforcement (2010), *at* http://www.healthlawyers.org/hlresources/PI/Pages/HealthCareDirector'sComplianceDuties.aspx.

15 Daniel R. Levinson, *Trustee Engagement and Hospital Success*, Trustee (July/Aug. 2010) (Levinson Article).

16 *Ethisphere* Article, *supra* note 11.

17 Amy Miller, *Pfizer settlement strips legal team of compliance brief*, Legalweek.com, Sept. 11, 2009 (Miller Article).

18 Another perspective is taken by a leading compliance observer "'[i]t's not a matter of can v. should. [Compliance Officers] tell you what is legally appropriate and legally inappropriate, not necessarily whether or not you 'should or shouldn't do something.'" Comments of Roy Snell, *Compliance Today*, Health Care Compliance Association, Dec. 2009. [Authors' Note: On its face, this perspective appears at odds with the government's position.] Another leading Compliance Officer describes the difference as "compliance is preventative medicine; law is surgery."

19 OIG 1998 Guidance, *supra* note 13, 63 Fed. Reg. 8987, 8993.

20 Letter from Senator Charles Grassley (Sept. 8, 2003); http://grassley.senate.gov/releases/2003/p03r09-08.htm.

21 *See, e.g.,* Pfizer Inc., Office of Inspector General of the Department of Health and Human Services Corporate Integrity Agreement (Aug. 31, 2009) (Pfizer CIA).

22 OIG 1998 Guidance, *supra* note 13, 63 Fed. Reg. 8987, 8993.

23 *Id.* "This responsibility [Compliance Officer] may be the individual's sole duty or added to other management responsibilities, depending upon the size and resources of the hospital and the complexity of the task."

24 OIG/AHLA, An Integrated Approach to Corporate Compliance (2004) at 2, *see supra* note 14.

25 OIG 1998 Guidance, *supra* note 13, 63 Fed. Reg. 8987, 8993-94; OIG Supplemental Compliance Program Guidance for Hospitals, 70 Fed. Reg. 4858, 4875 (Jan. 31, 2005) (OIG Supplemental Guidance).

26 *See, e.g.,* Levinson Article, *supra* note 15; OIG 1998 Guidance, *supra* note 13; OIG Supplemental Guidance, *supra* note 25, 70 Fed. Reg. 4858, 4874.

27 *See, e.g.,* Pfizer CIA *supra* note 21; Levinson Article, *supra* note 15. *See also, e.g.*, Maxim Healthcare Services CIA, Sept. 9, 2011.

28 Amendment 744 (November 1, 2010) to Guidelines Manual Section 8 C.2.5(f)(3) and to Commentary to Section 8 C2.5 captioned Commentary Notes.

29 *Id.*

30 NYCBA Task Force, *supra* note 7, at 105.

31 *See, e.g.*, NYCBA Task Force, *supra* note 7, at 104; OIG 1998 Compliance Guidance, *supra* note 13, 63 Fed. Reg. 8987, 8993; OIG Supplemental Guidance, *supra* note 25, 70 Fed. Reg. 4855, 4874; Guidelines Manual Sec. 8.B2.1(b)(2)(B) ("high-level personnel").

32 It also fails to give due recognition to the General Counsel's obligation to adhere to the Rules of Professional Conduct; indeed, in some respects it seems to presume that when challenged, the General Counsel may vary from those ethical duties. Perhaps this reflects unfortunate prior regulatory experience; i.e., the "bad apple spoiling the barrel" situation.

