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HERRICK, FEINSTEIN LLP AND ALVAREZ & MARSAL GLOBAL FORENSIC AND DISPUTE SERVICES, LLC PROGRAM ON:

CRITICAL ISSUES IN CORPORATE INVESTIGATIONS

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I. Introduction

Conducting an internal investigation is an often necessary response by a company to allegations of corporate or employee misconduct, particularly in this era of Dodd-Frank whistleblowers. If it is determined that an internal investigation is necessary, the work must be done thoroughly, effectively, timely, and in an independent manner designed to avoid allegations of a cover-up. If wrongdoing is confirmed as a result of the investigation, decisions must be made by the company as to what steps to take, such as self-reporting to the Government, discipline of employees and changes to compliance procedures. This paper discusses the necessary components of an effective internal investigation, and provides some examples of what can happen when an investigation goes wrong.

This paper is particularly timely given the increasing need for internal investigations as a result of, among other things, new whistleblower regulations, as well as the high profile nature of many recent internal investigations, such as those at Penn State, Wal-Mart, JPMorgan Chase and News Corp. Put simply, in today's climate of active scrutiny of corporate activities, a company is expected to conduct an internal investigation at the first whiff of trouble.

II. How to Conduct an Effective and Efficient Internal Investigation

A. Actions that May Trigger an Internal Investigation

1. Whistleblower

   a. Dodd-Frank

   b. False Claims Act

2. Employee complaint/Anonymous tip on confidential hotline

3. Government subpoena or investigation

4. Auditor

   a. Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. §78j-1)

5. Shareholder complaint - threatened or actual derivative action

6. Customer or vendor complaint

7. Industry-wide issue

8. New regulations or statutes

9. Media story

B. Preparing for and Structuring the Investigation

1. Do not turn a blind eye to corporate misconduct

   a. Is the complaint specific, detailed and appears to have merit, or is it vague and general?

      i. Consider credibility of person making allegations as well as nature, gravity and target of allegations

   b. If misconduct is apparent, or allegations appear credible, the company must promptly conduct an investigation and then stop the misconduct immediately -- not simply bury it

      i. Penn State

   c. Sarbanes-Oxley ("SOX") Section 307 requires that in-house counsel seek to ensure that a company takes appropriate steps in response to allegations of wrongdoing

      i. Can SOX certifications of financial statements/public filings be made absent an internal investigation?

2. Does the Board have a duty to investigate the claim?

   a. Board has a duty of care to the company to have an investigation conducted when there are credible allegations of serious misconduct

      i. Under *Caremark*, 698 A.2d 959 (Del. Ch. 1996), a director may be liable for breach of that duty of care

3. Who within the company needs to be apprised of the investigation?

   a. Options - Board, CEO, General Counsel, head of compliance, corporate security, inside auditor, outside auditor

4. Who within the company will be responsible for overseeing the investigation?

   a. Often, oversight is by Audit Committee or Independent Special Committee of the Board

      i. Resolution - outside counsel retained to conduct investigation, render legal advice and prepare report

      ii. Retention letter - discuss allegations under review and scope of investigation, and confirm rendering of legal advice

        iii. Under Section 301 of SOX, Audit Committee has authority to retain its own counsel

    b. Legal or Compliance

    c. A member of Senior Management

        i. Consider risks

    d. Those overseeing the investigation must be conflict free

5. Determine the scope and goals of the investigation

    a. Create an investigative plan

        i. Refer to known litigation or allegations, persons likely to have knowledge and whether purported misconduct may be ongoing

        ii. Purpose of investigation

            - Must be done for a valid purpose, not because of corporate politics or to retaliate

            - To provide legal advice to Audit Committee or Independent Special Committee

        iii. Define scope and process of investigation

        iv. Track progress of investigation

        v. Emphasize need for confidentiality

        vi. Company employees should report through attorneys

    b. Is the company's compliance/ethics program being followed?

        i. Employees who refuse to cooperate can usually be fired

    c. No retaliation against whistleblowers

    d. Employees must feel comfortable reporting criminal/improper conduct

6. Can the investigation be done internally by Legal or Compliance?

    a. Is there the necessary independence, experience and resources?

- Is in-house counsel too close to the problem to be able to investigate it?

- Is in-house counsel likely to be a witness?

b. Will the attorney-client privilege be compromised?

i. Yes, if investigation is viewed as a fact-finding inquiry to provide business advice, and not as one for purposes of providing legal advice

c. Will there be suspicion of a cover-up or an investigation that serves as mere "window dressing," or will the investigation be considered credible and reliable?

i. Company's actions will be very closely scrutinized.

ii. Do the allegations involve members of senior management or a company-wide practice?

iii. Wal-Mart's initial investigation into Mexican bribery allegations was cut short, and the company has been severely criticized

- A former Wal-Mart de Mexico attorney contacted company executives at its Bentonville, AR headquarters and told them how Wal-Mart de Mexico had routinely bribed Mexican officials

- The attorney had been in charge of obtaining building permits throughout Mexico, and his allegations raised concerns among Wal-Mart's senior management and prompted an internal investigation

- Nevertheless, even though the investigation found significant evidence supporting the attorney's claims, Wal-Mart's leaders shut down the investigation in 2006, and Government authorities were never notified

- It wasn't until *The New York Times* began asking questions within the past year that a new investigation was begun

7. Benefits of hiring experienced, independent outside counsel

a. Independent, unbiased viewpoint

i. Generally, do not use the company's regular outside counsel -- could lead to allegations of a "whitewash"/potential conflicts of interest/may be a fact witness

- Enron, Global Crossing, Broadcom

ii. Use a law firm with few, if any, ties to the company

b. Use someone with significant experience in conducting internal investigations

c. Attorney-client privilege and work product doctrine are protected

d. Outside counsel retains investigators and forensic accountants, and privilege will be preserved by having the experts sign retention agreements establishing that their engagement is intended to provide assistance so that outside counsel can render legal advice

e. Unless there is a conflict, in-house counsel can assist outside counsel

8. Anticipated costs and budget

9. Public relations

a. Consider retaining crisis management expert early on if warranted by allegations

10. Insurance

a. Do D&O or E&O policies cover the costs of the investigation?

i. If so, a claim must be made to the insurer promptly

C. Conducting the Investigation

1. Hold notice must be issued immediately

a. Briefly describe the reason for the hold notice

b. Relevant documents, both electronic and hard copy, must be located and preserved

c. Suspend routine document destruction policies that could result in inadvertent destruction of relevant documents

d. Relevant documents may not be destroyed by employees

i. Cooperation of employees is essential

e. Supplement hold notice as necessary

2. Gathering of relevant documents

a. Determine who are the likely sources of relevant documents

i. Obtain confirmation that these individuals are preserving relevant documents

b. Retention of qualified IT vendor for electronic documents

i. Image employee hard drives

ii. Preserve information stored on electronic servers

iii. Keyword searches

c. Gather relevant hardcopy documents

i. Bates-stamp and store in secure location

ii. Note custodians of particular records

d. Protect privileged and confidential information

3. Witness interviews

a. Should the employee be told about topics of discussion and be permitted to review relevant documents before the interview?

i. Generally yes, unless there are concerns of obstruction of justice or witness tampering

b. Who conducts / attends the interview?

i. At least two people should conduct the interview so one can take notes and testify as a witness if necessary

ii. Should internal counsel be present?

c. Employee should be advised as to the general nature of the investigation and expectation of cooperation

d. Employee should be advised that he or she must keep the interview confidential

e. *Upjohn* warnings

i. Attorney conducting the interview represents the company, or the Special Committee, not the individual being interviewed

- Be careful not to violate Model Rule of Professional Responsibility ("RPC") 4.3, entitled "Dealing with Unrepresented Person" which requires that (a) a lawyer who knows or should know that an unrepresented person misunderstands the lawyer's role must attempt to correct the misimpression, and (b) a lawyer cannot give legal advice to an unrepresented person.

- Similarly, pursuant to RPC 1.13(f), entitled "Organization As Client," in dealing with a company's directors, officers and employees, a lawyer must explain the identity of the lawyer's client when the lawyer knows or should know that the company's interests are adverse to the interests of the person that the lawyer is dealing with.

- Some commentators believe that the attorney should also tell the interviewee that he or she may obtain counsel if they wish, particularly if it appears to the attorney that the company and the employee are or may have potentially adverse interests

ii. Contents of the interview are protected by the attorney-client privilege, but the privilege belongs to the company, not the individual being interviewed

iii. Information being provided by the witness may be disclosed to the Government, a regulator or another third party pursuant to a waiver of the attorney-client privilege by the company

iv. Absent an effective *Upjohn* warning, as is discussed further below, the interview could be subject to a claim that the attorney-client privilege belongs to the employee who was interviewed

v. If an employee claims the privilege it could derail the company's or Special Committee's ability to waive the privilege and disclose to the Government or other third parties information obtained during the interview

f. Memo of interview

i. Include discussion of *Upjohn* warning

ii. Not verbatim / weave in thoughts and impressions to ensure attorney work-product doctrine applies

iii. Flag the memo as confidential and subject to attorney-client privilege and work-product doctrine

g. What if employee needs / requests an attorney?

i. Company's attorney doesn't represent the employee and can't provide employee with legal advice, including whether the employee needs personal counsel

ii. Consider adjourning the interview if employee asks about personal representation

iii. Indemnification of employee's attorney's fees if permitted by company's by-laws

- May want to approve selection of counsel

iv. Joint Defense Agreement

- But are the employee's interests adverse to the company?

h. Issue of outside counsel as witness

i. May arise during civil or criminal litigation if contents of statements a witness made to the attorney are in dispute

i. Lying to the attorney conducting the interview could be deemed to be obstruction of justice if there is an ongoing Government investigation and the witness knows his/her statements may be shared with the Government

i. *Computer Associates* case

4. Conduct a Thorough, yet Prompt, Investigation

a. Although the investigation usually will have a sense of urgency, make sure that it is done in a thorough and complete manner

b. A prompt investigation, and "first in the door" disclosure to the Government, is necessary to possibly obtain immunity in the context of federal antitrust cases

5. Reporting the results of the investigation

a. Is an interim report necessary?

   i. Periodic oral updates should generally be made to the client

b. Oral v. written final report

   i. Written report, particularly if disclosed to Government, could be discoverable in civil litigation against company

   ii. Conflicting court opinions on whether company and Government share a common interest

c. Contents of final report

   i. Identity of client

   ii. Purpose of investigation

   iii. Manner in which investigation was conducted

   iv. Evidence obtained

   v. Conclusion and recommendations

d. Who should the final report be presented to within the company?

6. Remedial actions

   a. Discipline

   b. Termination

   c. Remediation and compliance plan

   d. Training

   e. Have the improper/illegal practices actually stopped?

7. Disclosure of Investigation

   a. Voluntary disclosure to Government or self-regulatory organization

      i. Pros: Cooperation credit and the potential to shape the scope of any Government investigation

         - Could mean the difference between an indictment, and a non-prosecution or deferred prosecution agreement

ii. Cons: Exposure to potential criminal or civil liability, Government oversight, and reputational harm

iii. Absent disclosure, will the Government ever become aware of the issue?

- But keep in mind the incentives to whistleblowers.

iv. Consider which Government entity should receive the company's disclosure, *i.e.*, the DOJ's FCPA Unit for FCPA matters and the Antitrust Division for antitrust cases, where first company in the door may get immunity

v. Does the company agree to waive the attorney-client privilege? Will disclosure of the internal investigation report be deemed a waiver of the attorney-client privilege?

vi. Prepare a written agreement for execution by Government acknowledging confidential nature of information being disclosed, and seek to preclude disclosure by the Government to third parties

b. Public company reporting requirements

i. Regulation S-K of the Exchange Act requires that, if management "reasonably expects" that the improper conduct has had or will have a material impact on the company's financial statements, it must be publically disclosed in an SEC filing

c. Does a Suspicious Activity Report need to be filed?

8. Disclosure to the company's external auditor if required by auditor

III. Lessons Learned From Investigations That Went Off Course

A. Le-Nature's, Inc.

1. Background

a. This internal investigation resulted in a $500 million lawsuit filed by the liquidation trustee of Le-Nature's, Inc. ("Le-Nature's" or the "the company"), a bankrupt Pennsylvania beverage company, against the law firm that conducted the investigation and the accounting firm retained to assist the law firm.

i. The background of the investigation:

- In August 2003, Le-Nature's Chief Financial Officer, Chief Accounting Officer and Chief Credit Officer resigned, disclosing their suspicions that the CEO was engaging in improper conduct and financial improprieties, including denying them access to documentation supporting the company's general ledger

- Upon learning of the resignations, the company's outside auditor requested that the company "engage immediately competent independent legal counsel to conduct a thorough and complete investigation of the allegations"

- The Board of Directors appointed a Special Committee (3 independent Board members) to investigate the financial managers' claims

- The Special Committee retained a well-respected law firm to conduct an internal investigation, and the law firm, in turn, retained an accounting firm to assist it

- In December 2003, 3-1/2 months after being retained, the law firm provided the Special Committee with its final report

ii. The trustee alleged that the internal investigation was wholly deficient as a result of the failure to detect a massive financial fraud at the company, and sued the law firm for, among other things, legal malpractice.

iii. The crux of the trustee's claim:

> "This action stems from *the stunning failure of [the law firm] and [the accounting firm]* – specifically retained to examine serious and credible concerns that had been leveled by the senior financial officers of the Company regarding suspicions of improper conduct by a member of the company's senior management – *to conduct an even minimally competent investigation.*" (emphasis added)

iv. The Trustee also alleged:

> "That [investigative] failure is all the more egregious because, at the time the Investigation was conducted, a massive fraud was being perpetrated and *Defendants had been presented with a virtual road map of red flags concerning the fraud – all of which were recklessly ignored, dismissed or discounted in highly unreasonable and reckless reliance upon the representations of the wrongdoers*. As a result of the gross misconduct and other wrongdoing of the Law Firm Defendants and the Accounting Firm Defendants, the wrongdoers retained their senior management positions within Le-Nature's and were able to continue perpetrating their massive fraud, which resulted in damages to the Company of more than $500 million." (emphasis added)

2. Key Facts Alleged By The Trustee

a. The Lead Attorney's Lack of Investigative Experience

i. The law firm's lead attorney represented to the Special Committee that "he personally possessed precisely the type of investigative experience required by the Special Committee." Nevertheless, on the first day of the engagement, he directed the law firm's librarian to obtain copies of articles discussing how internal corporate investigations should be conducted.

- The lead attorney was a corporate lawyer, not a white collar lawyer experienced in conducting internal investigations. This lawyer dictated the manner in which the investigation was conducted and determined its scope.
- The law firm did not assign a white collar lawyer to the case.

b. The Law Firm Allowed Le-Nature's CEO, who was allegedly the primary wrongdoer, to Play an "Integral Role" in the Investigation

i. The law firm became "beholden" to the CEO, and treated him as the client, even though the Special Committee of Le-Nature's Board was the actual client

ii. All document requests to the company were submitted through the CEO, who also had exclusive control over the documents that were produced

iii. The CEO was provided with a description of the topics to be discussed prior to witness interviews, enabling him to coach witnesses

iv. The CEO was permitted to (a) preclude any interviews of certain employees and third-party witnesses (including all customer interviews), even though many of those witnesses possessed material information, and (b) preclude follow-up interviews of other witnesses

v. The CEO was given a draft of the law firm's investigative report before it was finalized, giving him the opportunity to (a) "discredit the resigning managers," (b) "fabricate justifications designed to conceal his fraudulent conduct," and (c) discuss the draft report with the company's Board

c. A Failure to Obtain Third-Party Documentation

i. The law firm failed to obtain independent third-party documentation regarding suspicious financial transactions

- The CEO's denial to Le-Nature's financial managers of access to documentation supporting the company's general ledger "should have underscored the critical importance and absolute necessity of obtaining independent corroboration of material facts"

ii. The law firm improperly relied on uncorroborated, "disingenuous and incredible" representations made by suspected wrongdoers, and "clearly inauthentic" documents received from them, including the CEO

d. Key Red Flags

i. Incomplete/inaccurate documentation for $ millions in equipment deposits

ii. No documentation for $ millions in "trade credits," which later turned out to be fictitious

iii. Indications of falsified bills of lading

iv. A supplier/customer for bulk tea appeared to be one and the same

v. Large wire transfers on last day of each month for even amounts, and inadequately documented wire transfers

vi. Lack of a written contract between the company and its sole bulk tealeaf supplier; the CEO claimed there was a 5-year oral agreement

e. The Law Firm Failed to Conduct a Thorough and Complete Investigation

i. The law firm limited the internal investigation to the review of “a number of discrete transactions” even though the financial managers’ “explicit warnings and disclosures, along with the red flags of misconduct, explicitly signaled the potential for widespread fraud and not simply some limited, discrete or isolated accounting irregularities.”

f. Examples of Egregious Financial Improprieties

i. Financial statements that inflated inventory by listing the company's tea stockpiles at $19/lb., "when, in fact, anyone familiar with the beverage industry (on making the appropriate or required inquiry) knew or should have known that tea sells wholesale at $.50 to $1.50 a pound"

ii. Difference between the company's publicly reported and actual sales in 2002: reported sales, $135 million; actual sales, $2 million

g. The Final Report

i. The report was a "grossly misleading whitewash report absolving the CEO and other suspected wrongdoers of any improper conduct"

- As the report stated: "Counsel found no evidence of fraud or malfeasance with respect to any of the transactions"

- This same conclusion was included in a draft report prepared almost one month before the final report, before the law firm had completed its interviews and before it had received all requested documents

ii. During the 3-year period after the wrongdoers were granted a "clean bill of health," they "proceeded to waste hundreds of millions of Le-Nature's dollars on unnecessary capital expansion projects - and outright stole tens of millions of additional dollars from Le-Nature's"

h. The Fraud is Uncovered and Criminal Charges are Brought

i. In late 2006, about 3 years after the law firm's final report was issued, a separate investigation by a forensic accounting firm quickly uncovered a massive fraud, Le-Nature's was forced into bankruptcy, and its assets were liquidated.

ii. Several of Le-Nature's officers were indicted and either pled guility or were convicted of fraud charges

iii. Le-Nature's founder and CEO was convicted of fraud and received a 20-year sentence

3. Legal Theories And Defenses in the Trustee's Case

a. In September 2009, the company's liquidation trustee filed a lawsuit against both the law firm and the accounting firm that had conducted the 2003 investigation.

b. The Trustee's Primary Legal Claims

i. Legal Malpractice

ii. Breach of Contract

iii. Breach of Fiduciary Duty

iv. Negligent Misrepresentation

c. The Law Firm's Primary Defenses

i. The law firm did not represent the company, only the Special Committee, so the company itself could not bring a legal malpractice claim due to lack of privity

ii. The *in pari delicto* defense barred the trustee's claims because the CEO's wrongful conduct is imputed to the company

iii. The trustee's claim, which was really for "deepening insolvency," did not allege a cognizable injury

iv. Lack of proximate causation

v. The complaint did not identify any actionable misrepresentations by the law firm, only subjective opinions

d. The Trial Court Dismisses the Trustee's Lawsuit

i. In December 2010, the court dismissed the Trustee's cause of action for attorney malpractice for two reasons: (a) the absence of any duty owed by the law firm to the company, as opposed to the law firm's client the Special Committee, which represented the interests of the holders of the company's preferred stock, and (b) the absence of any losses, as Le-Nature's was already bankrupt and the court rejected the Trustee's "deepening insolvency" argument.

ii. The court also rejected the Trustee's breach of contract claim against the law firm, noting that the law firm's retention letter was with the Special Committee, which was its sole client, and that it owed no duties to the company itself.

