The current financial crisis and the Department of Justice’s emphasis on combating corporate fraud and malfeasance have created an environment in which corporate counsel no longer remain immune from the civil or criminal liability that historically has applied only to directors and senior executives. Until recently, corporate counsel who exercised the reasonable care of a competent attorney would generally be considered no more than a witness in investigations of wrongdoing at the companies they represent. Today, however, the exercise of reasonable care alone is not sufficient. Both in-house and outside counsel have been elevated from mere advisors of the corporate world to protectors of corporate integrity. When the Securities and Exchange Commission (SEC) or Department of Justice determines that this lofty standard is not met, corporate counsel who share no culpability in the underlying misconduct may find themselves the targets of government investigations and facing similar consequences to those who perpetrated the wrongdoing.

Without doubt, attorneys must comply with the ethical rules that govern the practice of law. Unquestionably, attorneys must also respect and preserve the fiduciary duties they have toward their clients. When these rules and duties are violated, an attorney should face the appropriate consequences. But, as illustrated in this article, the standard of care necessary to adhere sufficiently to these rules and duties has greatly increased in the present regulatory and enforcement environment—at times to an insurmountable level. Corporate counsel are expected, and in some cases required, to act independently of the very executives to whom they report. The fiduciary duties of corporate counsel now dictate that, at the first signs of suspicious activity, corporate counsel are expected to consult with outside counsel, initiate internal investigations, and internally report the conduct through the appropriate channels, such as an audit committee, all unbeknownst to the executives they interact with day to day. Further, corporate counsel also shoulder the burden of implementing sufficient controls to thwart potential wrongdoing. Corporate counsel now play a pivotal role in corporate governance, and with this new responsibility come potentially grave consequences.

Case Studies

World Health Alternatives, Inc.
World Health was a nationwide health care staffing provider to hospitals and other health care facilities. Between 2003 and 2004, World Health began pursuing an aggressive growth strategy in which it raised more than $45 million through private placement transactions. World Health used these funds to acquire eight smaller staffing companies around the country, but by the end of 2004, the funds had been completely exhausted. World Health then began taking on various obligations to refinance outstanding debt and provide liquidity, but by February 2006, World Health was forced to file a chapter 11 bankruptcy petition, which was later converted to a chapter 7 case.

On behalf of the company, the bankruptcy trustee brought suit against several World Health executives including Brian T. Licastro, World Health’s vice president of operations and “in-house general counsel.” The suit alleged that, between 2003 and 2004, Licastro and other World Health executives either “engaged in and/or allowed the routine waste of World Health’s limited resources on expensive and unnecessary luxuries for their personal benefits.” For example, the company leased hours of flight time on private jets and maintained expensive leases on luxury cars for the president and the chief executive officer. In addition, the trustee alleged numerous fraudulent activities including improper IRS reporting, improper accounting methods, the issuance of misleading press releases regarding financial results, and material misrepresentations in financial statements.

Although the complaint did not allege that Licastro personally benefited from any of the improper activities, Licastro was named in the lawsuit because of his role as in-house general counsel. Specifically, the complaint alleged that Licastro “was responsible for failing to implement any internal monitoring system and/or failing to utilize such a system . . .” This simple, yet sweeping, allegation withstood Licastro’s challenge to the sufficiency of the claims against him. The Delaware Bankruptcy Court held that the trustee had sufficiently alleged that Licastro violated the duty of care articulated by In re Caremark International Inc. Derivative Litigation, which extended the duty of care owed by corporate directors to include corporate officers. In addition, in upholding the
sufficiency of the failure-to-act allegations against Licastro, the court identified unique duties owed by in-house counsel who are also corporate officers.

Licastro attempted to obtain dismissal of the claims against him because the trustee did not allege that Licastro personally benefited from any wrongdoing or had actual knowledge of the improper activities. Licastro asserted that as an officer, rather than a director, his knowledge of improper financial activities could not be assumed.

In rejecting Licastro’s arguments, the court noted that the SEC’s final rule under section 307 of the Sarbanes-Oxley Act places an affirmative duty on a general counsel to inspect SEC filings for truthfulness. In addition, the court noted that under section 307, “an attorney [must] report evidence of a material violation of securities law or breach of fiduciary duty or similar violation” by the issuer, up the ladder within the corporation. Based on these premises, the court then held Licastro, “as the in-house general counsel and the only lawyer in top management . . . had a duty to know or should have known” of the corporate wrongdoing and reported it. Accordingly, the allegations that Licastro failed to provide oversight and advice to prevent the corporation from making material misrepresentations to the SEC and in press releases were held sufficient to state a claim against Licastro for breach of fiduciary duty to the corporation, negligent misrepresentation, professional negligence, and aiding and abetting fraud. In addition, while recognizing that Licastro was not alleged to have “actively engaged” in the wasteful expenditures, the court also held allegations that Licastro “knew or should have known” about the wasteful expenditures but failed to “control or monitor the accrual of unnecessary expenses,” were sufficient to support a waste of corporate assets claim.