A lawyer's dilemma: the impact of up-the-ladder reporting under Sarbanes-Oxley

By Kevin Keogh, White & Case, New York

A junior in-house lawyer at a Peruvian subsidiary of a large Japanese trading company listed on a stock exchange in the United States discovers that financial information regarding the Lima operations has not been properly disclosed in the company's draft annual report. Confident the error was an oversight rather than a deliberate intent to mislead, the lawyer drafts a short memo to his supervisor, pointing out the mistake. Because the supervisor is out of the office advising on company-related matters, the lawyer emails a copy of the memo to his supervisor, as well as leaving a voice mail for her on both her cell phone and landline. Several hours pass and he still has not heard back from his boss. The lawyer grows nervous; the final version of the annual report is to be presented to the board in Tokyo in two days. In addition, the board meeting is slated just before the start of Golden Week in Japan, when businesses across the country shut down and offices are empty. When the lawyer's supervisor finally calls just before the close of business day in Lima, she thanks the lawyer for his diligence in catching the error and tells him that she will take care of it. By now it is six am in Tokyo, just one day before the board is supposed to meet.

When the final annual report is published, the lawyer sees it still contains the wrong information. Did his supervisor fail to inform the general counsel in Tokyo? Does he confront his supervisor and risk their relationship? Is he even sure that the error he noted truly is a failure to disclose and possibly a violation of securities laws, and if so, whose laws? Peru? Japan? The US?

Answers to the questions posed by this scenario may have been made a little murkier since the US Congress adopted the Sarbanes-Oxley Act last year. In-house attorneys may now find themselves faced with new requirements under section 307 of the Act, which establishes minimum standards of professional conduct for attorneys who appear and practice before the US Securities and Exchange Commission (SEC) in the representation of an issuer. In-house attorneys have always needed to earn the confidence and trust of their colleagues and superiors. They also, however, must act prudently to advise those colleagues and superiors if they are, unintentionally or not, violating laws or opening the company to liability. Maintaining this balance has always been a delicate dance, but under section 307, lawyers, including those representing non-US issuers, may now need to incorporate a few more steps into their tango.

After reporting evidence of a material violation, the attorney is required to determine whether he or she has received an 'appropriate response' from the issuer within a reasonable period of time

Although the SEC has not yet made a final determination regarding public reporting of these matters, the rules that have been adopted under section 307 mandate the following two requirements for any attorney who appears and/or practises before the SEC in the representation of an issuer:

- that any attorney who possesses evidence that a material violation of securities law, or a material breach of fiduciary duties of officers or directors, has occurred must report that evidence 'up-the-ladder' in the company until proper action has been taken to address the violation; and
- that if any attorney believes that up-the-ladder reporting has not resulted in an appropriate response, he or she either must cease all activities related to the breach in question, or resign from representation, and inform the company of his or her reason for doing so.

The SEC has proposed that the company must then inform the SEC that the attorney has withdrawn for ethical reasons within two business days, but this part of the proposal has not yet become effective.

These requirements stop short of the originally proposed and highly contentious 'noisy withdrawal' provision, which would have required that the resigning attorney provide the SEC with a report that he or she had resigned for professional reasons under section 307 of the Act. But they still raise tough questions about client-attorney privilege, which has long been viewed as fundamental for client communications by the legal community both in and outside the United States.

Moreover, terms such as 'awareness of evidence of a material violation' and 'appearing and practising before the SEC' initially had been so broadly defined by the SEC that many lawyers were concerned they would find themselves questioning nearly every document they reviewed or worked on.

Despite these very real concerns, however, compliance with SEC rules under Sarbanes-Oxley can be achieved successfully if one understands exactly how the new rules fit in with current laws in the attorney's home country or the home country of the issuer, and possesses a thorough understanding of the section 307 provisions.

Participation of non-US attorneys

One of the biggest sources of concern regarding section 307 was the SEC's decision to extend the requirements to include non-US lawyers. As of December 31 2001, more than 1,334 companies from 59 countries outside the United States filed reports with the SEC under the Securities

Exchange Act. Local lawyers in these countries are subject to a wide variety of professional regulatory regimes, some of which are quite different from the one in the United States. Moreover, many of those local lawyers have little or no knowledge of US securities law and are rarely licensed to practice in the US. That's why most non-US issuers and their in-house and local outside lawyers usually rely on US counsel as to the interpretation and application of US securities law matters. And while the SEC may have the authority in the United States to preempt domestic state law, it cannot preempt conflicting foreign professional requirements for lawyers.