e. The Appellate Court Reverses the Trial Court

i. The appellate court, in a decision filed on May 14, 2012, determined that the investigation was conducted by the law firm on behalf of the company. The appellate court made that determination by focusing on the initial Board resolution, which authorized the law firm's retention, as well as an engagement letter between the law firm and a financial expert which indicated that the investigation was being conducted on behalf of Le-Nature's

ii. The appellate court also held that when the Special Committee retained the law firm it was acting on behalf of the Board, and that the Board, in turn, was acting on behalf of the company

iii. Accordingly, the appellate court determined that there was in fact an attorney-client relationship between the company and the law firm.

iv. The law firm has appealed the appellate court's decision to the Supreme Court of Pennsylvania, claiming that the ruling will result in uncertainty in the defining of attorney-client relationships, and will make it more difficult for a law firm to structure an attorney-client relationship that precludes a later finding that the firm represented, not the entity with whom it signed a retainer agreement, but rather, a third party

4. Lessons Learned

a. Utilize an Experienced White Collar Attorney who has proper support

i. The lead attorney on any complex internal investigation involving allegations of fraud or financial improprieties should be a white collar lawyer experienced in conducting such investigations

- RPC 1.1, entitled "Competence," provides: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation."

ii. Other lawyers at the firm with expertise in those areas relevant to the investigation (*e.g.*, attorneys with corporate, transactional or finance backgrounds) should be utilized to support the lead white collar attorney

iii. Outside consultants such as accounting, investigative and IT firms should also be utilized as necessary

iv. The attorney needs to know, or learn about, the industry that the company operates in

b. Ensure that the Investigation is Truly "Independent"

i. The law firm should report only to the client that retained it, usually the Audit Committee or a Special Committee of the Board, to which it owes a duty of "undivided loyalty"

ii. Conversely, the law firm should not report to the company's management or the suspected wrongdoers

iii. Exercise "professional skepticism" concerning any explanations provided by suspected wrongdoers

c. Ensure that the Investigation is Thorough and Complete

i. Ensure that the results of the investigation are not predetermined by a too narrowly defined scope

ii. Go wherever the evidence takes you - follow the evidentiary trail to its end

iii. Conduct all necessary interviews of witnesses, both inside and outside of the company, and complete all required follow-up interviews

iv. Obtain all necessary company and third-party documentation

v. If too many impediments block the investigation, the law firm should either walk away - after reporting its concerns to the Board committee and/or the full Board - or it should fully discuss the impediments and their effect on the investigation in its report

B. William Ruehle/Broadcom Corp.

1. This case arose out of an alleged stock options backdating scheme at Broadcom, a Fortune 500 company based in Irvine, CA that provides semiconductors for both wired and wireless communications. As a result of the scheme, Broadcom ultimately had to restate its earnings to account for about $2.2 billion in added stock-based compensation expenses

a. The central figure in the case was Broadcom's former Chief Financial Officer ("CFO") William Ruehle

2. On May 18, 2006, the Audit Committee of Broadcom's Board retained a prominent law firm to conduct an internal investigation of the alleged stock options backdating

a. The law firm had previously represented both Broadcom and individual Broadcom employees, including Ruehle, in various matters over several years.

3. Two civil actions are filed

a. On May 25, 2006, a shareholder derivative action was filed in California federal district court concerning Broadcom's stock options practices. Ruehle and various other Broadcom officers, directors and employees were named as defendants.

b. The next day, May 26, 2006, in a California state court civil action, an amended complaint was filed, and it included allegations concerning Broadcom's stock options practices. Once again, Ruehle was named as a defendant.

c. The law firm retained by Broadcom to conduct the internal investigation was also Ruehle's counsel in both civil actions.

4. The law firm interviews Ruehle as part of the internal investigation.

a. The law firm interviewed Ruehle several times during the internal investigation, starting on June 1, 2006, about Broadcom's stock options practices.

i. The two law firm attorneys who conducted Ruehle's first interview testified that they did provide an *Upjohn* warning, but their notes did not describe the warning, and Ruehle didn't recall such a warning

ii. Ruehle was admittedly not given an *Upjohn* warning in any of his subsequent interviews

5. This law firm discloses the substance of Ruehle's interviews to prosecutors following his indictment

a. The U.S. Attorney's Office in Los Angeles, as well as the SEC, opened investigations into Broadcom's alleged backdating of its stock options

i. At some point the law firm disclosed to the U.S. Attorney's Office the substance of Ruehle's discussions with its attorneys during the internal investigation, without Ruehle's knowledge or consent

ii. Ruehle was indicted in June 2008, and the indictment was premised on the options backdating charges

6. Ruehle Moves to Suppress the Use of His Statements on Grounds of Attorney-Client Privilege

a. Prior to trial the prosecutors turned over to Ruehle's attorneys copies of FBI investigative reports that contained the substance of Ruehle's communications with the law firm's attorneys

i. The prosecutors indicated that they intended to use Ruehle's statements against him at trial

b. Ruehle's counsel claimed that the communications from Ruehle that the law firm had provided to the FBI were subject to Ruehle's attorney-client privilege, and moved to suppress

i. In court filings Ruehle noted as follows:

- When the law firm interviewed him during the internal investigation, they also represented him individually in two civil cases involving the same allegations

- Thus, the law firm represented both Broadcom's Audit Committee and Ruehle individually in cases involving the same subject matter

- The reasonable belief of the purported client, *i.e.*, Ruehle, rather than that of the attorney, controls in determining whether a party holds the privilege

- Therefore, because Ruehle reasonably believed that (a) the law firm represented him individually at the time of interviews, and (b) the interviews were conducted to further his individual representation, Ruehle held the privilege as to these communications irrespective of what the law firm's attorneys believed

7. The District Court Rules in Ruehle's Favor Following a 3-Day Evidentiary Hearing

   a. Ruehle had a "reasonable belief" that the law firm represented him at the time of the interviews, and never gave the law firm written consent to disclose the information to third parties such as the Government

   b. The court was clearly upset at the law firm's actions:

   > The ramifications of . . . this finding . . . are pretty serious. They're serious in that Mr. Ruehle has had his privileged information disclosed and there is nothing I can do to get that back.
   >
   > And I regret that, sir. And as an officer of the Court, I apologize that that happened to you.
   >
   > I also feel sorry for Broadcom because Broadcom . . . will not get the full benefit of cooperation with the government. . . .

   c. The court suppressed Ruehle's statements and even went so far as to refer the law firm to the State Bar of California for possible disciplinary action

i. The court found that the law firm had violated its duty of loyalty to Ruehle, with potentially severe consequences to him

ii. The court focused on the prohibition of representing more than one client in a matter where the clients' interests potentially conflict, in violation of California Rule of Professional Conduct 3-310(C).

iii. It was in Ruehle's interest to be candid with his attorneys, even to the point implicating himself in wrongdoing; conversely, it was in Broadcom's interest to blame Ruehle for any misconduct by claiming that he was a rogue employee who acted without the company's knowledge or consent.

8. The Government Appeals, and the Ninth Circuit reverses the District Court's Decision in December 2009

a. The Ninth Circuit did accept the district court's holding that an attorney-client relationship existed between Ruehle and the law firm

b. The Ninth Circuit held, however, that Ruehle's statements weren't privileged because they weren't made with the expectation of confidentiality.

i. The Ninth Circuit noted that Ruehle had actively taken part in the internal investigation and acknowledged several times that the investigation's results were expected to be provided to third parties, including Broadcam's outside auditors, who were conducting a review of the company's financial statements

ii. As the CFO of a multi-billion dollar public company, Ruehle could not "credibly claim ignorance of the general disclosure requirements imposed on a publicly traded company with respect to its outside auditors or the need to truthfully report corporate information to the SEC."

iii. Therefore, Ruehle could not credibly argue that he had a reasonable belief that any statements he made during his interviews with the law firm were confidential

iv. The Ninth Circuit did not exonerate the law firm, however, simply holding that the law firm's "allegedly unprofessional conduct in counseling Broadcom to disclose, without obtaining written consent from Ruehle, while troubling, provides no independent basis for suppression of statements he made."

9. Lessons Learned

a. Be particularly careful about the risks associated with a law firm's joint representation of the Special Committee and company employees during an internal investigation

i. If it is at all likely that a conflict of interest could arise, any joint representation should be prohibited

ii. RPC 1.7, entitled "Conflict of Interest: Current Clients," provides:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client; or
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
>
> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) the representation is not prohibited by law;
>
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in

the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

b. Do not use the company's regular outside counsel to conduct an internal investigation

c. Provide a detailed, complete *Upjohn* warning to everyone interviewed, and be consistent.

i. Restate the *Upjohn* warning in all subsequent interviews, particularly those that may occur months later

d. Document all *Upjohn* warnings

i. Although the *Upjohn* warning is usually given orally, a printed version of the text of the warning should be maintained by the attorney at every interview

ii. This ensures that every employee receives the same warning and helps to avoid any disputes about the content of the warning that was given

iii. The memo of each employee's interview should note that the *Upjohn* warning was given

e. Give the employee an opportunity to ask questions about the *Upjohn* warning to ensure that there are no misunderstandings

IV. Considerations When Conducting An Internal Investigation With International Implications

A. Collecting Documents Overseas

1. Foreign regulatory frameworks require counsel to conduct data collections in conformity with limitations found in the data privacy laws of the countries in which the documents' custodians are located

a. For example, European directives generally require that employee's consent be obtained before employer processes personal data, subject to certain exemptions.

b. Corporations may collect and review personal information and company files without providing this individualized notice so long as the corporation acts in light of "specified, explicit and legitimate purposes," or where enumerated exigent circumstances arise.

i. Such circumstances include processing that is "necessary for compliance with a legal obligation to which the [data] controller is subject"; or

ii. If processing is necessary for the performance of a task carried out in the public interest or the exercise of official authority.

c. In some countries, local law may require notification of national privacy officials prior to undertaking a collection, even in those circumstances in which an exception to general requirements of notification and consent seems applicable.

2. Sometimes must also conform to the rules of the home countries of people referred to in the documents.

3. Important to work with local counsel to consult on country-specific rules.

B. Extraterritorial Transfers

1. If data is to be transferred outside the country of collection, privacy laws often require that any jurisdiction to which protected data is to be transferred meets minimum adequacy requirements relating to the protection of data privacy.

a. Certain jurisdictions have been certified as adequately protective.

b. The United States has not been so certified, and official approval generally is required before transfer of data to the United States.

2. The United States and European Union ("EU") have entered into an agreement that creates a "safe harbor" for data transfers among companies that agree to seven data protection principles.

a. One principle requires that transferred data must be relevant and reliable for the purpose for which it was collected.

b. Therefore, it is generally a best practice to cull data in-place and transfer at most a clearly relevant subset of data to the United States.

3. Once documents are transferred to the U.S., corporations lose whatever protection EU and other data privacy regimes may have afforded them from producing documents in U.S. judicial proceedings had those

documents remained within a foreign jurisdiction whose privacy laws restrict their transfer.

a. Counsel should carefully consider the need to transfer data to the U.S. as opposed to conducting a review within the collection country; and

b. Transfer only data necessary to the issues at hand.

C. Interviews

1. Counsel conducting an internal investigation for a multinational corporate client has several options for ensuring that the interviews and documents created as a result of the investigation remain protected from disclosure.

2. Structure the engagement to ensure that it is construed as touching base with the U.S.

a. Counsel should consider including in its engagement letters a reference to potential investigations or litigations in the U.S. as part of the scope of the retention.

b. Focusing the investigation on potential violations of U.S. law as the main grounds for the retention should provide a strong basis for arguing that the investigation's activities touch base with the U.S.

3. Consider utilizing foreign outside counsel in interviews in a foreign country, in addition to U.S. outside counsel.

a. Although potentially costly, may provide another layer of protection against disclosure.

b. If a court finds that foreign privilege law applies, participation in internal investigation interviews by foreign outside counsel will assist counsel in maintaining the privilege given that,

i. the EU and many countries around the world do not recognize the privilege for in-house lawyers; and

ii. the only attorney-client communications that are guaranteed protection are those with an outside attorney qualified to practice in the EU.

D. In-House Legal Counsel in Foreign Countries

1. Majority of EU countries recognize confidentiality obligations between a lawyer and client, but do not recognize privilege for in-house counsel.

a. Some EU member states *do* recognize the privilege for inside counsel.

2. In *Akzo Chemicals Ltd* v. *European Commission* (September 14, 2010), European Court of Justice affirmed determination that company cannot secure confidentiality protection of communications between in-house lawyer and employees.

   a. European law requires that the communications must emanate from an *independent* lawyer, not an employee of the corporation.

   b. For companies subject to scrutiny by EU, communications with in-house counsel may be seized and used as evidence in EU court.

      i. EU authorities may disclose privileged documents to U.S. or other authorities.

3. Since U.S. attorney-client privilege is based on premise that client has a reasonable expectation of confidentiality, litigants may argue that U.S. companies have no reasonable expectation of confidentiality in communications to and from in-house counsel shared with company personnel in Europe because they are subject to seizure by the European Commission.

4. Strategy to Protect Privilege

   a. Become familiar with privilege laws in relevant jurisdiction.

   b. Limit privileged information sent from U.S. in-house counsel to foreign offices.

   c. Limit foreign offices' access to U.S. legal department files and servers.

   d. Seal and segregate privileged documents.

5. Involve Local Outside Counsel

V. Conclusion

A corporate internal investigation requires careful consideration and planning, and appropriate oversight throughout the process. It also must be conducted in an independent manner free from undue influence. Once the investigation is completed, it is necessary to carefully assess what actions need to be taken and what disclosures need to be made based upon the results of the investigation. A company that fails to follow these guidelines does so at its own peril.

VI. Attachments

A. American College of Trial Lawyers publication "Recommended Practices for Companies and Their Counsel in Conducting Internal Investigations," February 2008 (Tab A)

B. American Bar Association Criminal Justice Section, White Collar Crime Committee Working Group, "Upjohn Warnings: Recommended Best Practices When Corporate Counsel Interacts With Corporate Employees," July 17, 2009 (Tab B)

C. U.S. Department of Justice, U.S. Attorneys' Manual Chapter 9-28.000, "Principles of Federal Prosecution of Business Organizations," August 2008 (Tab C)

D. *Mark Kirschner, as Liquidation Trustee of Le-Nature's Liquidation Trust v. K&L Gates LLP, et. al.,* 2010 WL 5504811 (Allegheny Cty. Pa. Com. Pl. Dec. 28, 2010 (Tab D)

E. *Mark Kirschner, as Liquidation Trustee of Le-Nature's Liquidation Trust v. K&L Gates LLP, et. al.*, 46 A.3d 737 (Pa. Super. Ct., May 14, 2012) (Tab E)

F. *U.S. v. William Ruehle*, 583 F.3d 600 (9th Cir. 2009) (Tab F)

Speaker Bios

A.J. Bosco is Senior Vice President of Global Investigations for Moody's Corp. In that role, Mr. Bosco is responsible for coordinating and supervising the internal investigatory process firm-wide. Mr. Bosco began his career working for 11 years in the Manhattan District Attorney's Office, where he was a Deputy Bureau Chief in the Trial Division, responsible for supervising criminal investigations and trials. Subsequently, Mr. Bosco served as an Enforcement Division Branch Manager in the Northeast Regional Office of the Securities and Exchange Commission, where he participated in a wide range of investigations of federal securities laws. Prior to being employed at Moody's, Mr. Bosco also worked in the legal and compliance departments at Prudential Securities, Deutsche Bank Securities and Bank of America Merrill Lynch. Mr. Bosco is a co-chair of the Corporate Investigations Sub-Committee of the White Collar Crime Committee of the ABA Business Law Section. He has also served on the Securities Regulation and Criminal Advocacy Committees of New York City Bar Association.

Ernest Brod is a Managing Director with Alvarez & Marsal Global Forensic and Dispute Services where he leads the firm's Business Intelligence practice. He has extensive experience in applying cutting edge forensic techniques to corporate investigations and providing in-depth business intelligence services to clients around the world. He has offered insight on issues involving the theft of intellectual property, counterfeiting and grey marketing of goods, internal fraud, cyber smear and short seller raids and asset searches. Prior to joining A&M, Mr. Brod led the Business Intelligence practice at Navigant and was a Director in the Forensic and Dispute Services practice for Deloitte FAS. Earlier, he spent 17 years with Kroll as one of the leaders of its investigation and intelligence business, and was a founder and CEO of Citigate Global Intelligence. In 25 years as an investigative and intelligence consultant, Mr. Brod has worked with the country's leading law firms, corporations and financial institutions. He has held leadership positions in the Federal Bar Council, the Association of Corporate Counsel. and the International Bar Association.

Steven Feldman is the lead partner in Herrick's White Collar Defense practice. He represents companies and individuals accused of business crimes, public corruption, securities law violations and fraudulent practices by the U.S. Attorney's Office, State Attorney General, District Attorney and Securities and Exchange Commission. He works with companies to conduct internal investigations and represents individual executives in corporate internal investigations. In criminal and regulatory matters, Mr.

Feldman represents broker-dealers, stock brokers, hedge funds, investment advisors and corporate executives. Experienced as both a defense attorney and a prosecutor, Mr. Feldman has expertise in public corruption prosecutions, business crime matters, art and cultural object related crimes, health care fraud cases, and cases arising under the federal securities laws. Prior to joining Herrick, Steven spent more than six years as an Assistant U.S. Attorney for the Southern District of New York in Manhattan. During his last four years as a federal criminal prosecutor, Steven served on the Securities and Commodities Fraud Task Force. Steven also handles complex sentencing, forfeiture and restitution proceedings. He has briefed and successfully argued numerous appeals before the Second Circuit.

Gary F. Giampetruzzi is Vice President, Assistant General Counsel and Head of Government Investigations at Pfizer, Inc. He is responsible for government investigations of the company's operations around the world as well as associated government litigation before U.S. and international prosecutor's offices. Before joining Pfizer in 2001, Mr. Giampetruzzi was a member of the Litigation Department of Willkie Farr & Gallagher, where he focused primarily on complex commercial litigation, state and federal criminal matters and corporate internal investigations. In previous years, he served as Deputy Compliance Officer, International Investigations and Programs in the Corporate Compliance Group. Working with a headquarters team, a dedicated staff of regional compliance directors, and a network of international compliance liaisons, Mr. Giampetruzzi was responsible for the implementation and maintenance of compliance programs and systems throughout Pfizer's international operations, with an enhanced focus on emerging markets. He is a frequent speaker at industry conferences on compliance programs, internal investigations, and the Foreign Corrupt Practices Act. He has been instrumental in the development of Pfizer's compliance function and has been involved with the development of many critical aspects of its compliance program.

David M. Rosenfield, Counsel in Herrick’s White Collar Practice, concentrates his practice in white collar criminal defense, corporate internal investigations and securities and commodities regulation and litigation, representing both corporations and senior executives. Mr. Rosenfield represents and defends clients before federal agencies including U.S. Attorneys' Offices, the SEC, and the Department of Health and Human Services; state agencies, such as the New York State Attorney General's Office and the New Jersey Division of Criminal Justice; and self-regulatory agencies, such as the Financial Industry Regulatory Authority . In August 2011, Mr. Rosenfield began serving his 3-year term as chairperson of the White Collar Crime Committee of the American Bar Association's Business Law Section. Prior to joining Herrick, he was Senior Counsel and Manager of Legal Process at The Bank of New York, where he provided legal counsel to the Anti-Money Laundering Committee and taught the laws and regulations section of the Advanced Anti-Money Laundering Seminar. Prior to that, Mr. Rosenfield was a prosecutor in the Frauds Division of the U.S. Attorney's Office for the District of New Jersey in Newark. He prosecuted white collar criminal cases, including three complex securities fraud cases in which he supervised detailed, lengthy investigations and coordinated the activities of Assistant U.S. Attorneys, federal law enforcement agents and investigators from regulatory agencies.