The lesson learned from World Health is that corporate counsel need not affirmatively commit a wrongful act to face liability; mere inaction is sufficient. As the new corporate watchdogs, corporate counsel now have the significant burden of being proactive in the prevention of fraud and waste. Corporate counsel, especially counsel who serve as officers of the company, are obligated to monitor the activities of the company and develop and implement sufficient internal controls to prevent wrongdoing. While the boundaries of diligent control and monitoring are not fully known, World Health is a reminder that to avoid exposure to liability from the wrongdoing of executives, in-house counsel must ensure they are taking all appropriate and reasonable measures to prevent fraud and other improper activities.

Hewlett-Packard
In January 2006, CNET published an article detailing Hewlett-Packard’s (HP) long-term growth strategy, citing an unnamed “source” as providing the confidential information for the article. The source revealed inside details of HP’s management conference, including HP’s acquisition plans, the strategy for HP’s Imaging & Printing Group, and potential plans to use more microchips produced by Advanced Micro Devices (AMD) instead of those manufactured by HP’s long-time partner Intel. HP’s chairwoman, Patricia Dunn, recognized that the information contained in this article could have only come from one of the other 10 directors of the company and was intent on finding out the identity of the anonymous “source.” Without the knowledge or consent of the rest of HP’s board of directors, Dunn authorized a team of independent electronic-security experts to spy on the January 2006 communications of the 10 other directors. These experts engaged in data mining by scouring the records of phone calls made from the personal accounts of these directors. To do this, the security consultants engaged in a practice known as “pretexting,” described by the Federal Trade Commission as “the practice of getting [one’s] personal information under false pretenses.”

The tactics used in this investigation, including pretexting, were approved by both in-house counsel and outside counsel. At the time of the security investigation, the applicable federal law addressing pretexting was the Gramm-Leach-Bliley Act, enacted in 1999, which technically prohibited the use of pretexting with respect to financial institutions only. Kevin Hunsaker, HP’s chief ethics director and senior legal counsel, stated in news articles that he did about an hour’s worth of legal research into the legality of these tactics before approving the investigation. Ann Baskins, HP’s general counsel, also allegedly reviewed and approved the legality of the investigation. Indeed, Wilson, Sonsini, Goodrich & Rosati, HP’s outside counsel, advised a former HP director, who resigned due to the incident, that pretexting was a common method of investigation and there was “no electronic surveillance,” “no phone recording or eavesdropping,” and “no recording, review or monitoring of director e-mail.”

Nevertheless, in October 2006, Dunn, Hunsaker, and three individuals who worked for the outside security firm were charged with fraudulent wire communications, wrongful use of computer data, identity theft, and conspiracy to commit these three crimes. The California Attorney General’s Office also brought a civil complaint against the corporation.

In December 2006, HP settled with the Attorney General’s Office for $14.5 million under the condition that the state would not pursue civil claims against HP or its current and former directors, officers, and employees. In March 2007, the Attorney General’s Office dropped all criminal charges against Dunn. At the same time, Hunsaker along with the private detectives pled no contest to misdemeanor charges of fraud by deceit. That plea was rejected by the court because it did not include an admission of guilt. Ultimately, Hunsaker was required to perform 96 hours of community service and make restitution to victims in the event that claims are filed. Although not formally charged, Baskins, in light of her actions regarding the
security investigation, resigned from her position under pressure from the company.

Although it remains undetermined whether HP’s use of pretexting was illegal, the HP case illustrates the perils of corporate counsel providing advice regarding conduct that is in a “gray area” of the law. A company’s proposed conduct may not be technically illegal, but corporate counsel must now ensure that they also consider the best interest of the company in analyzing the proposed conduct. In today’s regulatory and enforcement environment, it is simply not a persuasive defense for an attorney to advise a company strictly based on whether the conduct is explicitly prohibited under the law.

American International Group and General Re Scam Transactions

In October 2000, the stock of American International Group (AIG) dropped 6 percent due to a reported $59 million decrease in “loss reserves.” The purpose of loss reserves in the insurance industry is to cover future claims on new insurance policies, and loss reserves are generally seen as an indicator of the financial well-being of a particular company. A decrease in loss reserves could indicate the insurance company was not obtaining new business or not purchasing new loss reserves in an effort to increase its earnings artificially. Christian Milton, AIG’s vice president, and several individuals at General Re (Gen Re), including Robert Graham, Gen Re’s assistant general counsel, worked together to create two contracts for AIG that made it appear as if AIG was reinsuring Gen Re for up to $600 million in limit of liability and Gen Re was paying AIG $500 million in premiums.13 As a result of the contracts, AIG was able to report a $106 million increase in loss reserves for the fourth quarter of 2000 and a $63 million increase in loss reserves for the first quarter of 2001, thus making it appear that the company was financially sound.