As a result, the final rules exclude 'non-appearing foreign attorneys' from the requirements. These are defined as any attorney admitted to practice law in a jurisdiction outside the United States:

'who conducts activities that would constitute appearing and practising before the SEC only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or is appearing and practising before the SEC only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other US jurisdiction.'

One hypothetical example is an IP attorney at a Hong Kong manufacturing company who regularly writes and reviews contracts relating to patents. The Hong Kong company is listed on the New York Stock Exchange, but this particular attorney is only responsible for writing and reviewing contracts relating to patents granted in China. As such, she rarely advises on securities law and never in conjunction with the United States. Therefore, she is exempted by the SEC as a non-appearing foreign attorney. However, if that same intellectual property attorney were to advise on what the potential impact those patents might have on the overall value of the company for an annual report filed with the SEC, and gave that advice without consulting with US securities counsel, she then would be subject to all the requirements under section 307, even though she reports to the vice president of research and development rather than to the general counsel.

These requirements stop short of the originally proposed and highly contentious 'noisy withdrawal' provision, which would have required that the resigning attorney provide the SEC with a report that he or she had resigned for professional reasons under section 307 of the Act

Up-the-ladder reporting

The up-the-ladder reporting system applies only in situations where an attorney who gives advice about US securities law matters becomes aware of credible evidence that a material violation of law or duty by an issuer, or by any officer, director, employee or agent of the issuer, has occurred, is occurring, or is about to occur. An attorney who becomes aware of such evidence is required to report the evidence to the issuer's Chief Legal Officer, or to its CLO and its Chief Executive Officer.

After reporting evidence of a material violation, the attorney is required to determine whether he or she has received an 'appropriate response' from the issuer within a reasonable period of time. The final rules define an appropriate response as a response to an attorney regarding reported evidence of a material violation which demonstrates:

- that no material violation has occurred, is ongoing, or is about to occur;
- that the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimise the likelihood of its recurrence; or
- that the issuer, with the consent of its board of directors, the audit committee of the issuer's board of directors, another committee of the issuer's board of directors, or a qualified legal compliance committee (more on this to follow) has retained or directed an attorney to review the reported evidence of a material violation.

However, if the attorney does not believe that the CLO or CEO has provided an appropriate response within a reasonable timeframe, he or she is then required to explain his or her reasons to the CLO and CEO and report the evidence of a material violation to the issuer's board of directors or a committee of the board of directors. An attorney who believes that a report to the CLO or CEO would be futile may bypass the CLO and CEO and instead report directly to the board or board committee.

The final rules also contain provisions permitting, but not requiring, a securities attorney to reveal to the SEC, without the issuer's consent, confidential information related to the representation to the extent that the attorney reasonably believes it necessary to:

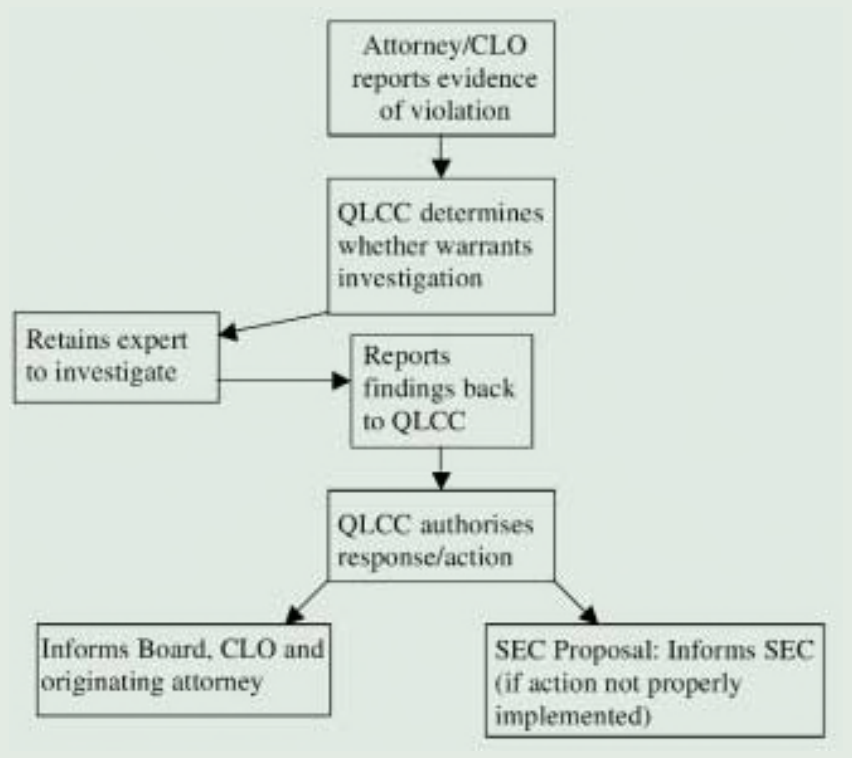
- prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
- prevent the issuer, in an SEC investigation or administrative proceeding, from suborning perjury, committing perjury, or committing an act that is likely to perpetrate a fraud upon the SEC; or
- rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors for which the attorney's services were used.

