



# CORPORATE ACCOUNTABILITY



## REPORT

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### **‘Up the Ladder’ Counsel Reporting Processes For the Nonpublic/Nonprofit Corporation**

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**T**he current “corporate responsibility” environment merits consideration by sophisticated nonpublic and nonprofit corporations of a formal “up the ladder” compliance reporting process for legal counsel.

As many corporate counsel are well aware, there is great across-the-board interest in adopting the types of governance “best practices” that have been published as of late by groups such as The Business Roundtable, The National Association of Corporate Directors, the Conference Board, and the American Bar Association. Furthermore, public and nonpublic corporations alike have adopted, or intend to adopt, internal policies and procedures designed to incorporate relevant provisions of the seminal Sarbanes-Oxley Act.

Of course, most of the provisions of Sarbanes-Oxley are applicable only to publicly held companies, and many of the “best practices” compilations are prepared from the perspective of public companies. However, as the American Bar Association has noted, “. . . many nonpublic organizations would benefit from many of the policies . . . [and thus should] . . . consider whether these policies would promote legal and ethical compliance.”<sup>1</sup> Furthermore, increasing attention is being focused, at both the state and federal level, of applying Sarbanes-like rules to nonprofit organizations.<sup>2</sup>

<sup>1</sup> There are currently at least three major legislative proposals—in New York (AG-2), California (SB 1262) and Massachusetts (Attorney General Tom Reilly, “An Act to Promote the Financial Integrity of Public Charities”)—that would apply selected portions of Sarbanes-Oxley to the non-profit sector.

<sup>2</sup> The Report of the American Bar Association Task Force on Corporate Responsibility (James H. Cheek, Esq., Chair) at fn. 62; © 2003 American Bar Association (hereinafter, “Cheek

Clearly, a major policy consideration—both of Sarbanes and many of the “best practices” compilations (particularly those proposed by the ABA) is the proper role of the general counsel and outside counsel in improving the ability of corporate governance to evaluate and respond to the legal risks facing the corporation. To that end, we now have both Sarbanes Section 307 and the amendments to Model Rules of Professional Conduct 1.6 and 1.13. Added to this mix is the renewed focus on organizational supervision of the corporate compliance program that is a key component of the proposed amendments to the Federal Sentencing Guidelines.<sup>3</sup>

Given this environment, it may be prudent for nonpublic and nonprofit corporations to consider the benefits of a “reporting up” process for counsel similar to that required by Sarbanes Section 307 (but without the notorious “noisy withdrawal” component). Such a process—which would be applicable to both inside and outside corporate counsel—could serve several purposes: (a) significantly enhancing organizational mechanisms designed to provide the governing board with adequate notice of the legal risks affecting the organization; (b) serving as a logical supplement to existing corporate compliance protocols; and (c) providing tangible evidence of the organizational commitment to corporate responsibility.

Accordingly, this article will discuss the possible framework of such a corporate “reporting up” process, in a manner that reflects the unique characteristics of the nonpublic/nonprofit corporation.

## 1. The Relevant Model Rules Of Professional Conduct.

Any consideration of a “reporting up” process should start with the concept that the lawyer represents the corporation—and not any individual or group through which the corporation acts. This is the core concept behind the recent amendments to the Model Rules of Professional Conduct, adopted by the ABA House of Delegates in August 2003.

The ABA’s Cheek Report—the basis for the Model Rule amendments—concluded that the lawyer’s role in bringing legal compliance issues to the Board’s attention could be enhanced through (a) adoption of certain specific governance policies set forth therein;<sup>4</sup> and (b) an amendment of Model Rule 1.13 (“Organization as Client”) to more effectively address those (unusual) situations in which action or threatened action (or refusal to act) by an organization’s employees violates a law or a legal obligation and is likely to cause substantial injury to the organization. Model Rule 1.13 was thus revised to provide that a lawyer with knowledge of such a situation would be (a) required to report the relevant facts up the ladder, including, if necessary, to the “highest authority that can act on behalf of the organization,” and (b) if the highest authority fails to address the report in a timely and appropriate manner and the lawyer reasonably believed that the situation involved a clear

Report”). The Cheek Report is available at <http://www.aba.net.org/buslaw/corporateresponsibility/home.html>.