On March 30, 2005, shortly before the expiration of the two contracts, AIG issued a press release stating that the accounting for the transaction was improper “in light of the lack of evidence of risk transfer.” On May 31, 2005, AIG filed its 2004 Form 10-K with the SEC and included the statement that “AIG has concluded that the transaction was done to accomplish a desired accounting result and did not entail sufficient qualifying risk transfer.” Ultimately, AIG revealed that the transaction should have been recorded as a deposit rather than insurance.14

In early 2005, as a result of the sham transaction, AIG suffered a dramatic loss in stock prices of between 6 and 15 percent. AIG entered into a $1.6 billion civil settlement deal with the SEC and New York state authorities.15 The company was ordered to pay the SEC an $800 million penalty with $700 million being returned to defrauded investors. In addition, AIG paid the Department of Justice a $25 million criminal fine.

However, the liability did not end with AIG’s penalties. Five individuals were named in a 2006 federal criminal indictment, including Gen Re’s assistant general counsel Robert Graham, one of the individuals instrumental in devising the sham contracts.16 Graham, in addition to the other individual defendants, was charged with one count of conspiracy to commit securities fraud, four counts of wire fraud, two counts of mail fraud, four counts of securities fraud, and two counts of causing false statement to be made to the SEC.17 Although, superficially, Gen Re received no economic advantage from this transaction, AIG agreed to pay Gen Re approximately $5 million as a fee to induce it to participate in the sham transaction. As evidenced by statements found in the indictment, Graham believed that, because AIG was the party actually involved in fraudulent conduct, Gen Re would be legally compliant despite its conduct in the fraudulent transaction.

Graham was ultimately convicted by a federal jury of conspiracy, securities fraud, making false statement to the SEC, and mail fraud.18 In May of 2009, Graham was sentenced to one year and one day in federal prison and ordered to pay a $100,000 fine.19 The circumstances of the fraud suggest how Graham might have protected himself from liability and the corporation from scandal. As Graham noted in his sentencing memorandum, he did not orchestrate or personally benefit from the fraud. However, the indictment suggests that Graham was aware that the transfers were improper. In an email, Graham advised that Gen Re should be careful with intercompany transfers because “a curious outside party could deduce that there is a link between the transactions.” In a 2001 telephone conversation about the transaction, Graham stated “I’m pretty comfortable that our own skirts are clean but that they, ah, they [AIG] have issues.” Although Graham was correct in that civil charges were never brought against Gen Re as a company, issues that ultimately led to Graham’s conviction might have been spotted sooner if Gen Re had sought an outside review of such a major transaction. Outside reviews also benefit companies by demonstrating compliance and integrity as a whole, even if unethical conduct by a few bad actors ultimately occurs. This extra layer of protection not only helps the company avoid legal liability, but it also prevents a tainted public image.

The Hollinger International Trial

From 1999 to 2001 Chicago-based Hollinger International, a Delaware corporation, sold hundreds of community newspapers across Canada and the United States. As part of these sales, buyers would pay an extra fee in exchange for Hollinger signing a non-compete agreement whereby Hollinger agreed not to acquire or establish a newspaper within a certain distance from the newspaper it sold for a certain period of time after the sale. Although this type of non-compete agreement was typical in the newspaper industry, buyers in the Hollinger transactions paid extra consideration for a separate non-compete agreement prohibiting the seller’s affiliates and officers from personally competing with the buyer. These agreements were structured
to divert a portion of the sale, approximately $60 million in the aggregate, from Hollinger International to Hollinger, Inc., a subsidiary in which Conrad Black, the chief executive officer and chairman of the board for Hollinger International, and David Radler, the deputy chairman of the board, the president, and chief operating officer for Hollinger International, had a controlling stake.