Attachment A

American College of Trial Lawyers publication
"Recommended Practices for Companies and Their
Counsel in Conducting Internal Investigations,"
February 2008.

RECOMMENDED PRACTICES FOR COMPANIES AND THEIR COUNSEL IN CONDUCTING INTERNAL INVESTIGATIONS

Approved by the Board of Regents
February 2008

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RECOMMENDED PRACTICES FOR COMPANIES AND THEIR COUNSEL IN CONDUCTING INTERNAL INVESTIGATIONS*

I. Purpose of the Paper

Since 2001, over 2,500 public companies have retained outside counsel to conduct internal investigations into suspected wrong-doing by corporate executives and employees. These investigations have included inquiries into suspected violations of the Foreign Corrupt Practices Act; alleged options backdating activities; alleged violations of the antitrust, environmental, import/ export, and other laws; and financial statement improprieties.[1] The Federal Criminal Procedure Committee of the American College of Trial Lawyers has observed counsel implementing a wide variety of procedures and protocols in conducting corporate internal investigations for issuers and public companies in particular. The result has been variances both in treatment of officers and employees and in outcomes of the investigations for such officers and employees and the corporations themselves. The Committee has sought to determine, and now recommends, what it believes to be the fairest and most effective practices for conducting internal investigations of possible corporate wrongdoing. Although the principles articulated in this paper are tailored to internal investigations by issuers and public companies where significant allegations of malfeasance are alleged or suspected, many of these principles may be applied in the context of other entities and smaller investigations.

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* The principal draftsman of this report was David M. Brodsky (New York, N.Y.). He was assisted by a subcommittee of the Federal Criminal Procedure Committee of the American College of Trial Lawyers consisting of its Chair Douglas R. Young (San Francisco, CA.), Fellows Nanci Clarence (San Francisco, CA.), James Brosnahan (San Francisco, CA.), John S. Siffert (New York, N.Y.), Robert G. Morvillo (New York, N.Y.), the Honorable Nancy Gertner (US District Court, District of Massachusetts), and Regent Liaison Robert W. Tarun (Chicago, IL.). Fellow Cristina Arguedas (Berkeley, CA.) also reviewed this report.

1 *See, e.g.*, the Wall Street Journal Options Scoreboard, where 143 public companies are listed as having conducted internal investigations into suspected options backdating, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

A sample of the internal investigations conducted by different law firms reveals the diversity of the matters under internal investigation since 2001:

- representation of Fortune 100 Company in a Special Litigation Committee investigation involving derivative shareholder claims against directors and officers regarding false financial statements and conflicts of interest arising out of acquisitions;
- representation of the Audit Committee of leading lessor of shipping containers and chassis in an internal investigation arising from an accounting restatement;
- representation of the Corporate Governance Committee of a major transportation company in a review of its corporate governance structure;
- representation of the Audit Committee of a large semiconductor company in an internal investigation involving alleged accounting improprieties and self-dealing;
- representation of the Audit Committee of a major computer data storage company regarding an investigation involving revenue recognition issues at one of the companies subsidiaries;
- representation of a leading fiber optics company in an internal investigation;
- representation of an Audit Committee into allegations of insider trading by certain directors and those affiliated with them
- representation of a U.S. public company and its U.S. subsidiary corresponding to the Japanese subsidiary in an investigation involving improper labeling of the grade and quality of plastics being used in computer monitors and other electronics equipment being shipped around the world, including the U.S.; and
- representation of an Audit Committee of one of the world's largest industrial corporations into the activities of foreign subsidiaries relating to energy plant inspections.

II. Initial Organizational Issues

A. Factors to Consider When Evaluating Whether to Commence an Internal Investigation When Allegations Have Been Lodged of Significant Corporate Malfeasance Or Where an Outside Auditor Suspects Illegality

Internal investigations typically result from discovery -- by the Company, the media, an external auditor, or a whistleblower -- of circumstances that raise a serious concern of potential liability or financial misconduct. The investigations are thus meant to determine the validity and seriousness of the circumstances alleged or disclosed and what action, if any, the Company should take consistent with the best interests of the shareholders. Among the possible responsive actions are remediation, market disclosure, and preparation for, and defense of, potential prosecutorial and regulatory actions or civil lawsuits. Depending on whose conduct is the focus of the investigation, senior management, the Board of Directors, an audit committee or a special committee of disinterested directors may decide to commence an investigation. There are some respected corporate lawyers who counsel that Boards should resist the trend of having audit committees or special committees of independent directors routinely investigating whistleblower complaints and the like.[2]

Whether to commence an internal investigation may be a discretionary decision, supra, or in limited circumstances may be prescribed by statute. In the latter case, Section 10A of the Exchange Act requires external auditors, who detect or otherwise become aware that an illegal act has or may have occurred, to determine whether it is likely such an illegal act has occurred and the effect of any illegal act on the Company's financial statements. Auditors look to the Company to investigate and evaluate such possible illegalities and then assess whether the Company and the Board of Directors have taken "timely and appropriate remedial actions" regarding such possible illegalities. In this regard, the methodology used in "10A investigations" is not materially different from an internal investigation commenced on the company's own initiative, and therefore, for the purposes of this paper they will be treated collectively.

Outside of the 10A context, there are several circumstance that have traditionally triggered the initiation of internal investigations by senior management, a Board, audit committee or special committee:

a. Receipt of a whistleblower letter or communication that raises allegations of misconduct by senior or significant members of management;

b. Shareholder demand in the nature of an actual or threatened derivative action against directors and officers, possibly leading to formation of a Special Litigation Committee;

c. Allegations of misconduct raised by external auditor, internal auditor, or compliance;

d. Board member suspicion of misconduct by officers or employees;

e. Receipt of subpoena or informal request for information by a government or self-regulatory organization (SRO), or an announcement by a government agency or SRO of suspicions of misconduct by the Company or industry; or

f. Allegations of misconduct by the media, watchdog groups, or academics.

2 Andrew Ross Sorkin, *Questioning an Adviser's Advice*, N.Y. TIMES, Jan. 8, 2008 (interview of Martin Lipton).

In addition, although there have been no reported enforcement actions under the section yet, the "reporting up" provisions of the Sarbanes-Oxley Act of 2002 require in-house counsel to ensure that the corporation takes appropriate steps in response to allegations of wrongdoing.

B. External Factors, Such as The Existence or Anticipated Existence of a Parallel Government Investigation or Shareholder Lawsuit, Should Be Considered When Making Decisions About How To Conduct and Document An Internal Investigation

There is a reasonable likelihood that any major internal investigation will be followed by, or conducted parallel to, an actual (or anticipated) external investigation by (one or more of): the Department of Justice, Securities and Exchange Commission, NYSE (or other self regulatory organization ("SRO")), a state attorney general or local district attorney, or other enforcement or regulatory authority. The Company and the Board may also be facing civil lawsuits, including shareholder class actions and derivative suits, pertaining to the alleged misconduct; and in certain instances, may be dealing with criminal investigations initiated by federal and, more recently, state prosecutors.[3]

The existence or threatened existence of any of these external events necessarily affects how the Company, Board, audit or independent committee, and outside counsel conduct and document an internal investigation. As discussed more fully below, counsel and the Company should anticipate that all documents created, facts uncovered, and witness statements made to them, may be disclosed to the government or regulator, and also may be discoverable by a private plaintiff. This assumption should be a factor in all major decisions about the procedure and protocol for any major internal investigation. In particular, the company, the Board or its independent committees, and counsel may want, or may be forced, to make an early determination about whether and how they will "cooperate" with government or regulatory investigations.

During approximately the last decade, driven by regulatory policies promulgated by the Department of Justice,[4] the Securities and Exchange Commission and other regulators,[5] and

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3 *See, e.g.*, Mark Gimein, *Eliot Spitzer: The Enforcer*, Fortune, Sept. 16, 2002, at 77; Charles Gasparino & Paul Beckett, *Quick Fix May Elude Citigroup and Weill*, Wall St. J., Sept. 10, 2002, at C1; Gregory Zuckerman & Mitchell Pacelle, *Now, Telecom Deals Face Scrutiny*, Wall St. J., June 28, 2002, at C1.

4 *See* text, *infra* at n. 7-10, 13-14.

5 *See* "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," issued on October 23, 2001 as Releases 44969 and 1470, available at http://www.sec.gov/litigation/investreport/34-44969.htm, and referred to as the "Seaboard Report." The Seaboard Report is the SEC's current policy regarding waiver of privilege and work product, and sets forth the criteria that it will consider in determining the extent to which organizations will be granted credit for cooperating with the agency's staff by discovering, self-reporting, and remedying illegal conduct, which cooperation, or lack thereof, in the eyes of the staff will be taken into consideration when the SEC decides what, if any, enforcement action to take. The Seaboard Report has been read by practitioners as encouraging companies not to assert, or to waive, their attorney-client privilege, work product, and other legal protections as a sign of full cooperation. *See* Seaboard Report at paragraph 8, criteria no. 11, and footnote 3.

Another example of a regulatory agency promulgating similar policies is the Commodity Futures Trading Commission ("CFTC"), the Enforcement Division of which issued an Enforcement Advisory on August 11, 2004, entitled "Cooperation Factors in Enforcement Division Sanction Recommendations," promoting the waiver of appropriate privileges. The CFTC issued a revised Enforcement Advisory eliminating the waiver language on March 1, 2007. *See* http://www.abanet.org/poladv/priorities/privilegewaiver/acprivilege.html.

the U.S. Sentencing Commission, the passage of federal legislation mandating certain activities by independent auditors and Audit Committees, and civil litigation, there has been a renewed emphasis on companies' expanding the scope of their cooperation with governmental investigations, and even initiating them, by conducting extensive internal investigations into perceived corporate misconduct in order to achieve longer-term benefits at the hands of such regulators and avoid what could be punitive reactions by regulators and auditors.

Since the mid-1990s, the principal focus of law enforcement and regulatory authorities in the United States has been to develop policies and guidelines designed to induce corporations and other business entities to waive, or not assert, applicable attorney-client and work-product privileges and protections.[6] In 1999, after several years of informal policies at various United States Attorney's Offices (principally the Southern District of New York), the Department of Justice formally adopted what came to be known as the "Holder Memorandum," after Eric Holder, then Deputy Attorney General of the United States. The Holder Memorandum, although advisory, set forth standards by which a corporation would be judged cooperative in a federal criminal investigation.[7] One factor was whether the corporation waived or did not assert privileges protecting the confidentiality of communications.

In 2002, then Deputy Attorney General Larry Thompson promulgated a revision of the Holder Memorandum, this time making mandatory the use of the factors in judging whether a corporation was sufficiently cooperative, including whether applicable privileges were waived or not asserted.[8] Among the most controversial of the nine additional factors in the Thompson Memorandum were those addressed to indicia of corporate "cooperation," including a willingness to waive or not assert the attorney-client privilege and the attorney work-product doctrine[9] and a willingness to deny advancement of fees and expenses and indemnification coverage.[10]

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6 *See* United States Attorneys' Criminal Resource Manual, Art. 162, §VI.B; United States Sentencing Guidelines Manual §8C2.5(g)(2001); the SEC's Seaboard Report, http://www.sec.gov/litigation/investreport/34-44969.htm; *see also* the EPA Voluntary Disclosure Program, the HHS Provider Self-Disclosure Protocol, and the Department of Justice Antitrust Corporate Leniency Policy.

7 *See generally* Memorandum from Eric Holder, Jr., Deputy Attorney General, to All Heads of Department Components and U.S.Attorneys (June 16, 1999) (including attachment entitled "Federal Prosecution of Corporations"), *reprinted in* Criminal Resource Manual, arts. 161, 162, *available at* http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00100.htm.

8 *See* US DOJ, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003) (the "Thompson Memorandum"), *available at* http://www.usdoj.gov/dag/cftf/business_organizations.pdf.

9 Regarding the attorney-client privilege and work-product doctrine, the Thompson Memorandum stated, in relevant part, that "[o]ne factor the prosecutor may weigh in assessing the adequacy of a corporation's cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client and work product protections, both with respect to its internal investigation and with respect to communications among specific officers, directors, and employees and counsel. Such waivers permit the government to obtain statements of possible witnesses, subjects and targets, without having to negotiate individual cooperation or immunity agreements."

10 Regarding denial of advancement of fees and expenses, the Thompson Memorandum stated, in relevant part, that "a corporation's promise of support to culpable employees and agents... through the advancing of attorneys' fees... may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation."

In 2004, following the general trend of policy reflected in the Thompson Memorandum, the United States Sentencing Commission adopted an amendment that a corporation's waiver of the attorney-client privilege and work product protections would be a prerequisite for obtaining a reduction by a corporation in its culpability score.

The adoption of these policies by the Department of Justice and other regulatory entities have made inroads into historic policies protecting privilege and work-product in favor of policies promoting cooperation with governmental agencies and maximizing the effectiveness and efficiency of governmental investigations.[11] Companies formerly expected that the work product of their counsel prepared as a result of an internal investigation (and advice given as a result of such investigation) would be protected. Instead, however, many have come to learn that, upon the initiation of a governmental inquiry (formal or informal, and whether the company is a target or not) such expectations of confidentiality have in many cases been illusory. Internal investigations, conducted by and at the direction of legal counsel, are a critical tool by which companies and their boards learn about violations of law, breaches of duty and other misconduct that may expose the company to liability and damages. They are also an essential predicate to enabling companies to take remedial action and to formulate defenses, where appropriate. But internal investigations no longer have clear and predictable protections of confidentiality in the current environment, viewed as a "culture of waiver."[12]

Following significant criticism by business organizations and bar associations, these principles were superseded in 2006 by the so-called McNulty Memorandum.[13] The McNulty Memorandum reaffirms many of the factors to be considered by federal prosecutors when conducting corporate investigations and deciding whether to indict corporations or considering corporate plea agreements, but places some procedural restrictions and additional procedural reviews on prosecutors regarding their ability to request waivers of corporate attorney-client privileges or work-product

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11 Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), *available at* http://www.actl.com/AM/Template.cfm?Section=All_Publications&Template=/CM/ContentDisplay.cfm&ContentFileID=68.

12 "The Decline of the Attorney-Client Privilege in the Corporate Context," Survey Results, Presented to the United States Congress and the United States Sentencing Commission, March 2006, http://www.nacdl.org/public.nsf/whitecollar/wcnews024/$FILE/A-C_PrivSurvey.pdf, and http://www.acca.com/public/attyclntprvlg/coalitionussctestimony031506.pdf ("Survey Results").

13 *See* Principles of Federal Prosecution of Business Organizations (December 12, 2006) (the "McNulty Memorandum"), *available at* http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf

protections.[14] [15] Despite these additional restrictions and reviews, there is little practical difference between the McNulty Memorandum and its predecessors: all maintain the position that waivers of the privilege and work product protections will be bases for favorable treatment of corporations and thus will still provide significant motivation for defense attorneys zealously representing their corporate clients to offer waivers without prosecutors having to ask. Since the main focus of both DOJ Memoranda is an evaluation of how the DOJ evaluates the "authenticity of a corporation's cooperation with a government investigation," including waivers, the McNulty Memorandum will still provide significant motivation for defense attorneys zealously representing their corporate clients to offer waivers without prosecutors having to ask.

In 2001, the SEC announced its own cooperation policy when it decided to take no action against Seaboard Corporation despite evidence that its former controller had caused the company's books and records to be inaccurate and its financial reports misstated. The Commission outlined thirteen factors it would consider in determining cooperation.[16]

In 2006, the SEC updated its standards for imposing civil penalties on corporations.[17] As explained in the Commission's Statement,

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14 The McNulty Memorandum lists nine factors that "prosecutors must consider... in reaching a decision as to the proper treatment of a corporate target":

(1) the nature and seriousness of the offense including the risk of harm to the public and any policies and priorities relating to the particular categories of crime;

(2) the pervasiveness of wrongdoing within the business organization including complicity in or condonation of the wrongdoing by management;

(3) the history of similar conduct within the company including prior criminal, civil and regulatory enforcement actions against the company;

(4) the timely and voluntary disclosure of wrongdoing and the company's willingness to cooperate in the investigation of its own agents;

(5) the existence and adequacy of the company's pre-existing compliance program;

(6) the company's remedial actions, including efforts to implement an effective compliance program or improve an existing one, efforts to replace responsible management, efforts to discipline or terminate wrongdoers, efforts to pay restitution, and efforts to cooperate with government agencies;

(7) collateral consequences, including disproportionate harm to shareholders, pension holders and employees not proven personally culpable, and impact on the public arising from the prosecution;

(8) the adequacy of the prosecution of individuals who are responsible for the corporation's malfeasance; and

(9) adequacy of civil, regulatory enforcement actions or other remedies. *Id.*

15 We note also that as this paper is being published, Congress is considering the "Attorney-Client Privilege Protection Act," which would impose a bar on federal investigations requesting companies to waive privilege or to refuse to advance fees (H. 3013, passed by the U.S. House of Representatives on November 13, 2007; S.186, now before the U.S. Senate Judiciary Committee).

16 *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Release No. 44969, Oct. 23, 2001, *available at* http://www.sec.gov/litigation/investreport/34-44969.htm.

17 Statement of the Securities and Exchange Commission Concerning Financial Penalties, January 4, 2006, *available at* http://www.sec.gov/news/press/2006-4.htm; *see also* Litigation Release No. 19520, January 4, 2006, *SEC v. McAfee, Inc.*, Civil Action No. 06-009 (PJH) (N.D. Cal. 2006); *see also* Baker and Holbrook, "SEC Statement Clarifies Corporate Penalties – A Bit," National Law Journal, March 13, 2006.

"whether, and if so to what extent, to impose civil penalties against a corporation... turns principally on two considerations: The presence or absence of a direct benefit to the corporation as a result of the violation...[and] [t]he degree to which the penalty will recompense or further harm the injured shareholders."

Several additional factors the Commission will take into account include:

(1) The need to deter the particular type of offense;
(2) The extent of injury to innocent parties;
(3) Whether complicity in the violation is widespread throughout the corporation;
(4) The level of intent on the part of the perpetrators;
(5) The degree of difficulty in detecting the particular type of offense;
(6 Presence or lack of remedial steps by the corporation;
(7) Extent of cooperation with the Commission and other law enforcement agencies.

Despite the DOJ memoranda and SEC guidance discussed above, in most cases, the precise benefits of the Company's cooperation, if any, cannot be known at the outset of an investigation. Indeed, many companies that have cooperated with the government have received stiff financial penalties, albeit perhaps lower than if no cooperation had been proffered.[18] In the area of enforcement of the Foreign Corrupt Practices Act, Assistant Attorney General Alice Fischer has stated that, although not in the "best interests of law enforcement to make promises about lenient treatment in cases where the magnitude, duration, or high-level management involvement in the disclosed conduct may warrant a guilty plea and a significant penalty,...there is *always a benefit* to corporate cooperation, including voluntary disclosure, as contemplated by the Thompson memo. ...*[I]f you are doing the things you should be doing* – whether it is self-policing, self-reporting, conducting proactive risk assessments, improving your controls and procedures, training on the FCPA, or *cooperating with an investigation* after it starts – *you will get a benefit*. It may not mean that you or your client will get a complete pass, but *you will get a real, tangible benefit*" (emphasis added).[19] While the number of DOJ-deferred prosecution or non-prosecution agreements has increased recently, many corporations and their counsel continue to believe that the benefits of cooperation have not been tangible and have, with certain DOJ divisions and sections or U.S. Attorney offices, been far too unclear. Some companies, after due consideration, have decided, in the face of a grand jury subpoena or allegation of wrongdoing, neither to conduct an internal investigation nor to cooperate with government authorities.