<sup>3</sup> Proposed Amendments to the Sentencing Guidelines, (U.S. Sentencing Commission, 68 Fed. Reg. 75339).

<sup>4</sup> Cheek Report, Section VI (“Recommended Corporate Governance Practices”).

violation of law that was reasonably certain to result in substantial injury to the organization, empowered to reveal relevant information to third parties, whether or not permitted by Model Rule 1.6, if and to the extent the lawyer reasonably believed necessary to prevent such injury.<sup>5</sup>

## 2. Sarbanes-Oxley and Professional Responsibility.

An effective “reporting up” process must also recognize Section 307 of the Sarbanes-Oxley Act (“Standards of Professional Conduct for Attorneys”). This provision directs the Securities and Exchange Commission (“SEC”) to adopt a rule imposing an “up the ladder” reporting requirement upon attorneys *appearing and practicing before the Commission in any way in the representation of issuers* [emphasis added].<sup>6</sup>

The rules promulgated under Section 307 provide, in essence, that any attorney who appears or practices before the SEC in the representation of an issuer is obligated to report “up the ladder” within the corporation “evidence of a material violation” involving the issuer. The reporting obligation is triggered only when an attorney becomes aware of credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is occurring or is about to occur.

The attorney is initially directed to make his or her report to the issuer’s chief legal officer (“CLO”) or to the CLO and the chief executive officer. When presented with such a report, the CLO is obligated to conduct a reasonable inquiry to determine whether the reported material violation has occurred, is occurring or is about to occur. If the CLO reasonably concludes that no material violation described in the report has occurred, is ongoing, or is about to occur, the CLO must notify the reporting attorney of this conclusion and the basis therefor. If, however, the CLO concludes that a material violation has occurred, is occurring or is about to occur, the CLO must take all reasonable steps to cause the issuer to adopt an appropriate response (including any necessary remedial disclosures) and advise the reporting attorney thereof.

A reporting attorney who receives an appropriate response within a reasonable time has satisfied his or her reporting obligations under the rule. In the event the reporting attorney does not receive an appropriate response within a reasonable time, he or she must report the evidence of the material violation “up the ladder” to the issuer’s audit committee (if any), to another com-

<sup>5</sup> We should note that Revised Model Rule 1.13 reinforcing (a) the lawyer’s duty to an organizational client as an entity, rather than to individual managers or constituencies, and (b) imposing on the lawyer a duty to report potential misconduct “up the ladder” in the organization, is consistent with most state rules and is generally accepted. However, the disclosure of client confidences without consent provided for by Revised Model Rule 1.6, and in some circumstances by Revised Model Rule 1.13, is significantly controversial and may even be contrary to some state laws. See, e.g., California Bus. & Prof. Code Section 6068(e), requiring that California attorneys maintain client confidences and secrets “at every peril to himself or herself.”

<sup>6</sup> 15 U.S.C. 7201 et seq.

mittee of independent directors (if there is no audit committee), or, if there is no such committee, to the full board.

A reporting attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time must explain his or her reasons for such belief to the CLO, the CEO and any directors to whom the attorney has reported evidence of a material violation. Under the final rule adopted in January 2003, the reporting attorney has no further obligations, although the attorney may reveal information about the material violation to the SEC in certain circumstances described in Section 205.3(d). The SEC has proposed amendments to Section 205.3(d) that would substantially broaden the reporting attorney's obligations to include an affirmative obligation to report evidence of a material violation that is ongoing or about to occur; the future of those proposals is unclear.

### 3. U. S. Sentencing Commission Guidelines.

Also noteworthy in this regard is the recently released proposal for changes to the Federal Sentencing Guidelines ("Guidelines") submitted by the U.S. Sentencing Commission.<sup>7</sup> The proposed revisions reflect two principal goals: (a) the promotion of an organizational culture that encourages a commitment to compliance with the law, and (b) the responsibility of organizational personnel or leadership with respect to compliance. This second proposal reflects an expectation that the board will be proactive in seeking information about compliance problems, evaluating information that is received and monitoring the implementation and effectiveness of responses when compliance problems are detected. This, in turn, is consistent with the ABA's governance recommendations and the need for the board to be regularly informed by the general counsel on legal compliance matters.