In addition to Black and Radler, the general counsel of Hollinger, Inc., Mark Kipnis, was included in an indictment by federal prosecutors for “facilitating” these improper transactions. Even though Kipnis did not directly benefit from these non-compete agreements, as general counsel Kipnis was responsible for documenting and closing the purchases and sales of newspapers by Hollinger and its subsidiaries. In addition, as noted in the federal government’s indictment, Kipnis had, as Hollinger’s in-house counsel, “a fiduciary duty of undivided loyalty to International, which, among other things, required Kipnis to disclose all material facts regarding all related party transactions to International’s Audit Committee, and to refrain from assisting others in any breach of fiduciary duty against International.” These non-compete agreements represented a breach of Kipnis’s fiduciary duty because they benefited International’s controlling partners at the expense of its other shareholders and none of these transactions was approved by the board or disclosed to the SEC. Kipnis had a duty to disclose any transactions he suspected were illegitimate to International’s Audit Committee, a task he failed to perform. At Kipnis’s trial in June 2007, his counsel raised three defenses. The first was ignorance, that Kipnis did not know anything about public companies and securities law when he became Hollinger’s vice president, corporate counsel, and secretary in 1998. The second defense was that Kipnis had been told that he could rely on Hollinger’s outside law firms to provide advice on any area of expertise that he lacked. Third, the outside counsel of Torys and Cravath, Swaine & Moore also failed to raise a warning on the company’s problematic deals. In essence, Kipnis’s argument was that he lacked the intent to commit these crimes and therefore could not be found to have breached any fiduciary duty. While Kipnis was ultimately acquitted of most charges, he was found guilty of three counts of mail fraud.

Kipnis’s argument that he was in over his head and thus did not intentionally engage in bad acts may have largely saved him from criminal liability, but general counsel of corporations have a professional responsibility to engage only in work they are competent to handle. In an age of accountability, it is not simply enough of a defense for in-house counsel to rely on the advice of outside counsel to avoid responsibility. In particular, in light of the requirements of Sarbanes-Oxley section 307, it is crucial for all counsel to understand a transaction completely before approving it, whether or not the intent to commit an unethical or illegal transaction exists.

Counsel’s Ethical Obligations as a Guide to Proper Behavior

Corporate counsel have many resources to assist them in navigating the present regulatory and enforcement environment and advising corporations without exposing themselves to criminal or civil liability or risking their professional reputation. One resource is the ABA Model Rules of Ethics. The ethical obligations that the rules place with respect to clients’ criminal activity are clear and concise. Although their application to real-world situations faced by corporate counsel is somewhat murky, corporate counsel must be aware of the unique application of these rules in the corporate environment to protect themselves from ethical violations.

Merely advising a client is no longer sufficient to protect corporate counsel from investigation and liability.

Three ABA Model Rules are of particular note because they are consistent with many of the increased burdens placed on corporate counsel: Rule 1.2, Rule 4.1, and Rule 1.13.

ABA Model Rule 1.2(d) states that:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Under this rule, a lawyer’s only obvious obligation is to avoid assisting or counseling a client in engaging in behavior that the lawyer knows is criminal or fraudulent. Often, as seen in the examples discussed in this article, corporate counsel are not asked simply to opine on conduct that is clearly criminal or fraudulent. Rather, they are asked to provide advice on an activity or course of conduct that falls into a gray area of the law. Corporate counsel face great risk when advising in a gray area. As the AIG case shows, merely advising a client on the explicit legality of a proposed course of conduct may be consistent with this rule, but such limited advice is no longer sufficient to protect corporate counsel from investigation and liability.

ABA Model Rule 4.1, Truthfulness in Statements to Others, requires that lawyers not knowingly make a false statement of material fact or law to a third person or fail to disclose a material fact to a third person when disclosure is necessary to
avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by rules of confidentiality. However, as demonstrated in the Hollinger International example, corporate counsel who fail to disclose suspicious activity or potential wrongdoing, even when they are not involved, may, by their very nature as corporate counsel, find themselves faced with significant exposure to liability.

Model Rule 1.13 imposes a sweeping fiduciary duty upon a lawyer to protect the best interest of the corporation. This rule states that:

If a lawyer for an organization knows that an officer, employee or other person associated with the organization 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 reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization.

While the spirit of this rule is to protect the organization, it offers corporate counsel little instruction on how to accomplish this task. As illustrated by the Hewlett-Packard case, protecting the organization becomes particularly difficult when it is unclear whether the conduct engaged in by executives violates legal obligations or laws, especially when the intent of the executives is to further the company’s interests.

**Conclusion**

The current economic climate coupled with limited federal government resources, will place more pressure than ever on companies to cooperate affirmatively with the Securities and Exchange Commission and the Department of Justice in government investigations. This environment and the case studies suggest that corporate counsel should review the rules that guide attorney’s behavior in light of the increased burdens under which they must now operate. It is clear that legal advice, identifying what is and is not legal, given to a corporation with reasonable care is no longer enough to protect corporate counsel from exposure to investigation and possible liability. To protect one’s reputation and career in this environment, the creation of both internal and external corporate monitoring programs to ensure compliance with legal and ethical obligations will become increasingly important. As demonstrated by the case studies above, without such programs, the activities of a few bad actors can result in heavy fines, exposure to individual criminal or civil liability, and loss of public confidence in a company.

**Endnotes**

2. Id. at 591.
5. Id.
22. Id., Indictment at g.
23. Jill Nawrocki, Former Hollinger GC Passes the Buck in Fraud Trial, CORP. COUNS., June 1, 2007.

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