Signally, the Antitrust Division has a very clear standard – that parties who cooperate fully receive amnesty and reduced civil penalties. The Antitrust Criminal Penalty Enhancement

18 For a discussion of the Securities and Exchange Commission's response to cooperation through the end of 2004, *see* Tim Reason, *The Limits of Mercy: The Cost of Cooperation with the SEC is High. The Cost of Not Cooperating is Even Higher*, CFO Magazine, April 2005, *available at* http://www.cfo.com/article.cfm/3804652/c_3805512?f=magazine_featured.

19 Prepared Remarks of Alice S. Fisher at the ABA National Institute on the Foreign Corrupt Practices Act, October 16, 2006, *available at* http://www.usdoj.gov/criminal/fraud/docs/reports/speech/2006/10-16-06AAGFCPASpeech.pdf.

and Reform Act, adopted in 2004, increases the criminal penalties for violations, but also increases the incentives for self-reporting and cooperation in criminal antitrust matters. Corporations and individuals reporting their involvement in antitrust violations may receive immunity from the DOJ's Antitrust Division under its leniency program, insulating successful applicants from criminal fines and imprisonment. The legislation thus creates strong incentives for antitrust violators to be the first to self-report their violations and thus insulate themselves from criminal prosecution, though not from the likely civil litigation to follow.[20] In a statement issued after the bill was signed into law, Assistant Attorney General for Antitrust R. Hewitt Pate stated that the Act would make the DOJ's Corporate Leniency Program "even more effective."[21]

As emphasized in the College's 2002 report *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations*,[22] the attorney-client privilege and work product doctrine play a central role in corporate governance and remain essential to the due administration of the American criminal justice system. A waiver of these protections should not be taken lightly. This paper assumes that while a company, board, or audit or independent committee will consider, first and foremost, whether and how to conduct an internal investigation so as to protect the interests of the company and its stakeholders, it will also be cognizant of the importance of the attorney-client privilege and work-product protections in our society. (See also footnote 15, preceding.)

C. The Role of the Board and Management in Conducting and Overseeing the Investigation

The relative participation of management and the Board in an internal investigation is a function principally of the nature of the allegations. Where the alleged or suspected conduct involves senior officers or serious employee misconduct, or where the corporate entity is the focal point of a government inquiry, it is important that management, including usually the General Counsel's office, not be, and not be perceived to be, in charge of the internal investigation. An investigation carried out by management, or a corporate department (such as an internal audit department), likely will not be afforded credibility. Furthermore, the continuing involvement in the conduct of the investigation by board members and officers whose conduct is at issue may taint the ability to preserve the privilege as well as the appearance of impartiality.[23]

Rather, the Board of Directors should delegate the task of overseeing the conduct of the internal investigation and retaining counsel to conduct the investigation to the Audit Committee of the Board, the independent members of the Audit Committee, or alternatively, some group of independent Board members forming a Special Committee (hereinafter, jointly referred to as the "Independent Committee").

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20 H.R. 1086, 108th Cong., Title II, §201-221(2004) The benefits to the second, third or fourth cooperating company in Antitrust Division investigations are significantly less.

21 Press Release, Department of Justice, Assistant Attorney General for Antitrust, R. Hewitt Pate, Issues Statement on Enactment of Antitrust Criminal Penalty Enhancement And Reform Act of 2004 (June 23, 2004), *available at* http://www.usdoj.gov/atr/public/press_releases/2004/204319.htm.

22 http://www.actl.com/AM/Template.cfm?Section=All_Publications&Template=/CM/ContentDisplay.cfm&ContentFileID=68

23 *See Ryan v. Gifford*, 2007 WL 4259557 (Del. Ch. Nov. 30, 2007) (*Ryan I*); *Ryan v. Gifford*, 2008 Del. Ch. LEXIS 2 (Del. Ch. Jan. 2, 2008) (*Ryan II*).

D. Independent Outside Counsel Should Be Retained To Conduct Significant Internal Investigations

At least since the era of Enron, WorldCom, Adelphia, and other corporate scandals, government prosecutors, regulators,[24] and, increasingly, the Company's independent auditors, have looked askance at the choice of regular outside corporate counsel to conduct a sensitive inquiry. This skepticism is based on the fear that regular corporate counsel may have a motive to avoid criticizing, and thus alienating, senior management, the source of perhaps sizeable past and future law firm revenues. Regular counsel may also have given advice on matters related to the subject of the investigation and members of the firm may become witnesses in the internal, or subsequent external, investigation. Similarly, the government and outside auditors will likely be concerned that the Company's regular outside counsel's business and social familiarity with the Company's management or implicated directors will cause counsel to pull punches to avoid alienating friends. However, there may be select circumstances where regular outside counsel's knowledge of a corporation's business, special expertise, and distance from the core investigation issues and subjects permit it to conduct an objective investigation. In some cases, in fact, the government agency most interested in the investigation may agree in advance that regular counsel is the most viable choice to conduct the investigation so long as the objectivity of the effort is assured.

The Company is best served to portray itself to the government, its independent auditors, the investment community, and the media as having complete integrity and a commitment to uncovering the facts. Thus, choosing independent counsel with few if any prior ties to the Company ("Special Counsel")[25] has become commonplace and is generally regarded as the first step in convincing governmental authorities of the "authenticity" of its cooperation.[26] Such Special Counsel are perceived as not beholden to the Company and able to view facts in an objective manner, neither biased in favor of the Company or its management, nor, indeed, the governmental authorities.[27]

There are several consequences to the bias in favor of Special Counsel:

First, placing a higher value on the perception of independence than on the experience of existing counsel comes at a price: existing counsel's familiarity with the people and practices of the corporate client is lost, and the absence of such, while it might satisfy the perceptions

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24 *See* speech by SEC Commissioner Campos, "How to be an Effective Board Member," August 15, 2006, at http://www.sec.gov/news/speech/2006/spch081506rcc.htm (". . when circumstances indicate possible wrongdoing, the audit committee and the board should have their own independent advisors, investigators, and lawyers. As guided by Sarbanes-Oxley, the board and its committees should 'engage independent counsel and other advisors, as it determines necessary to carry out its duties' and should not rely exclusively on the corporation's advisors and lawyers").

25 The term "Special Counsel" is used in the same sense as the term "independent counsel" is generally used by other authors and papers. In our view, counsel that have been used occasionally by companies for individual matters should not be precluded from being selected as Special Counsel; rather, we recommend that whatever counsel is chosen, such firm not have had a substantial prior relationship with the Company.

26 Bennett, Kriegel, Rauh, and Walker, "Internal Investigations and the Defense of Corporations in the Sarbanes-Oxley Era," 62 Bus.Law.55, 57 (Nov. 2006)(hereinafter, "Bennett").

27 Indeed, some firms have specialized in the conduct of internal investigations, at the possible risk that such consistent conducting of internal investigations may tend to align the Special Counsel regularly with the interests of the regulators, rather than the Company and its shareholders.

of the regulators and independent auditors, could well cause a consequential cost increase to the public company and its shareholders.[28]

Second, the bias sometimes results in the self-perception that Special Counsel are hired in order to find wrongdoing and thus to justify the Special Committee's judgment that wrongdoing may have occurred. In this regard, it is incumbent on the Independent Committee, as well as the Special Counsel, to ensure that the Special Counsel mandate is to investigate the validity of the allegations and not to ferret out some perceived concerns for the sake of justifying what inevitably is the significant cost of the investigation.

It should be the goal of the Independent Committee, in seeking to determine the truth of the underlying allegations, to safeguard and act in the best interests of the shareholders, as well as to prevent the internal investigation from impairing the reputations of employees, officers, and directors of the Company not found to have engaged in wrongdoing. To those ends, Special Counsel should be instructed to engage in investigative tactics designed to get at the truth, including using their investigative, technological, and professional capabilities.

The Independent Committee should be aware that Special Counsel, left unchecked, could succumb to the abuses that are an occupational hazard of special prosecutors as described by then-Attorney General Robert Jackson, and cited by Justice Scalia:

> If the prosecutor is obliged to choose his case, it follows that he can choose his defendants. Therein is the most dangerous power of the prosecutor: that he will pick people that he thinks he should get, rather than cases that need to be prosecuted. With the law books filled with a great assortment of crimes, a prosecutor stands a fair chance of finding at least a technical violation of some act on the part of almost anyone. In [such cases], it is not a question of discovering the commission of a crime and then looking for the man who has committed it, it is a question of picking the man and then searching the law books, or putting investigators to work, to pin some offense on him.[29]

Third, in the current and foreseeable regulatory environment, the findings of Special Counsel are more likely to be credited by prosecutors, regulators, or private counsel (*e.g.*, when justifying settlement of a class or derivative lawsuit) if the Special Counsel is independent – *i.e.*, without a substantial prior relationship with the company or its senior management.

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28 *See* announcement by Dell Corporation of the cost of $135 million to it in retaining Special Counsel and forensic accountants to investigate issues resulting in a restatement of net income for 2003 through 2005 of between $50 and $150 million on total net income of $12 billion for that period. According to the Form 8-K, the investigation was done by 125 lawyers from Special Counsel and 250 accountants who conducted 233 interviews of 146 Dell employees and reviewed 5 million documents. *See* http://www.sec.gov/Archives/edgar/data/826083/000095013407018421/d49260e8vk.htm.

29 R. Jackson, The Federal Prosecutor, Address Delivered at the Second Annual Conference of United States Attorneys, April 1, 1940, quoted in *Morrison, Independent Counsel v. Olson, et al.*, 487 U.S. 654 (1988) (Scalia, J., dissenting).

E. The Independent Committee and Special Counsel Should Determine The Appropriate Scope of the Inquiry and the Rules of the Road

The Board should pass a resolution broadly authorizing the Independent Committee to retain counsel and their agents (e.g., auditors or other experts), conduct an investigation, and report its ultimate findings to the Board. The Independent Committee should retain the Special Counsel in writing. Special Counsel's retention letter should state the allegations under review and the scope of the inquiry, and make clear that Counsel is to advise the Independent Committee of its legal rights and obligations, as well as potential liabilities. Absent a conflict, the general counsel or regular outside counsel will advise the Company of its related rights and obligations and liabilities. The scope of the Special Counsel's engagement can be expanded in appropriate circumstances, and that expansion should also be confirmed in writing by the Independent Committee.

The scope of Special Counsel's mandate as set forth in the retention letter should be determined by the Independent Committee, in consultation with the Board, and state whether the Committee shall act for the Board or investigate and report to the Board for action. In defining the scope of the investigation, the Independent Committee must decide whether to provide Special Counsel at the outset with a broad mandate to find any and all suspected corporate wrongdoing, or a narrower mandate, at least at the outset, to examine only specific allegations or suspicions. In the latter case, Special Counsel should reassess with the Independent Committee whether additional suspicions should form the basis for a separate investigation by this or other Special Counsel or by regular counsel.

The Independent Committee and Special Counsel should also agree upon specific reporting procedures and protocols for documenting the investigation (such as the designation of all communications with legends such as "ATTORNEY-CLIENT PRIVILEGED" and, where applicable, "ATTORNEY WORK PRODUCT"). The goal at the outset should be frequent updating by oral reporting. Careful consideration should be given to the extent to which written reports should be rendered, if at all, during or at the conclusion of the inquiry. There is typically limited utility and great risk in creating interim written reports of investigation. Such interim reports run the risk of creating confusion and credibility issues, as well as potential unfairness to officers or employees who are the subjects of the investigations, if facts discovered in the latter part of the investigation are inconsistent with preliminary factual determinations or interim substantive findings.

The Board of Directors, in consultation with the Independent Committee, should also determine whether and to what extent Special Counsel may waive the Company's attorney-client privilege or its own work product protections in its dealings with regulators or other third parties.[30] We question whether there are any circumstances where Special Counsel, either on its own or with the authority of the Independent Committee, but without specific authority from the Board of Directors, should waive the Company's attorney-client privilege. We recommend that the Special Counsel not be given the authority to make such waiver decisions without prior full deliberation by the Independent Committee and the full Board, with the latter being encouraged to take advice from regular or other counsel on this decision.[31]

Nor should Special Counsel be allowed to condition its retention by the Independent Committee upon a pre-retention decision by the Independent Committee to waive all privileges. Furthermore, the engagement letter for Special Counsel should make clear that Special Counsel's work product, data, and document collection and analysis belong to the Independent Committee and the Company, not to Special Counsel, and should be returned to the Independent Committee and Company upon completion of the investigation, for possible use by the Company in its defense of possible third party or government claims.

There are times when it is far more efficient in terms of both cost and time for an outside expert to assist Special Counsel in the course of its investigations. Under Sarbanes-Oxley, the Audit Committee (which may well be functioning as the Independent Committee) has the authority to retain expert assistance in the course of an investigation.[32] The Independent Committee should exercise that authority by permitting Special Counsel to retain additional professionals, including forensic auditors, investigators, and public relations advisers, where necessary and with appropriate consultation with the Committee.

The choice of a particular expert and the manner in which it is retained are critical junctures in an investigation. In order to protect the attorney-client privilege and general confidentiality of communications between Special Counsel and its additional professionals, it is not advisable to choose professionals who also regularly or generally are employed by the Company to perform similar services, unless a very convincing case can be made that the Special Counsel's professionals are different and separated from the Company's regular professionals. In some situations, Special Counsel have conferred with prosecutors and regulators and obtained the prior approval of experts well-known to the company.

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30 *See In re Qwest Communications International Inc. Securities Litigation*, 450 F.3d 1179 (10 Cir. 2006), in which the Court held that a company's turning over to the SEC and DOJ of internal investigative documents, pursuant to a confidentiality agreement, constituted a waiver of the attorney-client and work product privileges, and rejected the doctrine of "selective waiver" or "limited waiver." See also *U.S. v. Reyes*, 2006 U.S. Dist. Lexis 94456 (N.D. Cal. Dec. 22, 2006), holding that investigating counsel's oral report to DOJ and SEC summarizing otherwise privileged internal investigation interviews created a waiver, and rejecting the concept of "selective waiver." In connection therewith, the Judicial Conference of the United .States proposed and the U.S. Senate Judiciary has reported favorably to the Senate for a floor vote S. 2450, which would enact new Rule 502 of the Federal Rules of Evidence, placing, *inter alia*, new restrictions on waivers of the attorney-client privilege, such as limitations on the scope of a waiver and inadvertent disclosure and new procedures on the effectiveness of confidentiality orders. See http://www.uscourts.gov/rules/index2.html#sen502. Notably, however, the Judicial Conference did not recommend and the Senate Judiciary Committee did not adopt any version of the "selective waiver" doctrine.

31 We note the possibility that Special Counsel may unintentionally induce an inadvertent waiver of the corporate attorney-client privilege if there are communications by Company's officers or Board members directly with Special Counsel, rather than through the Independent Committee. See *Ryan v. Gifford*, 2007 WL 4259557 (Del. Ch. Nov. 30, 2007) (*Ryan I*); see generally, Gregory P. Joseph, "Privilege Developments I," The National Law Journal, February 11, 2008. However, the confines of this paper do not allow for analysis and recommendations with respect to this circumstance.

32 15 U.S.C. 78f(m)(5) ("AUTHORITY TO ENGAGE ADVISERS- Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.")

Experts should sign retention agreements that make clear their engagement is in contemplation of providing assistance for legal advice. Conclusions of independent experts also improve the appearance to outsiders (*i.e.*, government agencies and auditors) that the investigation is in fact independent.

F. Communications to, and Indemnification of, Company Employees

Numerous management and employee morale issues will likely arise during the course of an internal investigation, especially where long-standing practices or the conduct of senior employees are under investigation. These issues should be addressed promptly by the Independent Committee, usually by a memorandum to all affected employees to keep employees abreast of general information about the purpose and expected length of the inquiry, the expectation of the Audit Committee that all employees will cooperate with the inquiry and with Special Counsel, and the need to preserve all data related to the investigation.

Importantly, the Independent Committee should explicitly communicate what constitutes "cooperation" of an employee during an internal investigation, and that an employee's refusal to cooperate in this regard may result in dismissal. In most circumstances, the cooperation of employees should include: (1) the provision, upon request, of all documents related to company business whether kept in the employee's office, home, or personal computer; (2) strict compliance with all document hold and retention notices; and (3) submission to interviews by Special Counsel.[33]

The Independent Committee should make an early determination of the extent to which employees of the Company will be authorized to retain separate representation by counsel whose fees will be advanced or indemnified, either through existing indemnification policies or new policies designed for the scope of the internal investigation (a decision that is largely governed by state law and the entity's bylaws). The Company should give consideration to distributing a memorandum to employees notifying them of the nature of any prospective investigation, the possible need for witness interviews, the Company's ability to recommend counsel for individual employees, the possibility that the Company will be responsible for advancing fees and expenses for the employee's representation, and the absolute requirement that any employee being interviewed tell the truth to Special Counsel.[34]

Whether to indemnify or advance legal fees (and the scope of any such indemnification or advancement) to employees has become a significant area of controversy under the

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33 We distinguish the situation where an employee must cooperate fully with an internal investigation, including making himself available for an interview , or be subject to employment sanctions including possible discharge, from the situation where an employee invokes constitutional protections under the Fifth Amendment not to testify before a governmental body. In the latter situation, we do not think it appropriate for a Company to sanction the employee's invocation of constitutional rights by penalty or discharge. Nor, importantly, do we think it appropriate for governmental bodies to consider a corporation non-cooperative if it does not discharge or sanction an employee who invokes such protections, see *infra* at 22. We note the observation of the U.S. Supreme Court in *Slochower v. Board of Higher Education*, 350 US 551, 557-58 (1956) that "... a witness may have a reasonable fear of prosecution and yet be innocent of any wrongdoing. The privilege serves to protect the innocent who might otherwise be ensnared by ambiguous circumstances..." and do not think a Company should be in any way penalized for respecting an employee's invocation of such constitutional right.

34 *See Bennett*, at 65.

Thompson Memorandum and will likely continue to be under the McNulty Memorandum.[35] Under the Thompson Memorandum, in making charging decisions with respect to entities, prosecutors were required to consider whether the entity was supporting "culpable employees and agents . . . through the advancing of attorney's fees."[36] In June 2006, just months before the Department of Justice issued revised guidelines through the McNulty Memorandum, a district court in the Southern District of New York held this provision of the Thompson Memorandum unconstitutional in connection with the government's prosecution of several former KPMG employees for participation in the creation of allegedly fraudulent tax shelters.[37] In that case, the court held that the government's exertion of pressure on KPMG to refuse to advance legal fees for certain of its former employees violated those employees' Fifth and Sixth Amendment rights.[38]

In response, the McNulty Memorandum softened the DOJ's guidance. Under the McNulty Memorandum, federal prosecutors "*generally* should not take into account whether a corporation is advancing attorneys' fees to employees or agents under investigation and indictment;" but may take indemnification of employees into account in "extremely rare cases" in which "the totality of the circumstances show[s] that [the advancement of fees] was intended to impede a government investigation."[39] It is yet unclear whether a federal prosecutor's invocation of this aspect of the McNulty Memorandum in "extremely rare" circumstances would survive constitutional challenge. (Judge Kaplan's initial holdings with respect to the broader provisions of the Thompson Memorandum are currently before the Second Circuit.) It is also not clear the extent to which provisions of the McNulty Memorandum dealing with corporations' waiving the applicable privileges or not denying indemnity to employees under investigation are actually being followed by the line Assistant U.S. Attorneys, by whom most investigations are being conducted.[40]

As a general matter, the SEC for its part has generally not considered, and in our view should not consider, whether an entity has chosen to indemnify or advance legal fees

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35 *See generally, United States v. Stein*, 435 F.Supp.2d 330 (SDNY 2006); *see also United States v. Stein* 452 F. Supp. 2d 230 (S.D.N.Y. 2006), *vacated by Stein v. KPMG* LLP) 486 F.3d 753 (2d Cir. 2007); *United States v. Stein*, 488 F.Supp.2d 350 (S.D.N.Y. 2007); *see also SEC v. Lucent Technologies*, Litigation Release No. 18715 / May 17, 2004, *available at* http://www.sec.gov/litigation/litreleases/lr18715.htm (Lucent fined $25 million for non-cooperation in that, *inter alia*, after reaching an agreement in principle with the staff to settle the case, and without being required to do so by state law or its corporate charter, Lucent expanded the scope of employees who could be indemnified against the consequences of the SEC enforcement action and failed over a period of time to provide timely and full disclosure to the staff on a key issue concerning indemnification of employees.)