### 4. A 'Reporting Up' Proposal.

It is in the context of this environment that the potential value of a "reporting up" process arises for the nonpublic/nonprofit corporation. Such a process would logically be based upon the policy considerations raised by amended Model Rule 1.13, Sarbanes-Oxley's Section 307, and the proposed amendments to the Sentencing Guidelines. The principal goal of such a process would be to supplement existing internal mechanisms designed to advise senior corporate leadership of the organization's legal risk profile.

A "reporting up" process for the nonpublic/nonprofit corporation should have the flexibility to reflect unique characteristics of the subject corporation. It should also reflect the extent to which applicable state ethics rules have adopted amended Model Rule 1.13. The specific process might include a combination of internal organizational policy revisions and procedural guidelines together with the establishment of a formal process with outside counsel. Ideally, it would be adopted together with the other "best practices" with respect to the role of the corporate general counsel designed to enhance to

role of such counsel in advising the Board, as identified by the Cheek Report.

**A. Factors Fundamental to the Process.** To be effective, the proposed "reporting up" process must be designed to address the professional responsibilities of both the organization's office of general counsel and of its various outside counsel firms. This involves recognition of a number of fundamental factors relevant to both general and outside counsel:

■ *The Justification for the Process.* It will be important that all of the affected participants—inside and outside counsel (as well as senior corporate leadership)—understand clearly the organization's rationale for instituting a "reporting up" process. These key corporate "stakeholders" must recognize and agree on the legal compliance benefits of a "reporting up" process in order for it to be a success.

■ *Interpretations Under Section 307.* The SEC's rules under Section 307 only apply directly with respect to an attorney who is "appearing and practicing" (as defined) before the SEC in connection with the representation of an issuer with registered, publicly traded securities, and thus will not have a direct impact on attorneys in the representation of nonpublic/nonprofit corporations unless their activities have required the registration of securities with the SEC. However, interpretations under the SEC rules may significantly influence public and judicial perceptions of lawyers' duties in representing organizational clients, even where the rules have no direct force. Further, subsequent regulations or judicial interpretation may extend the applicability of the rules to a broader range of organizations (for example, issuers of exempt securities). Thus, a cavalier dismissal of Section 307's application would be short-sighted; both general counsel and outside counsel should remain alert to ongoing interpretations of the SEC rules.

■ *State Ethics Rules.* Again, both internal and outside counsel must be sensitive to state rules of professional responsibility and the extent to which they adopt the policy considerations reflected by amended Model Rule 1.13. For, even if the attorney is not subject to Sarbanes Section 307, he/she will be bound by the provisions of state rules of professional responsibility as they relate to "the corporation as the client." It is in this context in which appears the attorney's obligation to report upwards within the organization evidence of a "material violation." Indeed, while the ABA's amended Model Rule 1.13 makes this obligation obvious and pronounced, it actually only serves to refine what had been a basic feature of the original 1.13: the obligation to advise the client of violations of the law. In other words, the "reporting up" policy concept is not "new news."

■ *Expanded Role of General Counsel.* The benefit of a "reporting up" process can be enhanced where the nonpublic/nonprivate corporation is simultaneously implementing the "best practices" recommendations of the Cheek Report relating to the role of the corporation's general counsel. These "best practices" are designed to enhance the board's understanding of the legal risk profile of the corporation by elevating the role of the general counsel with respect to interaction with the board. A key component of the Cheek recommendations is to position the general counsel within all outside counsel engagements of the corporation, regardless of

<sup>7</sup> United States Sentencing Commission, "Sentencing Guidelines for United States Courts," December 30, 2003, *supra*.

the corporate officer who may have effected the specific engagement.<sup>8</sup>

■ *“Subordinate” and “Supervisory” Attorneys.* The scope of any effective “reporting up” process must extend to both the “subordinate” and “supervisory” attorneys, if it is to be truly effective. “Subordinate attorneys” will likely involve both associates of the outside counsel, as well as “associate” members of the internal general counsel’s office. A “supervisory attorney” would generally be the senior lawyer—either a partner in the outside law firm or of the general counsel’s office—who actually directs or supervises the actions of the subordinate attorney.