Instead of reporting to the CLO and ultimately the board in the up-the-ladder reporting mechanism described above, the final rules provide an alternative reporting mechanism to a special committee of the board of directors

The Qualified Legal Compliance Committee

Instead of reporting to the CLO and ultimately the board in the up-the-ladder reporting mechanism described above, the final rules provide an alternative reporting mechanism to a special committee of the board of directors. The issuer can form a Qualified Legal Compliance Committee (QLCC) responsible to ensure compliance with applicable US federal or state securities law, federal and state imposed fiduciary duties, and similar violations of any United States federal or state law.

The QLCC must consist of at least one member of the issuer's audit committee and two or more independent members of the board of directors. It also must establish written procedures for the confidential receipt, retention, and consideration of any report of evidence of material violation. The accompanying charts illustrate how the QLCC reporting mechanism works.



Subordinate and supervisory attorney's reporting obligations

Under the final rules, the reporting obligations of attorneys vary according to their position as either subordinate or supervisory attorney. An attorney supervising or directing another attorney who is appearing and practising before the SEC in the representation of an issuer is a supervisory attorney. This includes, for example, the company's CLO or a partner in a law firm. Any attorney appearing and practising before the SEC in the representation of an issuer on a matter under the supervision or direction of another attorney is considered a subordinate.

After receiving a report of a material violation from a subordinate attorney, a supervisory attorney is required to follow the reporting requirements imposed by the final rules. A subordinate attorney is able to discharge his or her reporting obligations by reporting evidence of a material violation to a supervisory attorney. The final rules permit, but do not require, a subordinate attorney to report evidence of a material violation up-the-ladder when he or she reasonably believes that the supervisory attorney to whom he or she reported evidence of a material violation has failed to comply with the imposed reporting obligations.

In this age of global business, it is vital that the SEC doesn't overstep its reach, incorporating requirements that may conflict with other countries' laws or that discourage foreign issuers from listing stock on the various US exchanges

Returning to the scenario regarding the junior Peruvian attorney employed by the Tokyo trading company, as a subordinate attorney he fulfilled his legal obligations under Sarbanes-Oxley when he informed his supervisor of improper disclosure in the draft annual report. Even though the attorney never confirmed that his supervisor did report the error to the CLO or CEO, he 'reasonably believes' that to be the case since his supervisor told him she would do so. Thus, despite the many questions the situation may have raised for the junior attorney, he is not required to take any further action. This clarification between supervisory and subordinate attorneys should reduce the risk of friction between boss and employee when it comes to reporting potential violations.

The final rules have also eliminated the documentation requirements contained in the original proposal with respect to a supervisory attorney who decides that evidence reported to him or her by a subordinate attorney is not evidence of a material violation and thus does not need to be reported 'up the ladder'.