36 *Thompson Memorandum, supra* n. 8, at 7-8.

37 435 F. Supp. 2d at 365-69.

38 *Id.* at 356-360.

39 *Id.* at 360-365.

40 In a survey conducted in 2007 by the Association of Corporate Counsel and the National Association of Criminal Defense Lawyers, corporate members were contacted via email and invited to participate confidentially in a survey to determine whether there had been or continued to be instances of prosecutorial abuse in the coercion of the waiver of their clients' attorney-client privilege or work product protection or denial of the rights to counsel or job security protections for their employees in the corporate investigation process. In a report to the U.S. Senate Judiciary Committee by the former Chief Justice of the Delaware Supreme Court, E. Norman Veasey, numerous instances of such coerced waivers and other abuses were cited, including several where Assistant U.S. Attorneys either did not know of the McNulty Memorandum, or were unfamiliar with its modifications of prior Department of Justice Practices. *See* Letter to Senate Judiciary Committee, dated September 13, 2007, *available at* http://www.abanet.org/poladv/abaday07/acpresources.html

for its employees or former employees, in determining whether the entity has been sufficiently "cooperative." (However, in 2004, the SEC took action against Lucent in part because the company "expanded the scope of employees that could be indemnified against the consequences of this SEC enforcement action," after it had reached "an agreement in principle with the staff to settle the case, and without being required to do so by state law or its corporate charter."[41]) The SEC has explicitly barred settling parties from recovering penalty payments through indemnification agreements. This policy, adopted in 2004 to purportedly "enhance deterrence and accountability," "require[s] settling parties to forgo any rights they may have to indemnification, reimbursement by insurers, or favorable tax treatment of penalties."[42] We question whether such a policy is fair to employees who may have engaged in what the SEC perceives as wrongdoing but did not do so as so-called "rogue" employees, but rather in furtherance of what they may have mistakenly believed was corporate policy. We also question what legitimate interest the SEC or, for that matter, any agency of the government has in interfering in any way with a corporation's legal right to pay the legal fees and expenses of past and present employees in defense of an investigation, trial, or appeal; with the exception of making payments for the purpose of the employee's committing acts of obstruction of justice by, for example, destroying documents, threatening witnesses, or suborning perjury.

Based upon the treatment by the SEC and the courts of indemnification and advancement of fees issues, we recommend that Independent Committees adopt a written policy at the outset of an internal investigation regarding the scope of indemnity and advancement that will be followed, presumably in adherence to its by-laws, applicable state laws, and other corporate and regulatory governance policies. The policy should include the possibility that, at the outset, the Independent Committee could desire to expand the scope of indemnity to include employees who might not be covered by the by-laws but are likely witnesses, subjects or targets of the inquiry, as well as independent contractors or acting officers of companies or their subsidiaries who perform important executive functions but are not literally within the company's standard indemnity policies. It is not recommended that, to curry favor with the regulators or governmental authorities, those individuals performing such functions be excluded from indemnification or advancement.

III. Creating an Accurate Factual Record: Document Review & Witness Interviews

Given the attention being given by prosecutors and regulators to document preservation and production, the expedient collection and review of relevant documents, and interviewing of relevant witnesses, are principal steps in ensuring an accurate factual record.

A. Mechanics of a Litigation Hold

At the outset of an investigation, counsel (likely Special Counsel in collaboration with regular or internal counsel) should identify the universe of documents that must be *preserved*,

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41 "*Lucent Settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud.*" http://www.sec.gov/news/press/2004-67.htm. ("Companies whose actions delay, hinder or undermine SEC investigations will not succeed," said Paul Berger, Associate Director of Enforcement. "Stiff sanctions and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interests of investors.")

42 Speech by Stephen Cutler, Director of Division of Enforcement, 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute, April 29, 2004, http://www.sec.gov/news/speech/spch042904smc.htm.

as opposed to the universe of documents that must be *collected.* Counsel should not send a blanket email request that all relevant documents be forwarded to a central source.

The first step should be the identification of all relevant employees who are the likely sources of documents; preliminary interviews should be conducted by regular outside counsel and internal counsel to determine such relevant employees. Then, internal counsel should send an email direction to relevant employees stating, in essence, that no documents, including electronic documents and attachments, may be destroyed without explicit approval of counsel, see *infra.*

Third, regular counsel should engage in an analysis of relevant documents to determine if others should be included in the "litigation hold." This is especially important when the organization affected by the internal inquiry is in many disparate locations. For electronic documents, this may include communicating with the "key players" to learn how they stored information. Because of the amendments to the Federal Rules of Civil Procedure pertaining to e-discovery that went into effect on December 1, 2006, internal counsel should already have prepared and have available guides to all sources of "electronically stored information" in the Company, *see* Rule 16(f), and should be prepared to institute a litigation hold on all such materials.[43]

External counsel should oversee compliance with a litigation hold, using reasonable efforts to continually monitor the party's retention and production of relevant documents.[44] Once the relevant documents are obtained, all documents should be logged in the same way that one would during traditional litigation. A revised document storage and retention policy should be established as early as possible following the collection of relevant documents. This should involve the segregation of relevant backup electronic media, which in some cases may necessitate counsel's taking physical possession of backup tapes.[45]

As with traditional litigation, care should be taken to avoid over- or under-production during discovery. Over-producing data, especially in light of the volume of electronic media, can greatly drive up fees without yielding additional relevant data. An even greater risk of over-production or uncontrolled production is the waiver of privilege, which can result when documents are produced in their native application formats without care being taken to reveal metadata or

43 Among the varieties of electronically stored information, or "ESI," is one particular type called "metadata," defined by one Federal Magistrate Judge, as "(i) information embedded in a ESI in Native File [the electronic format of the application in which such ESI is normally created, viewed and/or modified] that is not ordinarily viewable or printable from the application that generated, edited, or modified such Native File; and (ii) information generated automatically by the operation of a computer or other information technology system when a Native File is created, modified, transmitted, deleted or otherwise manipulated by a user of such system." Suggested Protocol for Discovery of Electronically Stored Information, *In re Electronically Stored Information,* U.S.D.C., D.Md (Magistrate Judge Paul Grimm)(2007), *available at* http://www.mdd.uscourts.gov/news/news/ESIProtocol.pdf at pgs. 2-3. Metadata has provided Special Counsel with the ability to view drafts of documents and emails, including electronic information concerning the creation, formation, editing of such document, as well as the author or viewer of such edits and the dates of creation and viewing.

44 *See Zubulake v. UBS Warburg,* 2004 WL 1620866 (S.D.N.Y. July 20, 2004) ("Zubulake V"). *See also Telecom International Am. Ltd. V. AT&T Corp.,* 189 F.R.D. 76, 81 (S.D.N.Y. 1999) ("Once on notice [that evidence is relevant], the obligation to preserve evidence runs first to counsel, who then has a duty to advise and explain to the client its obligations to retain pertinent documents that may be relevant to the litigation") (citing *Kansas-Nebraska Natural Gas Co. v. Marathon Oil Co.,* 109 F.R.D. 12, 18 (D.Neb. 1983)).

45 *In re Electronically Stored Information, supra* n. 41, at 10.

maintain relationships between attachments and emails. Under-production and spoliation during the discovery process may result in sanctions ranging from adverse inference instructions[46] to default judgments because of counsel's insufficient actions[47] to monetary fines.[48]

B. Document Collection & Review

Document collection is usually accomplished by the Company's regular outside and internal counsel, and then review of the documents and interviewing of witnesses by Special Counsel. The relevant universe of hard-copy and electronic documents must be identified and collected as early as possible in the investigative process, even before Special Counsel is retained, so that all available information will be preserved and there will be a sufficient factual background to identify relevant witnesses and conduct efficient interviews by asking the appropriate questions and being able to refresh witnesses' recollections.

Inside counsel and internal technology experts can be particularly helpful in identifying processes and sources of documents, and in coordinating the document collection process; each should play a major role in supervising the gathering, production, and preservation of documents, including electronic documents. However, once the Independent Committee has been appointed and Special Counsel retained, we recommend that the function of document analysis should be that of the Special Counsel and retained technology professionals to retrieve, host, and analyze electronic and hard documents. Internal technology professionals should be used only in those circumstances in which the Company has a sufficiently sophisticated staff that is trained in issues that may become critical in a subsequent litigation (*i.e.*, chain of custody) or in a government investigation (*i.e.*, the preservation of metadata).

C. Witness Interviews

After relevant documents are reviewed (assuming time permits), Special Counsel should identify the relevant witnesses and begin conducting the interviews. Investigating lawyers should be aware that they could become witnesses in a criminal or civil procedure where an issue arises as to what statements a witness made to them during the investigation. In certain cases, such as when the scope of the issues are unclear, it may make sense for Special Counsel to begin the interview process before all relevant documents can be digested. Careful consideration should be given as to who should attend each interview both for reasons of obtaining objective responses and for ensuring the appearance of obtaining objective responses. Whether inside counsel should be present during the employee interviews is an issue that should receive special attention. The risks of having internal counsel present at the interview include inadvertently chilling the employee's ability to be forthcoming and having the employee incorrectly perceive that she is represented personally

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46 *See In Re Seroquel Products Liability Litigation,* 244 F.R.D. 650 (M.D.Fla., Aug. 21, 2007) (granting in part a motion for sanctions against the defendant for failure to produce the discovery in usable format).

47 *See Metropolitan Opera Assoc., Inc. v. Local 100, Hotel Employees & Restaurant Employees International Union,* 212 F.R.D. 178, 222 (S.D.N.Y. 2003).

48 *See In the Matter of Banc of America Securities LLC,* Admin. Proc. File No. 3-11425, Mar. 10, 2004, *available at* http://www.sec.gov/litigation/admin/34-49386.htm (fining Banc of America $10,000,000 for violating sections 17(a) and 17(b) of the Exchange Act for failure to produce documents during a Commission investigation).

by the internal counsel. It may also inadvertently trigger concerns by external auditors or regulators that inside counsel may herself be a potential wrongdoer, and thus inappropriately present when interviews are being conducted. At the very least, the issue should be thoroughly vetted with the Independent Committee before inside counsel takes a seat at the investigating table.

In some instances, it may be necessary for the Company to hire separate legal counsel for employees who are being interviewed that may have — or may appear to have — interests adverse to the Company. However, depending upon the Company's by-laws, it should not be necessary to retain such counsel until such adversity becomes sufficiently clear, or until an employee makes a reasonable request for separate counsel. An employee may on her own choose to seek the advice of counsel and ask that counsel be present for the interview. Absent exigent circumstances, *e.g.*, the need to immediately conduct interviews in order to qualify for corporate amnesty under Antitrust Division Corporate Leniency Program, a company should not refuse to grant such a request for counsel. However, as indicated earlier, an employee should be advised that his failure timely to cooperate – which includes fully submitting to interviews by Special Counsel – may result in adverse employment consequences including dismissal.

Special Counsel should be especially wary of the situation that arises frequently in the course of an internal investigation, when an employee who is otherwise without counsel is about to be interviewed and, before or as an interview is being conducted, asks whether she needs to consult counsel, or if she retains counsel, would the Company pay for such counsel. Special Counsel is best advised under these circumstances to remind the witness that he does not represent her and that if she wishes to speak to counsel, the Special Counsel would be willing to adjourn the interview for a reasonable time to allow such consultation, and, assuming that the Company's by-laws so allow, to consider the Company's indemnification of the employee's costs of counsel and advancement of fees and expenses.

As discussed above, advance preparation for such contingencies should include consultation with the Independent Committee at the outset of the engagement regarding the scope of the Company's obligations to indemnify and advance fees to categories of directors, officers, and employees.

The Independent Committee should also decide whether Special Counsel will agree with counsel for employees to make documents available to them for review before conducting interviews. Absent special circumstances such as valid concerns of possible witness tampering, obstruction of justice, other evidence of attempts to disrupt the integrity of the internal investigation, or an inability to retrieve and review voluminous documentation, Special Counsel generally should not interview witnesses before the witnesses have had a chance to review relevant documents. We specifically disapprove of Special Counsel's attempting to interview a witness who has not been given an adequate opportunity to refresh his recollection as to prior events by reviewing key hard or electronic documents, or Special Counsel's succumbing to pressure from prosecutors or regulators to attempt to do so, in an effort to trap a witness into a misstatement, which would otherwise not occur if the witness were properly refreshed with all relevant documents and electronic communications. This is particularly true since the government has indicted several executives in obstruction of justice cases in recent years based on alleged misstatements to outside counsel during the course of an investigation.[49] Accordingly, before interviews of officers and employees, and whenever practical, Special Counsel should make available to counsel for employees the topics and documents that will be covered in the interview, and allow employees to obtain copies of their documentary files, including calendars and electronic data.

At the outset of the interview, in addition to providing an overview of the investigation and the purpose of the interview, Special Counsel should make very clear that (1) Special Counsel represents the Company (or the Independent Committee, as the case may be); (2) Special Counsel is not the employee's lawyer and does not represent the employee's interests separate from those of its own client; (3) the conversation is protected by the attorney-client privilege, but the privilege belongs to the Company; and therefore (4) the Company can choose to waive its privilege and disclose all or part of what the employee has told Special Counsel during the interview to external auditors, the government, regulators, or others. Employees also should be apprised of their rights and responsibilities if they are contacted by regulators or prosecutors and asked to subject themselves to an interview, including the ability, without employment sanction, to invoke constitutional rights.

In light of the position taken by the DOJ, as indicated above, that an employee can be indicted for obstruction of justice under 18 U.S.C. 1512, if she lies to private counsel conducting an internal investigation, where she knows that her statements may be shared with a government agency such as the SEC or DOJ conducting its own investigation, we recommend that Special Counsel advise employees at the outset of the interview whether the Company has made a decision to waive the attorney-client privilege and work product protections, or is likely to do so, and to disclose the memorandum of interview to governmental authorities. In recent years, the government has brought several such cases.[50] It should be anticipated that an employee, being so advised, would seek individual counsel and Special Counsel should be prepared to accommodate the request for an adjournment to seek such counsel.

The interviews should be memorialized in a manner consistent with the attorney work-product doctrine and the ultimate purpose of the investigation. A memorandum should be prepared by Special Counsel of the substance of each witness's interview as close in time to the interview as possible. Ultimate decisions on the contents of the memorandum of a witness's interview should be Special Counsel's. However, fairness, and the possible use of such memoranda in follow-up inquiries by Special Counsel, regulators, or prosecutors, causes us to recommend that counsel for witnesses be given reasonable opportunity to review the memoranda for substance and to recommend possible modifications (which Special Counsel may, but is not compelled to, adopt, especially where the recommended modifications are, in Special Counsel's opinion, contrary to what was stated at the interview) so as to avoid misstating or mischaracterizing a witness's statements and

49 *See* text, *infra*, at n. 50.

50 *Id.*

to address adverse inferences that may be submitted in company proffers.[51] Special Counsel should consider reading, explaining the substance of, or showing a draft of the memorandum of interview of the witness to counsel for interviewed witnesses to review for accuracy but not to keep a copy thereof.[52]

In addition, if a final written report is to be prepared, we recommend that tentative conclusions as to witnesses' conduct should, as a matter of fairness and completeness, be shared with counsel for present or former employees whose conduct is under examination for possible correction, modification or explanation. Again, we do not suggest that Special Counsel is obligated to adopt any modification suggested, but rather only to give any suggestion whatever weight is in Special Counsel's opinion warranted under the circumstances.

The question of the extent to which, if at all, privileged and work-product protected material should be made available to the company's independent auditors, if, as would be expected, they so request, is highly complex.[53] There is little, if any, authority to support the view that dissemination of privileged information to an independent auditor does not create a waiver of the privilege. With respect to the production to external auditors of Special Counsel's work product prepared in anticipation of litigation, the decisions are inconsistent regarding whether doing so constitutes a waiver.[54] In the latter circumstance, we believe that entry into a written agreement with the independent auditor, acknowledging the confidentiality of the information shared and assuring that it will be held in confidence *might* be effective in some jurisdictions despite *Medinol*. However, under current case law, it is doubtful that any written confidentiality agreement with the independent auditor with respect to privileged material could prevent a waiver from being found. Notwithstanding

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51 *See U.S. v. Kumar, E.D.N.Y., DOJ News Release, September 22, 2004* ("Former Computer Associates executives indicted on securities fraud, obstruction charges"), *available at* http://www.usdoj.gov/opa/pr/2004/September/04_crm_642.htm ("Shortly after being retained, the company's law firm met with [executives] in order to inquire into their knowledge of the practices that were the subject of the government investigations. During these meetings, the defendants ... allegedly presented to the law firm an assortment of false justifications to explain away evidence of the 35-day month practice. The indictment alleges that [the defendants] ... intended ... that the company's law firm would present these false justifications to the U.S. Attorney's Office, the SEC and the FBI in an attempt to persuade the government that the 35-day month practice never existed").

52 We note the possible argument that disclosure to a witness or her counsel of the substance of a draft memorandum of interview or of tentative conclusions as to a witness's conduct may be deemed a waiver of the corporate privilege and perhaps Special Counsel's work product. We believe that risk of the success of such argument may be able to be mitigated by conditioning such limited disclosure upon the execution of a narrow "common interest" agreement between Special Counsel and counsel for the witness, premised upon the common interest that exists to prevent inadvertent factual errors and conclusions based thereon from being made by Special Counsel and the Independent Committee. See *Ryan v. Gifford I, supra* ("Under [the common interest] exception [to the attorney-client privilege],... for the communication to remain privileged even after its disclosure to others, the "others [must] have interests that are 'so parallel and non-adverse that, at least with respect to the transaction involved, they may be regarded as acting as joint venturers.'" *Saito v. McKesson HBOC, Inc.*, No. 18553, 2002 WL 31657622, at *4 (Del. Ch. Nov. 13, 2002) (citing *Jedwab v. MGM Grand Hotels, Inc.*, No. 8077, 1986 WL 3426, at *2 (Del. Ch. Mar. 20, 1986))."

53 See Brodsky, Palmer, and Malionek, "The Auditor's Need For Its Client's Detailed Information vs. The Client's Need to Preserve the Attorney-Client Privilege and Work Product Protection: The Debate, The Problems, and Proposed Solutions," http://www.abanet.org/buslaw/attorneyclient/publichearing20050211/schedule.shtml

54 *See Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002) (holding that the disclosure of an internal investigation report to outside auditors waives both the attorney-client and work-product privileges, because the auditor's interests are not necessarily aligned with the corporation's interests). *But see Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2004 WL 2389822 (S.D.N.Y. 2004) (holding that the disclosure of internal investigation reports to outside auditors, while waiving the attorney-client privilege, does not waive the work product privilege because under the facts of the case the auditor and the corporation is not the equivalent of the type of tangible adversarial relationship contemplated by the work product doctrine).

the resulting dilemma to the Independent Committee and the Board of Directors, we believe there may well be circumstances where the independent auditor will insist that presentation of privileged material is a *sine qua non* for the certification of financial statements. Under those circumstances, a Board may have no choice but to authorize the delivery of such materials. However, we recommend that all other alternative courses of action be first explored with the independent auditors before such an outcome. We further recommend that Special Counsel be advised by the Board and Independent Committee at the outset of the engagement not to share information with the Company's external auditors without the written, fully informed consent of both the Independent Committee and the Company's Board. We recommend that the Board formally consider and decide the production and waiver issue before any steps leading to waiver are taken.