**B. Critical Internal Steps.** Establishment of an effective internal “reporting up” process also requires a series of implementation items unique to the nonpublic/nonprofit organization. These could logically include the following:

■ *Establishment of a “Trigger.”* A fundamental aspect of an effective “reporting up” process must necessarily be the identification of the specific types of events that would “trigger” a reporting obligation on the part of a “subordinate” or “supervisory” attorney within the general counsel’s office. As embodied in Section 307 and amended Model Rule 1.13, these trigger events may potentially involve a wide variety of circumstances.

The SEC rules under Section 307 define “material violation” to include material violations of federal or state securities law, material breaches of “fiduciary duty” under federal or state law, or “similar material violations” of federal or state law—a rubric that can encompass a wide range of acts or omissions. Similarly, amended Model Rule 1.13 relates to an actual or threatened act or omission by a corporate agent that involves either a “violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization.” It should be noted that neither of these standards is limited to violations involving crime or fraud.

Further, the “lawyer’s knowledge” standard required for the “trigger” can also be quite expansive. The SEC rules are “triggered” when the lawyer *is aware* of credible evidence of facts or circumstances in which it would be unreasonable for a “prudent and competent attorney” not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur—a convoluted standard that may be difficult to apply, but one which the SEC interprets as less than “more likely than not.” Amended Model Rule 1.13’s duties come into play where the lawyer “*knows* [emphasis added] facts from which a reasonable lawyer . . . would conclude” that a violation was occurring or was intended. While that standard is more straightforward, it should be noted that both rules are based not on what the lawyer in question actually believes, but what that lawyer *thinks* a reasonable (or “prudent and competent”) lawyer might conclude on the same facts.

The nonprofit/nonpublic organization may have the flexibility to develop “trigger events” which are most consistent with the organization’s corporate compliance plan and which incorporate particular “hot buttons” within the organization’s activities. Further, such an organization may wish to consider incorporating a standard that is based on the actual conclusions of the

lawyer in question, rather than on hypothetical conclusions about the range of opinions that may be held by hypothetical “reasonable lawyers.”

■ *Futility Bypass.* The process would also materially benefit from a “futility bypass,” i.e., a reporting process for the attorney to follow if he/she believes it would be futile to report evidence of a material violation to the organization’s chief legal officer or chief executive officer (or equivalent thereof). A “futility bypass” provides an alternative form of reporting in such a circumstance. Given the prevailing allegations of misconduct against senior executives in various organizations, inclusion of such an alternative methodology may make it less likely that the process established will be viewed as ineffective. Moreover, boards of directors (particularly independent members of the board) may feel strongly that such a “bypass” should be available in order to provide an adequate level of assurance that the board receives proper notification of matters that create significant risk to the corporation (and the board).

■ *The Review Body.* From an organizational perspective, there is some value in identifying some existing internal body—e.g., the audit committee—to address reports made by lawyers (internal or external). (There is very little evidence to suggest that the concept of the “qualified legal compliance committee” would make sense in the nonpublic/nonprofit setting; indeed, the early consensus of most practitioners is that it will be little used in the public company setting.) This would likely require modification of the audit committee charter to identify it as the board committee directed to receive “reporting up” notices from counsel, and to empower it to: (a) advise the CEO and chair upon receipt of such notification; (b) determine whether investigation is necessary; (c) make appropriate recommendations at the conclusion of investigation; and (d) take other action as deemed necessary to protect the interests of the corporation (e.g., notifying external authorities). The audit committee charter would also need to be revised to establish (i) reporting procedures—for example, regarding receipt, retention, and consideration of an attorney’s report of evidence; and (ii) procedural matters such as meetings, minutes, and staff or advisors). This is consistent with the underlying rationale of Sarbanes-Oxley that the audit committee, made up entirely of independent directors, serves as the first line of defense in matters affecting the financial integrity of the corporation. Attendant to this increased responsibility, the audit committee charter would likely need to contain explicit authorization for the committee to retain independent counsel and consultants necessary for it to carry out these functions.