Outside reporting obligations

Reporting violations internally is clearly the first step in helping to reduce or eliminate potential wrongdoing. But because in rare, though nonetheless very real, situations board members or other internal governing entities either ignore or even endorse illegal activity, the SEC sought to protect investors by including the so-called 'noisy withdrawal' provision, which goes beyond the requirements of the Sarbanes-Oxley Act.

Noisy withdrawal has been hotly debated, though not well understood. It would only be required in the rare situation where an attorney reported evidence of a material violation and did not receive an appropriate response, or had not received an

appropriate response within a reasonable time, *and* in either case, the attorney reasonably believed that a material violation was ongoing, or about to occur, and was likely to result in substantial injury to the financial interest or property of the issuer or investors. While the procedure differs slightly depending on whether or not the attorney is outside counsel or in-house staff, the attorney essentially would have been required to notify the SEC within one business day that a document filed with or submitted to the SEC may be misleading or provide false information. If the attorney was retained by the issuer, he or she also would have been obligated to resign or withdraw as outside counsel and inform both the company and the SEC of the reasons for that resignation.

That proposal generated numerous objections because it is incompatible with deeply-rooted notions of attorney-client privilege, both within the United States and in other jurisdictions. That is why the SEC proposed an alternative mechanism where an attorney would, depending on whether he is outside or in-house counsel, either resign or cease participation in activities, but not have to report evidence of a material violation to outside authorities. This mechanism would only be triggered when the attorney reported evidence of a material violation and did not receive an appropriate response, or had not received an appropriate response within a reasonable time, *and* in either case, the attorney reasonably concluded that there was *substantial* evidence that a material violation was ongoing, or about to occur, and was likely to result in substantial injury to the financial interest or property of the issuer or investors. The requirement that there be substantial evidence means that the standard for triggering the mechanism is higher than what was proposed for noisy withdrawal.

That proposal generated numerous objections because it is incompatible with deeply-rooted notions of attorney-client privilege, both within the United States and in other jurisdictions

Under the alternative proposal, an outside attorney retained by the issuer would be required to withdraw from representation of the issuer and notify the issuer, in writing, that the withdrawal was based on professional considerations.

An attorney employed by the issuer would be required to cease any participation or assistance in any matter concerning the violation and notify the issuer, in writing, that she believes that the issuer has not provided an appropriate response in a reasonable time to her report of evidence of a material violation, but would not be required to resign.

After receiving notice, an issuer would be required by the alternative proposal to report it and the related circumstances within two business days using SEC forms 8-K, 20-F or 40-F. This could prove problematic for some companies, especially in Asia. Returning to our opening scenario, for example, if it turned out that the CEO did knowingly provide false information in the annual report, and up-the-ladder reporting did not yield the necessary response, the start of Golden Week in Japan would make it nearly impossible to file the appropriate form with the SEC in the requisite two days. And even under normal workday schedules, the international dateline as well as the 12-hour time zone difference would make it extremely difficult to comply in the required timeframe.

Because the alternative proposal requires that the issuer, rather than the attorney, notify the SEC of an attorney's withdrawal from representation (or cessation of work in the case of an in-house attorney), it raises fewer attorney-client privilege issues than noisy withdrawal. It also attempts to limit the application of such provisions to only those situations where the SEC views some form of reporting outside the issuer as absolutely necessary to protect shareholders and investors. But the provision still goes beyond the specific mandate of the Act, wherein Congress only requires that the SEC promulgate a rule requiring reporting within issuers, and it still represents a significant departure from existing attorney-client confidentiality practice in the United States.

Good intentions

Congress enacted the Sarbanes-Oxley Act with the best of intentions: to protect investors and employees in the event that executives or board members acted unscrupulously. However, as with all laws enacted in response to particular crisis, there is always the danger of over-regulation and unintended consequences. In this age of global business, it is vital that the SEC doesn't overstep its reach, incorporating requirements that may conflict with other countries' laws or that discourage foreign issuers from listing stock on the various US exchanges. Hopefully, concerns raised by international law firms and others experienced with global securities issues during the SEC's open comment period have helped address many of the challenges posed under section 307 of the Sarbanes-Oxley Act and will contribute to making compliance less onerous.

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