IV. Developing a Record of the Investigation

During the course of the investigation, we recommend that Special Counsel keep and continuously update a record of witnesses and documents examined, documents shown to witnesses, and issues being raised. We also recommend that the Independent Committee be regularly updated on the course of the investigation. Under certain circumstances, these updates, especially those being done in the early stages of an inquiry, should be made orally, because the possibility exists that preliminary information gathered or early conclusions formed may well prove to be inaccurate or incomplete; premature recording of such information or conclusions could well be prejudicial to the company as well as implicated employees. In particular, once the Special Counsel has conveyed early impressions to the Independent Committee (based on preliminary reviews of documents and early interviews), those impressions may, as a practical matter, prove embarrassing to modify or be impossible to eradicate from the minds of the Independent Committee.

Once the investigation has been completed, Special Counsel must report its findings, conclusions, and bases to the Board, the Audit Committee, or the Independent Committee, as the case may be. Careful and early consideration must be given to whether the ultimate form of the report will be written or oral, and the effect of preparing a report on issues concerning the corporate attorney-client privilege and work product protections. The form of the report and the nature of its preliminary dissemination should be analyzed because of the likelihood that some version of the report will likely make it into the hands of government authorities or plaintiffs' attorneys, resulting in the substantial risk of enhanced civil litigation against the Company, and the officers and directors. If the report is to be written, careful consideration must be given to whether it will be posted on a website[55], and whether it will be turned over to prosecutors, regulators, and the independent auditor. [56]

Special Counsel should be careful to remind the governing body that the report's conclusions are ultimately that of the Independent Committee, not just Special Counsel, and that the Board members have fiduciary responsibilities to draw their own conclusions as to the evidence presented, and should not simply accept the conclusions as drawn by Special Counsel without a full understanding of the bases for such conclusions.

V. The External Investigation

A. Role of Special Counsel in Follow-on Investigations and Civil Litigation.

The Company may be tempted to use the services or work product of its Special Counsel in connection with its defense of external investigations and civil litigation. However, many experienced General Counsel and practitioners believe that Special Counsel should not be used as Company defense counsel, lest the independence of the Special Counsel be brought into question, and the legitimacy of the inquiry be compromised. We recommend that such follow-up inquiries be handled by counsel other than Special Counsel; otherwise, the view of Special Counsel as being independent of management will likely be dissipated, and external auditors, as well as regulators or prosecutors, are likely to disregard the work of such Special Counsel as being the product of bias.

B. Use of Work Product of Special Counsel

As to whether the documents and database accumulated by the Special Counsel may be utilized by Company or employee counsel to minimize expenses to the Company and maximize the speed of preparation, we recommend that, absent genuine regulatory concerns regarding possible obstruction of justice, such documents and databases should be available for that use, once stripped of the evidence of the internal thought processes of Special Counsel.

Among the more difficult issues facing Company counsel that has inherited such document depositary and work product is the extent to which such should be made available to counsel for present or former employees, who are likely also facing civil litigation and regulatory

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55 Posting a copy of an internal investigative report to the Independent Committee on a website or otherwise making it available to the public runs the risk of waiving both the protections of the work product doctrine and the corporate attorney-client privilege. *In re Kidder Peabody Securities Litigation*, 168 F.R.D. 459, 467, 469-70 (SDNY 1996) ("The decision to release the report appears, in retrospect, to have been virtually a foregone conclusion from the outset since this was a crucial aspect of Kidder's public relations strategy... In practical terms this means that Kidder's waiver by publication requires disclosure of those portions of the interview documents that are specifically alluded to in the [Special Counsel] report.")

56 *See Ryan v. Gifford*, 2007 WL 4259557 (Del. Ch. Nov. 30, 2007) (*Ryan I*), where it was held that delivery of a report by a special investigative committee, set up following the filing of a derivative action, to a Board of Directors consisting of several directors who were also named as defendants in the derivative action, constituted a full waiver of the privilege as to all communications between the committee and its counsel, including all correspondence between the special committee and its counsel, the investigation report, and all correspondence between the company and counsel to the special committee. Several unusual factors contributed to the finding of waiver. For example, because the directors were present at the committee's report in their personal, not fiduciary, capacities, the Court found the privilege had been waived, particularly as their personal attorneys were present and they used the committee's findings in their individual defenses. Furthermore, the special committee lacked sufficient authority to take action independent of the other board members.

investigations. Although outside the strict boundaries of this paper, we again believe that, absent genuine concerns about obstruction of justice, fairness dictates that such materials be made available on an individualized basis to such present or former employees, especially since it is likely that they have also been made available already to the Department of Justice, SEC, or other regulators.[57] Accordingly, we also recommend that the presumption be that the work product of Special Counsel such as witness interviews conducted by Special Counsel should be made available, on an individualized basis, to counsel for present or former employees, again, absent genuine concerns of obstruction of justice.

VI. Recommendations

1. An organization should take steps to consider an internal investigation when allegations have been lodged of significant corporate malfeasance or where an outside auditor gives notice that it suspects the possibility of illegal corporate activity. A Board of Directors, an audit, or a special committee may in select circumstances conclude that it is not in the best interests of the Company to investigate, disclose to, or cooperate with the government. In reaching the decision as to what is in the best interests of the shareholders, the Board, audit committee, or special committee may weigh and consider published prosecutorial and regulatory policies, related cases and dispositions, DOJ and/or SEC statements and the impact and costs of actual or anticipated litigation on the Company.

2. Where the alleged or suspected conduct involves senior officers or serious employee misconduct, or where the corporate entity is the focal point of a government inquiry, management, including usually the general counsel's office, should not be, and should not be perceived to be, in charge of the internal investigation.

3. A committee of the Board of Directors consisting of the independent members of the Board (the "Independent Committee") should be delegated the task by the Board of Directors of overseeing the conduct of the internal investigation when allegations have been lodged of significant corporate malfeasance or where an outside auditor gives notice that it suspects the possibility of illegal corporate activity and retaining counsel to conduct the investigation.

4. The goal of the Independent Committee should be to seek to determine the truth of the underlying allegations, to safeguard and act in the best interests of the shareholders, and to prevent the internal investigation from impairing the reputations of employees, officers, and directors of the Company not found to have engaged in wrongdoing.

5. The Board should pass a resolution broadly authorizing the Independent Committee to retain counsel and their agents, conduct an investigation, and report its ultimate findings to the Board. In order to preserve communications between the Committee and the Board as privileged, the Committee should have authority to take action independent of the Board.

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57 It should be noted that the Department of Justice is on record in at least one option backdating case that disclosure of witness interview memoranda of Special Counsel to counsel for derivative plaintiffs, and other parties, would constitute premature disclosure of the substance of testimony from potential Government witnesses and would facilitate efforts by subjects and potential criminal defendants to manufacture evidence and tailor their testimony and defenses to conform to the Government's proof. *In re UnitedHealth Group Shareholder Derivative Litigation*, USDC, D.Minn., Civil No. 06-1216JMR/FLN.

6. Outside counsel which has not had a substantial prior relationship with the Company and its senior management ("Special Counsel") should be retained to conduct significant internal investigations.

7. The Independent Committee should retain the Special Counsel in writing. Special Counsel's engagement letter should state the allegations under review, the scope of the inquiry, and make clear that Special Counsel is to advise the Company of its legal rights and obligations, as well as its potential liabilities.

8. The scope of the Special Counsel's engagement can be expanded in appropriate circumstances, and that expansion should also be confirmed in writing by the Independent Committee.

9. The Special Counsel should be instructed to engage in investigative tactics designed to get at the truth of the underlying allegations of wrongdoing, including using such investigative, technological, and professional techniques of which they are capable.

10. It should not be the goal of the Special Counsel, absent specific mandate from the Independent Committee, to investigate any perceived wrongdoing by corporate officers or employees wherever it may occur.

11. The Independent Committee and Special Counsel should also agree upon specific reporting procedures and protocols for documenting the investigation.

12. The Independent Committee should also determine whether and to what extent Special Counsel may waive the Company's attorney-client privilege or its own work product protections in its dealings with regulators or other third parties. The waiver of these protections is a major corporate decision that requires full and frank discussion of the benefits of these privileges and the impact of a waiver on prosecutorial, regulatory or parallel proceedings. In few, if any, cases, should Special Counsel be given the authority to make such waiver decisions on its own without prior full deliberation by the Independent Committee and the full Board, with the latter being encouraged to take advice from regular or other counsel on this decision.

13. Special Counsel should not be allowed to condition its retention by the Independent Committee upon a pre-retention decision by the Independent Committee to waive all privileges.

14. The engagement letter for Special Counsel should make clear that Special Counsel's work product, data, and document collection and analysis belongs to the Independent Committee and their Special Counsel, and upon completion of the investigation, may, in appropriate circumstances, be shared under the common interest privilege with the Company for possible use in its defense of third party or government claims. Any sharing of the materials with any director-defendants should be done only if it is clear those directors are acting in their fiduciary, not individual, capacities; to this end, their individual counsel should not be present and the directors should not use those materials in their individual defenses, or else the common interest privilege could be waived.

15. The Independent Committee should authorize the Special Counsel in writing to retain additional professionals, including forensic auditors, investigators, and public relations advisers, where necessary.

16. Experts should sign retention agreements that make clear their engagement is in contemplation of providing assistance for legal advice.

17. The Independent Committee should consider promptly addressing management and employee morale issues by a memorandum to all affected employees to keep employees abreast of general information about the purpose and expected length of the inquiry, and the expectation that all employees will cooperate with the inquiry and with Special Counsel.

18. The Independent Committee should explicitly communicate what constitutes "cooperation" of an employee during an internal investigation, and that an employee's refusal timely to cooperate in this regard may result in dismissal. In most circumstances, the cooperation of employees should include: (1) the provision upon request of all documents related to company business whether kept in the employee's office, home, or personal computer; (2) strict compliance with all document hold and retention notices; and (3) submission to interviews by Special Counsel.

19. At the outset of an investigation, the Independent Committee should adopt a written policy regarding the scope of indemnity and advancement to directors, officers and employees, or others affiliated with the Company, in adherence to its by-laws, other corporate governance policies or new policies designed for the scope of the internal investigation.

20. The Independent Committee should also consider, at the outset of an internal investigation, adopting a written policy expanding the scope of indemnity to include employees otherwise not covered by normal indemnification policies, and independent contractors or acting officers of companies or their subsidiaries who perform important executive functions but are not literally within the company's standard indemnity policies. The adoption of any expanded indemnification or advancement policy should be adhered to, once adopted, and not thereafter expanded to include those originally excluded, unless the scope of the investigation is altered.

21. The Independent Committee should give careful consideration to distributing a memorandum to affected employees notifying them of the nature of any prospective investigation, the possible need for witness interviews, the ability of the Company to recommend counsel for individual employees, the possibility that the Company will be responsible for advancing fees and expenses for the employee's representation, and the requirement that any employee asked to give an interview cooperate and tell the truth to Special Counsel.

22. External counsel should oversee compliance with a litigation hold, using reasonable efforts to continually monitor the party's retention and production of relevant hard-copy and electronic documents.

23. The relevant universe of hard-copy and electronic documents must be identified and collected as early as possible in the investigative process, even before Special Counsel is retained.

24. Special Counsel and retained forensic professionals should conduct document review and analysis of electronic and hard documents.

25. Assuming time permits, after review and analysis of documents, Special Counsel should identify the relevant witnesses and begin conducting the interviews.

26. At the outset of the interview, Special Counsel should advise each witness that (1) the Special Counsel represents the Independent Committee, (2) Special Counsel is not the employee's lawyer and does not represent the employee's interests; (3) statements made to the Special Counsel should be truthful; (4) the interview is protected by the attorney-client privilege, but the privilege belongs to the Company; and (5) the Independent Committee can unilaterally choose to waive its privilege and disclose all or part of what the employee has told Special Counsel during the interview to external auditors, the government, regulators, or others.

27. The Independent Committee and Special Counsel should give careful consideration as to whether inside counsel should attend witness interviews, with an eye to maximizing the possibility of obtaining objective responses and to ensuring the appearance of obtaining objective responses.

28. Special Counsel should advise employees at the outset of the interview whether the Company has made a decision to waive the attorney-client privilege and work product protections, or is likely to do so, and to disclose the memorandum of interview to governmental agencies such as the SEC or DOJ that is conducting its own investigation.

29. Special Counsel should tell witnesses at the outset of the interview that the Department of Justice has taken the position that an employee can be indicted for obstruction of justice under 18 U.S.C. § 1512, if he or she lies to private counsel conducting an internal investigation, where he or she knows that his or her statements may be shared with a government agency such as the SEC or DOJ that is conducting its own investigation.

30. Absent special circumstances such as valid concerns of possible witness tampering, obstruction of justice, other evidence of attempts to disrupt the integrity of the internal investigation or the unavailability of hard-copy or electronic documents, Special Counsel should make available to witnesses or their counsel the topics and documents that will be covered in the interview, and allow employees to obtain copies of their documentary files, including calendars and electronic data.

31. Absent special circumstances such as valid concerns of possible witness tampering, obstruction of justice, or other evidence of attempts to disrupt the integrity of the internal investigation, Special Counsel should not generally interview witnesses before they have had a reasonable opportunity to review relevant documents.

32. Absent special circumstances such as valid concerns of possible witness tampering, obstruction of justice, or other evidence of attempts to disrupt the integrity of an investigation, Special Counsel should resist attempts by prosecutors or regulators to seek the Special Counsel's interview of a witness who has not been given an opportunity to refresh his recollection as to prior events.

33. Special Counsel should not advise an employee whether he or she should seek the advice of individual counsel, lest the employee misunderstand the role of Special Counsel as being the exclusive representative of the Independent Committee. Under these circumstances Special Counsel should remind the witness that the Special Counsel does not represent the witness and that if he or she wishes to speak to counsel, the Special Counsel will adjourn the interview for a short time to allow such consultation, and, if previously authorized by the Independent Committee, to provide recommendations of counsel.

34. Special Counsel should memorialize the substance of each witness interview as close in time to the interview as possible and in a manner consistent with the attorney work-product doctrine and the ultimate purpose of the investigation.

35. Absent special circumstances such as valid concerns of possible witness tampering, obstruction of justice, or other evidence of attempts to disrupt the integrity of an investigation, Special Counsel should give counsel for witnesses an opportunity to suggest modifications to the memoranda so as to avoid misstating or mischaracterizing a witness's statements. Special Counsel should consider reading, explaining the substance of, or showing a draft of the memorandum of the interview of the witness to counsel for interviewed witnesses to review for accuracy, but not to keep a copy thereof.

36. Absent special circumstances such as valid concerns of possible witness tampering, obstruction of justice, or other evidence of attempts to disrupt the integrity of an investigation, if a final written report is to be prepared, Special Counsel should share tentative conclusions as to witnesses' conduct with counsel for present or former employees whose conduct is under examination for possible correction or modification.

37. If the company's independent auditors request access to privileged information or the Special Counsel's work product, the Independent Committee should first explore all other alternative courses of action, but should not have the power or authority to decide the issue on its own. The Independent Committee should give careful consideration to such request and make a recommendation to the Board. The Special Counsel should be advised by the Board and Independent Committee at the outset of the engagement <u>not to share</u> information with the Company's external auditors without the written, fully informed consent of both the Independent Committee and the Company's Board.

38. We recommend that the Board formally consider and decide the issue of production to the independent auditors before any steps leading to waiver are taken. In light of inconsistent decisions regarding whether production of Special Counsel's work product to external auditors constitutes a waiver of the work product protections, it is important to enter into a written confidentiality and common interest agreement with external auditors that allows for work product information to be provided without a waiver issue arising.

39. During the course of the investigation, Special Counsel should keep and continuously update a record of witnesses and documents examined, documents shown to witnesses, and issues raised.

40. Special Counsel should regularly update the Independent Committee on the course of the investigation. In the early stages of an inquiry, updates should generally be made orally, because of the possibility that preliminary information gathered or early conclusions formed might prove to be inaccurate or incomplete, and prejudicial to the company as well as employees implicated by them.

41. Upon the completion of the investigation, Special Counsel should report its findings and the conclusions, and the bases therefor, to the Board, the Audit Committee, or the Independent Committee, as the case may be. Special Counsel should be careful to remind the governing body that the report's conclusions are ultimately that of the Independent Committee, not just Special Counsel, and that the Board members have fiduciary responsibilities to draw their own conclusions as to the evidence presented.

42. Before presentation of the final report, the Independent Committee and Special Counsel should again give careful consideration to whether the ultimate form of the report will be written, oral or PowerPoint, to whom it will be provided, and how it will be published.

43. Special Counsel should not be used as Company defense counsel in civil or criminal litigation or investigations that follow the internal investigation.

44. Absent genuine regulatory concerns regarding possible obstruction of justice, the database of documents and selected work product, once stripped of the evidence the internal thought processes of Special Counsel, should be made available for use by any Special Litigation Committee, counsel to the Company, and on an individualized basis, to counsel for present or former employees.

Attachment B

American Bar Association Criminal Justice Section, White Collar Crime Committee Working Group, "Upjohn Warnings: Recommended Best Practices When Corporate Counsel Interacts With Corporate Employees," July 17, 2009.

ABA WCCC WORKING GROUP, July 17, 2009

UPJOHN WARNINGS: RECOMMENDED BEST PRACTICES WHEN CORPORATE COUNSEL INTERACTS WITH CORPORATE EMPLOYEES

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I. EXECUTIVE SUMMARY

This Report and Recommended Best Practices are the product of a Task Force established in early-2008 by the White Collar Crime Committee of the American Bar Association's Criminal Justice Section. They are intended to address an increasingly-common question associated with the attorney-client privilege: What best practices should corporate counsel follow when interacting with corporate employees while conducting internal investigations on behalf of the corporate entity? In particular, what advice or warnings – commonly referred to as Upjohn warnings, or corporate Miranda warnings – should corporate counsel (attorneys for any legal entity that is distinct from its members) provide to corporate officers, employees, shareholders, directors and trustees (collectively referred to as "Constituents"[1]) and how should counsel give those warnings?

Upjohn warnings are named after *Upjohn v. United States*, 449 U.S. 383 (1981), the case in which the Supreme Court made clear that the corporate attorney-client privilege applied to a much wider group of Constituents than the corporation's "control group." Although *Upjohn*, itself, does not reach the issue of warnings, the case confirmed that communications between corporate counsel and corporate employees were potentially privileged. Out of the *Upjohn* decision, issues arose as to who held the privilege (the corporation, the corporate employee, or both) and who could waive the privilege associated with such communications.

Whether the corporation, the Constituent, or the corporation and the Constituent hold the attorney-client privilege has taken on special significance with the promulgation of federal corporate prosecution guidelines that have incentivized corporations under investigation to waive the privilege in order to gain cooperation credit. In the typical case, a corporation that is alleged

[1] "Officers, directors, employees, and shareholders are the constituents of the corporate organizational client." MODEL RULES OF PROF'L CONDUCT R. 1.13(a) cmt. 1 (2004).

to have committed wrongdoing will retain counsel to conduct an internal investigation to assess the allegations and provide legal advice. Corporate counsel will, in turn, interview the relevant Constituents who possess knowledge about the allegations. Those interviews – involving only corporate counsel and the Constituent – are usually subject to a legitimate claim of attorney-client privilege.