■ *Establishment of Written Procedures.* From an internal procedure perspective, it would also be important to formalize “reporting up” and similar communication mechanisms within the office of the general counsel. A first step in this process would be to monitor evolution of professional ethical obligations of the state bar, as well as further evolution of the “appearing and practicing before the Commission” concept in the SEC rules. A crucial part of internal policy development is to confirm the specific scope of the law and of relevant state ethical rules to the office of the general counsel. A second step would be to draft the specific internal procedure, including the preparation of written policies describing the reporting requirements of members of the legal staff of the OGC.

<sup>8</sup> Cheek Report, *supra*, Section IV, p. 31.

It would also be important to implement initial and ongoing training programs for reporting attorneys as well as senior management and governance. From an external perspective, it would be important to establish a similar reporting relationship with each outside counsel firm with which the corporation conducts business. At a minimum, such procedures should address the need to have open lines of communication to surface potential issues and address them, where possible, before a formal “report” is made (and the train of events begins inexorably to move), and such procedures should also address such things as whether reports are expected to be made in writing.

■ **Reporting Obligations.** The “subordinate” and “supervisory” definitions discussed above are crucial regardless of Section 307 jurisdiction, because they define the scope of a lawyer’s reporting obligations under the typical “reporting up” process. Again, for the nonpublic/nonprofit corporation, these obligations can be reasonably uniform for both inside and outside counsel. Nonetheless, there are some subtle but important distinctions which should be reflected in the process.

Within the *general counsel’s office*, a subordinate attorney who becomes aware of a material violation should be directed to promptly bring it to the attention of the relevant supervisory attorney. Similarly, a supervisory attorney would likely make the report to the CLO or a designated senior attorney reporting to the CLO.

For the *subordinate attorney in the outside law firm*, it would be logical for the initial reporting to be to the partner directly supervising the subordinate on the particular matter. A more complex process is typically required, however, of the supervisory attorney who receives this report from the subordinate attorney. While this will vary on a firm-to-firm basis, it will often involve a number of steps: (a) consultation with several other firm partners (particularly, those with expertise in the subject area) to seek concurrence as to the report; (b) if there is concurrence, reporting the matter “upstream” to a formal firm committee responsible for addressing credible reports; and (c) if there is not concurrence, communication to the subordinate attorney of the supervisory partner’s decision and related rationale (together with filing a written report to the firm’s committee).

**C. Unique Steps With Outside Counsel.** Of course, a crucial component of the “reporting up” process is reaching an understanding with outside counsel con-

cerning the circumstances and procedures by which the outside firm will report material violations committed by the corporation. Ultimately, the outside counsel is free to establish whatever internal policy it believes is in the best interests of its clients at a whole, and of the firm. This policy may not, of course, be the same as that which is used by the organization for its own office of general counsel.

Nevertheless, it will be important for the organizational client to reach a “terms-of-engagement-level” understanding with its outside counsel regarding (a) the expectation that the firm will adopt and advise the client of the existence of its specific “reporting up” policy; (b) the standards adopted by the firm that would mandate a report; (c) firm procedure on addressing situations where a reporting obligation is unclear and on attempting to address concerns before a reporting obligation is triggered; (d) the process by which the firm would make the report to the client (e.g., oversight of reports submitted by subordinate attorneys; pre-clearance through a specific firm committee; written versus oral reports); and (e) agreement on the organizational body, e.g., the corporation’s audit committee, to which the report is to be made if there is no general counsel or where reporting to the general counsel were perceived to be futile.

## Conclusion.

It is not the intent of the authors to suggest that the establishment of a “reporting up” process by a nonpublic/nonprofit corporation is either mandated or constitutes some form of “best practice.” No—to the contrary—we cannot currently point to any evidence supporting such a conclusion.

Rather, we are advocating consideration of such a process as an organizational “smart play.” The various indices of the current corporate responsibility environment speak to the importance of (a) enhanced governance awareness of the organization’s legal risk profile; (b) the role of the lawyer in promoting organizational legal compliance; and (c) the promotion of an organizational culture that encourages a commitment to corporate legal compliance.

In that context, our view is that consideration (at the very least)—and perhaps implementation—of such a process and how it might further organizational legal compliance is in the best interest of the organization.