But if the corporation later comes under investigation, especially federal investigation, it may seek to obtain cooperation credit – to mitigate criminal or civil regulatory exposure – by waiving the privilege and producing to the government the statements made by Constituents to corporate counsel during the internal investigation. Upjohn warnings have therefore emerged as the mechanism for making clear to Constituents that the corporation, and the corporation alone, is the holder of the privilege. In the absence of such warnings, Constituents may be able to assert that they, too, hold the privilege: that, as privilege holders, they elect not to waive the privilege, and that the corporation may not produce their statements to government investigators. By providing unambiguous warnings, corporate counsel may be able to limit later disputes over the extent and nature of the attorney-client relationship, and Constituents are better able to assess their own risks.

II. RECOMMENDED BEST PRACTICES

The following "best practices" are intended to provide guidance to corporate counsel. As "best practices," they sometimes go beyond what may be required by model rules and applicable case law. The objective is not to impose additional burdens on corporate counsel, but to make sure that investigations are conducted in a way that abides by the operative principles, and simultaneously protects the attorney-client privilege between counsel and the corporation.

A. Suggested Upjohn Warning

I am a lawyer for or from Corporation A. I represent only Corporation A, and I do not represent you personally.

I am conducting this interview to gather facts in order to provide legal advice for Corporation A. This interview is part of an investigation to determine the facts and circumstances of X in order to advise Corporation A how best to proceed.

Your communications with me are protected by the attorney-client privilege. But the attorney-client privilege belongs solely to Corporation A, not you. That means that Corporation A alone may elect to waive the attorney-client privilege and reveal our discussion to third parties. Corporation A alone may decide to waive the privilege and disclose this discussion to such third parties as federal or state agencies, at its sole discretion, and without notifying you.

In order for this discussion to be subject to the privilege, it must be kept in confidence. In other words, with the exception of your own attorney, you may not disclose the substance of this interview to any third party, including other employees or anyone outside of the company. You may discuss the facts of what happened but you may not discuss *this* discussion.

Do you have any questions?

Are you willing to proceed?

B. Recommended Procedures to Follow

Although the facts of the particular situation may call for different warnings, a number of general principles should guide Upjohn warning practices:

First, counsel should provide the warnings to the Constituent before the interview is conducted.

Second, counsel should orally advise the Constituent of the Upjohn warnings, and should utilize a prepared written statement to ensure that the warnings are consistently and accurately given in each interview.

Third, counsel should make a record that the warnings have been provided through, at minimum, handwritten notes or the creation of a contemporaneous memorandum of the interview.

C. Counsel Interviewing Constituents

The following is suggested for the typical situation where corporate counsel seeks to interview a Constituent.

1. Upjohn warnings should inform the Constituent that the investigating attorney is representing the corporation and is not representing the Constituent.

2. The warnings should be explicit and unambiguous to ensure that the Constituent does not believe that the Constituent has formed an attorney-client relationship with the investigating attorney.

3. The purpose of the interview should be made clear so it is apparent that counsel is acting on behalf of the corporation, and that counsel is gathering information for the corporation in order to provide legal advice to the corporation.

4. Counsel should give the Constituent the opportunity to ask questions about the Upjohn warnings and counsel's role. This helps ensure that the Constituent understands the Constituent's relationship with counsel.

5. The warnings should inform the Constituent that the interview is subject to the attorney-client privilege and, as such, the interview is regarded by the corporation as confidential and the Constituent may not disclose the substance of the interview – questions asked by counsel and answers given to those questions – to third parties outside the corporation because that could effectively waive the privilege.

6. The warnings should further inform the Constituent that, while the interview is subject to the attorney-client privilege, the privilege belongs only to the corporation, not the Constituent. That means it is up to the corporation – and the corporation alone – to decide if or

when the substance of the interview should be disclosed to third parties (*i.e.*, without the consent of the Constituent).

D. Other Issues for Consideration

1. Constituents Approaching Counsel

The propriety, necessity and strategic advantage of providing Upjohn warnings are less apparent when a Constituent approaches corporate counsel. Indeed, the analysis will be fact-specific, with a particular focus on whether the Constituent is approaching counsel to self-report misconduct or to report alleged misconduct by others. This analysis is further complicated by whether the events being reported present a risk of criminal or civil exposure for the corporation. Factors that guide this analysis include, but are not limited to, the following: whether there is an apparent conflict of interest between the Constituent and the corporation; whether the Constituent is reporting facts that place the corporation and/or Constituent at risk of prosecution; whether the Constituent is a whistleblower as defined by the Sarbanes-Oxley Act and therefore subject to certain protections; and, finally, whether the Constituent is reporting events that question the integrity of the corporation's management or its public filings. The existence of a conflict at minimum necessitates counsel notifying the Constituent that counsel does not represent the Constituent. Moreover, as a best practice, counsel should provide Upjohn warnings whenever a likely conflict of interest exists.

2. Supplementing Oral Warnings

Counsel may wish to consider supplementing oral warnings by giving the Constituent Upjohn warnings in writing. Counsel may go even further by having the Constituent sign a written acknowledgment of the warnings.

Although using a written warning is not a common practice, they reduce the risk of later challenge to the warnings provided. On the other hand, handing out a written warning and asking someone to sign a statement can have a chilling effect on the Constituent's willingness to share information, which defeats the fact-finding purpose of the interview, especially if the Constituent has no reason to believe that counsel personally represents the Constituent.

One approach to this issue would be to provide written Upjohn warnings to all Constituents at the onset of a formal relationship with the corporation, such as when an employee is hired, or when the investigation is about to commence. That approach could have the benefit of setting Constituent expectations before any issue arises. On the other hand, those expectations may lead to the unintended consequence that Constituents are less cooperative and candid across a wide range of activities than they otherwise might be in the absence of such blanket warnings.

3. "Do I need a lawyer?"

If, as is often the case, the Constituent asks whether the Constituent needs separate counsel, counsel should advise the Constituent that counsel cannot provide advice on that issue but that the Constituent has the right to have separate counsel. Given the prevalence of the issue, counsel may wish to advise that the Constituent has the right to have separate counsel as part of the Upjohn warning, without waiting for the Constituent to ask the question. If applicable, counsel may also consider advising the Constituent that the corporation has a policy of paying for the Constituent's counsel.

4. "What is my status? Is there a conflict of interest?"

Related to the preceding question, it is common for counsel and the Constituent to discuss whether a conflict of interest exists between the corporation and the Constituent. If counsel believes a conflict of interest currently exists, counsel should consider advising the

Constituent of that belief. If conflicts of interest are discussed, counsel should emphasize that facts and circumstances can change, that the interests of the Constituent and the corporation could come into conflict with each other, that counsel will alert the Constituent of such a conflict if and when counsel learns of one, and that the Constituent should do the same.

5. Separate Counsel for Constituents

Even when no conflict of interest is apparent, the corporation should consider, when feasible, hiring separate counsel for employees and entering into a joint defense relationship with that counsel. The advantage of such an approach is that separate "pool counsel" will have an undivided interest in representing employees, which may facilitate the fact finding process. On the other hand, such a course may pose risks for the corporation because corporate prosecution guidelines have been known to penalize corporations that enter into joint defense arrangements with other parties.

6. "What if I refuse to cooperate in this investigation?"

In cases where the Constituent inquires about the consequences of not cooperating in the investigation, the Constituent should be informed of the pertinent corporate policies applicable to internal investigations. In particular, most corporate policies will discipline employees who refuse to cooperate in internal investigations, and such discipline can include termination of employment.

7. Third Party Uses of Information

Counsel may wish to advise the Constituent that third parties to whom the corporation may elect to disclose information include federal or state government agencies, who might ask the corporation for such information, and who might regard false statements provided to counsel as a prosecutable offense. In addition, counsel may wish to consider advising the Constituent that the corporation presently has no position on the matter because the factual investigation is still under way.

8. Confidentiality of Communications Between Counsel and the Constituent

Counsel may further wish to provide to the Constituent further elaboration on the aspect of counsel's interaction with the Constituent that should be regarded as confidential. As a general matter, in order to preserve the attorney-client privilege only the actual questions asked and the actual answers given should be treated as confidential. This means that the actual underlying facts known to the Constituent are not necessarily confidential, and the Constituent is not precluded from, for instance, appropriately reporting allegations of wrongdoing based on those underlying facts to law enforcement authorities. On the other hand, some of the underlying facts known to the Constituent could include proprietary business and/or trade secret information that could be subject to a legitimate assertion of confidentiality by the corporation. To reconcile these competing concerns, counsel may wish to consider advising the Constituent to seek further legal advice should the issue arise.

9. Joint Representation of the Corporation and the Individual

There will inevitably be instances where the interests of the corporation and the Constituent appear, in the first instance, to be aligned. In that context, the corporation sometimes consents to having its corporate counsel represent both the corporation and the Constituent, provided no conflict of interest arises. There are, however, potential risks associated with the situation, which are discussed in more detail in Section VI of this Report, "Current Upjohn Warning Practices."

* * *

The remainder of this Report provides the rationale for the foregoing Recommended Best Practices. Section III explores the establishment, history, and elements of the attorney-client privilege; Section IV reviews the United States Supreme Court's decision in *Upjohn v. United States*, and explains how it shaped Upjohn warnings; Section V reviews the codification of the warnings, in particular by the ABA; and Section VI describes current practices.

III. THE ATTORNEY-CLIENT PRIVILEGE

A. Introduction

"The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law."[2] Indeed, as even the Department of Justice recognizes, it "is one of the oldest and most sacrosanct privileges under the law."[3] The privilege "rests on the need for the advocate and counselor to know all that relates to the client's reasons for seeking representation if the professional mission is to be carried out."[4] While the purpose of the attorney-client privilege "is to encourage full and frank communication between attorneys and their clients," it also "promote[s] broader public interests in the observance of law and administration of justice."[5] As such, it is "perhaps, the most sacred of all legally recognized privileges, . . . essential to the just and orderly operation of our legal system."[6] While

[2] *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981). The attorney-client privilege can be traced back to the Roman legal tradition. EDWARD J. IMWINKELRIED, THE NEW WIGMORE: EVIDENTIARY PRIVILEGES § 6.2.4, at 471 (2002). However, the earliest known cases referencing the attorney-client privilege date back to the 1570s and do not question the existence of the privilege. 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2290, at 542 (John T. McNaughton ed., 1961).

[3] United States Attorneys' Manual, Principles of Federal Prosecution of Business Organizations § 9-28.710 (Attorney-Client and Work Product Protections) (2008), citing *Upjohn Co. v. United States*.

[4] *Trammel v. United States*, 445 U.S. 40, 51 (1980).

[5] *Upjohn Co. v. United States*, 449 U.S. at 389.

[6] *United States v. Bauer*, 132 F.3d 504, 510 (9th Cir. 1997); EDWARD J. IMWINKELRIED, THE NEW WIGMORE: EVIDENTIARY PRIVILEGES § 6.2.4, at 471 (2002).

commentators have argued the merits of the attorney-client privilege for centuries,[7] no other aspect of the privilege has prompted more controversy than its application to corporations.[8]

The Supreme Court, in *Upjohn v. United States*, acknowledged that "complications in the application of the privilege arise when the client is a corporation, an artificial creature of the law, and not an individual."[9] It is from these complications that Upjohn warnings have evolved.

While a corporation may only speak through its Constituent, typically when in-house counsel, or outside counsel represent a corporation, the corporation itself is counsel's only client.

Upjohn warnings should set appropriate expectations between the Constituent and the corporation. The warnings are intended: (1) to inform the Constituent that the Constituent is not a client; (2) to warn the Constituent that the corporation's counsel is not bound to keep the Constituent's information confidential; and (3) to explain that the corporation alone, not the Constituent, may choose to reveal to outside parties what transpired during the interview between the Constituent and corporate counsel.

B. Relevant Principles Underlying the Attorney-Client Privilege

The attorney-client privilege and associated legal duty of confidentiality protect communications between an attorney and client. The attorney-client privilege applies only to private client communications, whereas the duty of confidentiality applies to all information gained from the representation. In the corporate context, an important consideration often is who qualifies as a client that may invoke the privilege. Typically, the client is the corporation, though Constituents may believe that they also are clients and later attempt to invoke the privilege over statements made to the attorney.

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[7] BLACKSTONE'S COMMENTARIES ON THE LAW 683 (Bernard C. Gavit ed., Washington Law Book Co. 1941) (1892).

[8] Gerald F. Lutkus, Note, *The Implications of* Upjohn, 56 NOTRE DAME L. REV. 887, 887 (1981); *see also* John E. Sexton, *A Post-*Upjohn *Consideration of the Corporate Attorney-Client Privilege*, 57 N.Y.U. L. REV. 443 (1982).

[9] *Upjohn Co. v. United States*, 449 U.S. at 389–90.

For example, a Constituent interviewed by corporate counsel as part of an internal investigation – undertaken so that counsel can learn pertinent facts and competently advise the corporation – may later claim that the statements provided to corporate counsel were subject to an attorney-client privilege held by the Constituent and the corporation. The Constituent may then assert that, as a holder of the privilege, it is up to the Constituent, not the corporation, to decide whether to waive the privilege to allow third parties – such as government investigators or members of the media – to obtain the statements.[10/] To defeat such a claim, corporations seeking to establish that they, and they alone, are the holders of the privilege have required that Upjohn warnings be provided to Constituents prior to any interview by corporate counsel.

1. What Is the Privilege?

The attorney-client privilege is an evidentiary privilege,[11/] that protects the client from disclosures of private communications made by the client while seeking legal advice.[12/]

2. Elements

The privilege itself covers only *client* communication made *in confidence*. The historical elements of the attorney-client privilege are as follows: "(a) Where legal advice of any kind is sought (b) from a professional legal adviser in his capacity as such, (c) the communications relating to that purpose, (d) made in confidence (e) *by the client*, (f) are at his insistence permanently protected (g) from disclosure by himself or by the legal adviser, (h) except the protection be waived."[13/] In the corporate context, the identity of the client is of greatest concern

[10/] *See, e.g.*, *In re Grand Jury Subpoena*, 415 F.3d 333 (4th Cir. 2005) (corporate employees subject to criminal prosecution based on statements made to corporate counsel sought to suppress those statements based on the alleged inadequacy of Upjohn warnings provided by the corporate counsel).

[11/] STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF LAW AND ETHICS 28 (7th ed. 2005).

[12/] *Id.*

[13/] 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2290, at 542 (emphasis added).

and was the focus of the *Upjohn* case.[14] Therefore, determining when an attorney-client relationship is created informs the analysis of privilege in the corporate context.

3. Formation of the Attorney-Client Relationship

"A relationship of client and lawyer arises when: a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person; and either (a) the lawyer manifests to the person consent to do so; or (b) the lawyer fails to manifest lack of consent to do so, and the lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services."[15]

a. Client Intent

A prospective client's reasonable belief about the formation of an attorney-client relationship is critical to determining when the relationship arises. For instance, courts have found a relationship when the client reasonably relied on the attorney's advice, even though the lawyer declined the representation.[16] On the other hand, other courts have observed that "a party's mere expectation that an attorney will represent him or her is insufficient to create an attorney-client relationship."[17]

While "most client-lawyer relationships are still formed the old-fashioned way," a relationship may arise in a more casual manner.[18] Formal indicia of the relationship are sufficient to show a relationship, but they are not prerequisites. A prospective client's argument that a relationship has been initiated is bolstered when there is an exchange of personal

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[14] *Upjohn Co. v. United States*, 449 U.S. at 389–97.

[15] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 (2000); *see also Miller v. Mooney*, 725 N.E.2d 545, 549 (Mass. 2000); 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2290, at 542.

[16] *See, e.g., Togstad v. Vesely, Otto, Miller & Keefe*, 291 N.W.2d 686 (Minn. 1980).

[17] *Gramling v. Memorial Blood Ctrs.*, 601 N.W.2d 457, 459–60 (Minn. Ct. App. 1999); *see also Catizone v. Wolff*, 71 F.Supp.2d 365 (S.D.N.Y. 1999).

[18] STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF LAW AND ETHICS 19 (7th ed. 2005).

confidential information between the client and the attorney.[19] A relationship can arise without a written contract.[20] Furthermore, the client need not pay or agree to pay the lawyer.[21] However, in addition to the client's reasonable belief, the attorney's actions must be considered in determining whether an attorney-client relationship is formed.

b. Attorney Intent

The attorney need not expressly consent to the representation in order for an attorney-client relationship to arise.[22] Rather, if the attorney fails to deny the relationship and the attorney reasonably should know that the prospective client may rely on the attorney, a relationship may be formed.[23] Specifically, where an attorney "knowingly obtains material [personal] confidential information from the client and renders legal advice or services as a result," the attorney assents to the representation.[24] Any conveyance of advice could trigger the formation of a relationship.

4. Application to the Corporate Context

As mentioned previously, application of the attorney-client privilege to corporations raises issues not present when the client is an individual. While corporations have a separate legal identity, they are also made up of individuals – employees, officers, directors, trustees, and shareholders (*e.g.*, Constituents) –who may, depending upon the circumstances, speak on behalf of and legally bind the corporation. The issue that then arises is who is the client for privilege purposes – exactly who does corporate counsel represent? Only the corporation? Only the

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[19] *See, e.g., Analytica, Inc. v. NPD Research, Inc.*, 708 F.2d 1263 (7th Cir. 1983).

[20] ABA/BNA, LAWYERS' MANUAL ON PROFESSIONAL CONDUCT § 31:101.

[21] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14.

[22] *Id.*

[23] *Id.*

[24] *Dep't of Corps. v. SpeeDee Oil Change Sys., Inc.*, 980 P.2d 371 (Cal. 1999).

Constituent? The corporation and the Constituent? Resolution of these issues is fact-specific, but the principles that serve as a guide are well known.

a. Client Identity

Typically, an attorney for a corporation represents the entity and not its Constituents.[25] "A [corporation's] lawyer . . . owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity."[26] For example, when a corporation learns of an allegation of wrongdoing within the corporation, the corporation – in the guise of its senior management, board of directors, or committees of the board (such as the audit committee or a special litigation committee) – may call upon attorneys representing the corporation to conduct an internal investigation to determine whether the allegation can be substantiated and to provide legal advice to the corporation on an appropriate course of action. Under such circumstances, the attorney involved in the internal investigation will typically engage with the corporation's Constituents to obtain the facts necessary to advise the corporation, and that is when Upjohn warnings typically will be given. Indeed, the Model Rules make clear that the corporation's lawyer is responsible for clarifying the identity of the client to the Constituent whenever it appears that the Constituent has interests adverse to the entity.[27]

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[25] MODEL RULES OF PROF'L CONDUCT R. 1.13(a) & cmt. 1.

[26] *Bobbitt v. Victorian House, Inc.*, 545 F.Supp. 1124, 1126 (Ill. Dist. Ct. 1982); *see also Rosman v. Shapiro*, 653 F.Supp. 1441, 1445 (S.D.N.Y. 1987) ("[I]n the ordinary corporate situation, corporate counsel does not necessarily become counsel for the corporation's shareholders and directors . . . .").

[27] MODEL RULES OF PROF'L CONDUCT R. 1.13(f).

b. When Joint or Concurrent Representation May Arise

Under certain circumstances, an attorney representing the corporation may also take on a joint or concurrent representation of the entity's Constituents.[28] For example, if the Constituent approached the corporation's lawyer for advice and "[i]f the [Constituent] . . . makes it clear when he is consulting the corporation lawyer that he personally is consulting the lawyer and the lawyer sees fit to accept and give communication knowing the possible conflicts that could arise, [the Constituent] may have a privilege."[29] Similarly, there may be situations where a corporation and its Constituents choose to be represented by the same attorney. Whether the attorney represents the corporation alone or also represents a Constituent is a question of fact, determined by the reasonable expectations of the parties under the circumstances.[30]

The formation of an attorney-client relationship between the Constituent and corporate counsel hinges on the reasonable belief of the Constituent and the attorney's actions in light of that belief. The Constituent must have "manifested [his] intention to seek professional legal advice."[31] For instance, the Constituent may approach the attorney to seek advice about his personal liability. Alternatively, the attorney may approach the Constituent to investigate possible wrongdoing, during which the Constituent may seek personal legal advice from the attorney as to the Constituent's own liability. In either instance, "due consideration" should be given to the unreasonableness of the Constituent's belief that the attorney is his personal representative, especially in instances where a "readily apparent conflict of interest exists

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[28] *Id.*

[29] *In re Grand Jury Proceedings*, 434 F.Supp. 648 (E.D. Mich. 1977).

[30] *See Westinghouse Elec. Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311 (7th Cir. 1978).

[31] *Id.* at 1319.

between the organization and the Constituent claimed to be a co-client."[32] The more actions the attorney takes to discount the presence of an attorney-client relationship, the more unlikely it is that the Constituent has a reasonable belief that the Constituent is a client.

If counsel does not expressly discount a relationship with the Constituent, the counsel's actions could implicitly assent to concurrent representation of the entity and Constituent. First, conversations between the attorney and the Constituent about the latter's personal liability may imply a concurrent representation.[33] Courts have imposed relationships when the Constituent conveys confidential information to the corporate counsel,[34] and the attorney promises the Constituent confidentiality.[35] However, the attorney does not enter into a relationship solely because the Constituent communicates with the attorney about issues relevant to the entity that are also relevant to the Constituent personally.[36] "Normally a corporate director talking to corporate counsel should understand anything he told that attorney was 'known by the corporation.'"[37]

Second, when the attorney provides personal legal services for the Constituent, a concurrent representation is more likely established. For instance, courts have found a concurrent representation when the attorney appears on behalf of both the Constituent and the

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[32] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 cmt. f; *see also Bobbitt v. Victorian House, Inc.*, 545 F.Supp. at 1126 ("[I]t is clear that the firm was representing the corporation and thus [the officer] could not have reasonably believed or expected that any information given to the firm would be kept confidential from the shareholders or from the corporation as an entity.").

[33] *United States v. Walters*, 913 F.2d 388 (7th Cir. 1990); *Montgomery Academy v. Kohn*, 50 F.Supp.2d 344 (D.N.J. 1999) (finding an attorney-client relationship when the director consulted the organization's attorney about investment losses for which the director was later found responsible).

[34] *Home Care Indus. v. Murray*, 154 F.Supp.2d 861 (D.N.J. 2001).

[35] *Perez v. Kirk & Carrigan*, 822 S.W.2d 261 (Tex. App. 1991).

[36] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14. *But see Montgomery Academy v. Kohn*, 50 F.Supp.2d 344 (D.N.J. 1999) (finding an attorney-client relationship when the director consulted the organization's attorney about investment losses for which the director was later found responsible).

[37] *Bobbitt v. Victorian House, Inc.*, 545 F.Supp. at 1126.

corporation.[38] Likewise, a court has determined that relationship exists when the Constituent identifies the lawyer as his counsel to outsiders and the attorney does not clarify his role.[39] Some affirmative action on the part of the attorney to implicitly create a relationship is necessary.

A pattern of dealing between the Constituent and the corporate counsel may support both the Constituent's belief that a relationship exists and the attorney's assent to that relationship. The corporate form is often disregarded in closely-held corporations and the interest of the shareholder may merge with that of the entity. In a "close corporation consisting of only two shareholders with equal interests in the corporation, it is indeed reasonable for each shareholder to believe that the corporate counsel is in effect his own individual attorney."[40] However, even in these instances, a concurrent representation will be unlikely if the attorney never purports to represent the Constituent.[41] A longstanding personal relationship between the corporate counsel and a Constituent does not, by itself, show a reasonable belief by the client or implied assent by the attorney.[42]

The American Bar Association's Committee on Ethics and Professional Responsibility issued a Formal Opinion, in 1991, that identified a number of factors that may help determine when a concurrent relationship is established: "(a) whether the attorney affirmatively assumed a duty of representation to the constituent, (b) whether the constituent was separately represented by other counsel in connection with his affairs, (c) whether the attorney had represented the constituent before undertaking to represent the organization, and (d) whether there was evidence

[38] *E.F. Hutton & Co. v. Brown*, 305 F.Supp. 371 (S.D. Tex. 1969).

[39] *Advanced Mfg. Techs., Inc. v. Motorola, Inc.*, 2002 WL 1446953 (D. Ariz. 2002).

[40] *Rosman v. Shapiro*, 653 F.Supp. 1441, 1445 (S.D.N.Y. 1987).

[41] *Bowen v. Smith*, 838 P.2d 186 (Wyo. 1992).

[42] *Telectronics Proprietary, Ltd. v. Medtronic, Inc.*, 836 F.2d 1332 (Fed. Cir. 1988).

of reliance by the Constituent on the attorney as his or her separate counsel, or of the Constituent's expectation of personal representation."[43]

B. Duty of Confidentiality to Prospective Clients

Even if the corporation does not consent to counsel's concurrent representation of the corporation and the Constituent, the counsel interacting with a Constituent may have a duty of confidentiality to the Constituent as a prospective client.

1. Elements

Attorneys are governed both by the evidentiary attorney-client privilege and by the broader duty of confidentiality to all clients and potential clients.[44] "Even when no [attorney-client] relationship ensues, a lawyer who has had discussions with a prospective client shall not use or reveal information learned in the consultation."[45] Even if the attorney expressly denies the establishment of a relationship, the attorney remains bound by this duty.

2. Application to the Corporate Context

In order for the duty of confidentiality to attach, the Constituent must be a prospective client. Therefore, the Constituent must seek personal representation from corporate counsel.[46] For instance, a Constituent might approach corporate counsel about the Constituent's personal liability for actions taken during the Constituent's employment. Even if the corporate counsel clarifies that the counsel does not represent the Constituent individually, but rather only the corporation, corporate counsel still could be obligated to keep the Constituent's information confidential.

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[43] ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 91-361 (1991).

[44] GILLERS, REGULATION OF LAWYERS: 27–28.

[45] MODEL RULES OF PROF'L CONDUCT R. 1.8(b); *see also Westinghouse Elec. Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311, 1319 (7th Cir. 1978).

[46] *See Montgomery Academy v. Kohn*, 50 F.Supp.2d 344 (D.N.J. 1999).

Whether a duty of confidentiality arises would again hinge on whether the Constituent reasonably believed that the Constituent was seeking legal advice from the Constituent's personal attorney. In the corporate context, the reasonableness of that belief may be questioned, as the Constituent usually knows that the Constituent is speaking to the corporation when speaking to corporate counsel.[47/] However, if the Constituent's belief was reasonable, corporate counsel would be bound by the duty of confidentiality and could not reveal the information learned from the Constituent to the entity itself.[48/] Whether or not this is truly an issue will depend on the facts and circumstances.

The foregoing helps to explain why it behooves corporate counsel to provide clear warnings to Constituents, lest counsel find themselves in a position where Constituents who claim the privilege and/or a right to confidential treatment prevent them from using the facts they have gathered to represent the corporation effectively.

IV. *UPJOHN* AND ITS IMPACT ON THE ATTORNEY-CLIENT PRIVILEGE

While many of the principles behind formation of the attorney-client relationship are clear, their application to corporations can be difficult. Before *Upjohn*, circuits were split over which Constituents were considered clients and, therefore, were covered by the privilege. The *Upjohn* decision extended the privilege to communication between corporate counsel and Constituents, but made it clear that the corporation is the client and the holder of the privilege. The corporation can waive the privilege to the detriment of the Constituent. Due to this conflict of interest, corporate counsel began giving warnings to prevent Constituents from asserting the privilege for themselves.

[47/] *Bobbitt v. Victorian House, Inc.*, 545 F.Supp. at 1126.

[48/] *Cf. Montgomery Academy v. Kohn*, 50 F.Supp. 2d 344 (D.N.J. 1999); *Gilmore v. Goedecke Co.*, 954 F.Supp. 187 (E.D. Mo. 1996) (disqualifying a corporation's long-standing law firm from representing the corporation in a lawsuit brought by a Constituent who had consulted with a member of the firm before filing suit).

A. The Corporate Attorney-Client Privilege Prior to *Upjohn*

Corporations have invoked the attorney-client privilege in cases dating back almost one-hundred years.[49] For the greater part of the twentieth century, the Supreme Court "accepted tacitly the proposition that the attorney-client privilege available to individuals also was available to corporations, but it never had delineated the scope and meaning of the corporate attorney-client privilege."[50] Over time, however, a significant circuit split developed, and various federal courts of appeal adopted conflicting standards.[51] Some courts extended the privilege to all communications between the attorney and members of the "control group" of the corporation.[52] Other courts opted for the more restrictive "subject matter" test, extending the privilege to communications based on the "nature and purpose of the information imparted to the lawyer, not merely the identity of the source."[53] The split among the circuits was resolved in *Upjohn*, when the Supreme Court held that the attorney-client privilege extends beyond a comparatively small group of senior employees. Rather, it encompasses all employees who act within the scope of their employment and who are in a position to legally bind the corporation through such acts.[54]

[49] *See, e.g.*, *United States v. Louisville & Nashville R.R. Co.*, 236 U.S. 318, 336 (1915).

[50] John E. Sexton, *A Post-*Upjohn *Consideration of the Corporate Attorney-Client Privilege*, 57 N.Y.U. L. REV. 443, 443 (1982).

[51] *See Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1978) (en banc) (applying a "subject matter" test for confidential communications made to secure legal advice); *Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487 (7th Cir. 1971) (applying a "subject matter" standard for communication in the scope of the employee's duties); *General Elec. Co. v. Kirkpatrick*, 312 F.2d 742 (3d Cir. 1962) (applying a "control group" test); Sexton, *A Post-*Upjohn *Consideration of the Corporate Attorney-Client Privilege*, 57 N.Y.U. L. REV. 443; *see also Upjohn Co. v. United States*, 449 U.S. at 390–92 (describing the different standards espoused by the circuits).

[52] *See, e.g.*, *General Elec. Co. v. Kirkpatrick*, 312 F.2d 742 (3d Cir. 1962); *see also* GILLERS, REGULATION OF LAWYERS 32.

[53] GILLERS, REGULATION OF LAWYERS 32; *see also, e.g.*, *Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487 (7th Cir. 1971); *see also* Lutkus, Note, *The Implications of* Upjohn, 56 NOTRE DAME L. REV. 887.

[54] *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

B. The *Upjohn* Decision

In *Upjohn*, the Supreme Court rejected the control-group test, opting instead for a broader rule that expanded the application of the privilege to certain lower level employees.[55] *Upjohn* involved an internal corporate investigation into improper payments by Upjohn managers to foreign government officials.[56] Upjohn's general counsel and outside attorneys sent questionnaires to all foreign managers and interviewed the recipients of the questionnaires and other employees.[57] In response to an IRS summons and on attorney-client privilege grounds, the corporation refused to produce the questionnaires, and the issue proceeded to litigation.[58] The district court concluded that the privilege was waived.[59] But on appeal, the Sixth Circuit found no waiver, holding instead that because the communications were outside the "control group," the communications were not the "client's" and no privilege attached.[60]

The Supreme Court disagreed and reversed. First, it concluded that the control group test articulated by the Sixth Circuit frustrated a major purpose of the attorney-client privilege: full and frank communication of relevant information by employees of the client corporation to attorneys who are seeking to render legal advice.[61] Second, the control-group test lacked certainty, resulting in disparate decisions regarding the employees to which the privilege applied.[62] Finally, the test created a "Hobson's choice," by which the counsel had to choose

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[55] *Id.* at 396–97.

[56] *Id.* at 386–87.

[57] *Id.* at 387.

[58] *Id.* at 388.

[59] *Id.*

[60] *Upjohn Co. v. United States*, 600 F.2d 1223, 1226–28 (6th Cir. 1979), *rev'd*, 449 U.S. 383 (1981).

[61] *Upjohn Co. v. United States*, 449 U.S. at 390–91. The Court recognized that lower level employees, who would not otherwise fall within the control group, often possess the information needed by the corporation's lawyers. *Id.*

[62] *Id.* at 390–93 ("An uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all.").

interviewing lower-level employees (and risking disclosure of unprivileged information) or avoiding those interviews (and risking failing to gather sufficient facts).[63]

To preserve the purposes behind the attorney-client privilege, the Court expanded its application beyond the "control group." That led the Court to find a valid attorney-client privilege where: (a) the communications were made by Upjohn employees; (b) to counsel for Upjohn acting as such; (c) at the direction of corporate superiors; (d) in order to secure legal advice from counsel; (e) concerning matters within the scope of the employees' duties; and (f) the employees "were sufficiently aware that they were being questioned in order that the corporation could obtain legal advice."[64]

Although the Court did not expressly endorse any particular test to determine the circumstances under which the corporate attorney-client privilege existed, commentators believe *Upjohn* accepted the so-called "Weinstein Test,"[65] espoused by Judge Jack Weinstein and discussed by the Eighth Circuit in *Diversified Industries, Inc. v. Meredith.*[66] But *Upjohn* made one noticeable addition: the employee's subjective awareness of the legal purpose of the communication.[67] The Court explained this element through the following discussion of case-specific facts:

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[63] *Id.* at 390–91.

[64] *Id.* at 394.

[65] John E. Sexton, *A Post-*Upjohn *Consideration of the Corporate Attorney-Client Privilege*, 57 N.Y.U. L. REV. 443, 461 (1982); Lutkus, Note, *The Implications of* Upjohn, 56 NOTRE DAME L. REV. 892; *see also* 2 JACK B. WEINSTEIN & MARGARET A. BERGER, WEINSTEIN'S EVIDENCE ¶ 503(b)(04) (1975). The Weinstein Test required that (1) the communication was made for the purpose of securing legal advice; (2) the employee making the communication did so at the direction of his corporate superior; (3) the superior made the request so that the corporation could secure legal advice; (4) the subject matter of the communication is within the scope of the employee's corporate duties; and (5) the communication is not disseminated beyond those persons who, because of the corporate structure, need to know its contents.

[66] 572 F.2d 596, 609 (8th Cir. 1977) (en banc).

[67] *Upjohn Co. v. United States*, 449 U.S. at 394–95.

> A statement of policy accompanying the questionnaire clearly indicated the legal implications of the investigation. The policy statement was issued "in order that there be no uncertainty in the future as to the policy with respect to the practices which are the subject of this investigation." It began "Upjohn will comply with all laws and regulations," and stated that commissions or payments "will not be used as a subterfuge for bribes or illegal payments" and that all payments must be "proper and legal." Any future agreements with foreign distributors or agents were to be approved "by a company attorney" and any questions concerning the policy were to be referred "to the company's General Counsel."[68]

V. FORMALIZING UPJOHN WARNINGS

A. Codification through the ABA Model Rules

ABA Model Rules of Professional Conduct 1.13(f) and 4.3 appear to be logical extensions of the *Upjohn* decision, and were adopted after the decision was handed down.[69] Both rules provide guidance with respect to an attorney's obligation to provide warnings to Constituents.

1. ABA Rule 1.13(f)

Rule 1.13 governs instances where a lawyer has an organization as a client. Section (f) of the Rule requires an attorney representing the corporation to identify to Constituents the attorney's representation of the corporation alone "when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents."[70]

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[68] *Id.*

[69] The Rules were adopted by the ABA House of Delegates in 1983, replacing the Model Code of Professional Responsibility. Although the Model Rules were adopted almost two years after the *Upjohn* case was decided, the Commission on Evaluation of Professional Standards (the Kutak Commission) began circulating proposed drafts of the Model Rules as early as 1980. Differences between the proposed draft of the Rules in 1980 and the Model Rules adopted in 1983 indicate that the Commission recognized the impact of the *Upjohn* decision on an attorney's ethical obligations. Thus, while the legislative history of Rules 4.3 and 1.13 do not specifically reference the *Upjohn* decision, it is likely the decision was considered in revising the Rules. Regardless, the Rules are consistent with the purpose and scope of the attorney-client privilege as expressed by the Supreme Court in *Upjohn.*

[70] "In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing." Model Rules of Prof'l Conduct R. 1.13. Under the predecessor ABA Model Code, there was no direct counterpart to Rule 1.13(f). While there are some Model Code provisions that track the language of other subsections of Rule 1.13, there is no counterpart to Rule 1.13(f). The original version of Rule 1.13(f) (formerly 1.13(d)), provided that "[i]n dealing with

Comments to Rule 1.13 shed additional light on the topic. Specifically, Comment [2] explains:

> When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, *if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6* [dealing with confidentiality]. (Emphasis added).[71]

In addition, Comment [10] provides the following guidance for situations where the interests of an organization and one of its Constituents become potentially adverse:

> Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal

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an organization's directors, officers, employees, members, shareholders or other constituents, a lawyers shall explain the identity of the client when the lawyer believes that such explanation is necessary to avoid misunderstandings on their part." In 1983, the Rule was amended to replace the last phrase with "when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing." In 2002, "it is apparent" was replaced with "the lawyer knows or reasonably should know," and subsection (d) became subsection (f).

[71] Rule 1.6 provides as follows:

> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
> (1) to prevent reasonably certain death or substantial bodily harm;
> (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
> (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
> (4) to secure legal advice about the lawyer's compliance with these Rules;
> (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
> (6) to comply with other law or a court order.

Model Rules of Prof'l Conduct R. 1.6.

representation for that constituent individual, and that discussion between the lawyer for that organization and the individual may not be privileged.[72]

These comments address issues associated with Upjohn warnings.[73]

2. ABA Rule 4.3

Rule 4.3 is more general in scope, but has application here as well. It provides:

> In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that an unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

Rule 4.3 is also similar to Disciplinary Rule ("DR") 7-104(A)(2), which provides that that during the course of a lawyer's representation of a client, a lawyer shall not "[g]ive advice to a person who is not represented by a lawyer, other than the advice to secure counsel . . . ."[74]

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[72] On the other hand, Comment [11] acknowledges that these are fact-specific situations, stating that "[w]hether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case." Comments [3], [8], and [9] to the original Rule, which address the issues decided in Upjohn, became Comments [2], [10], and [11] of the current Rule, respectively.

[73] As also discussed at note 69, *supra*, while the *Upjohn* decision is not specifically referenced in either the annotations to the ABA Rule or the legislative history, the language of the Rule itself and the Comments to the Rule essentially restate the Court's holding in *Upjohn*.

[74] MODEL RULES OF PROF'L CONDUCT DR 7-104(A)(2). The original version of Rule 4.3, adopted in 1983, did not contain a prohibition on providing advice to an unrepresented person in the text of the Rule itself. That prohibition on providing advice was contained in the Comment to the original rule. In 2002, the prohibition on giving legal advice to unrepresented persons was moved from the Comment to the main text of Rule 4.3, consistent with the practice of the majority of states in restricting the prohibition to situations where the lawyer "knows or reasonably should know" that the interests of the unrepresented person are in conflict with the interests of his or her client. Other changes were also made to the Comment in 2002. In particular, "[i]n order to avoid a misunderstanding, a lawyer will typically need to identify the lawyer's client and, where necessary, explain that the client has interests opposed to those of the unrepresented person. For misunderstandings that sometimes arise when a lawyer for an organization deals with an unrepresented constituent, see Rule 1.13(d) [now Rule 1.13(f)]." Model Rules of Prof'l Conduct R. 4.3 cmt. 1. Based on the cross-reference, it seems that Rule 4.3 was intended to be construed in conjunction with Rule 1.13(f) in determining what ethical guidelines an attorney should consider when representing a corporation.

3. The Relevance of the Model Rules to Upjohn Warnings

Read together, 1.13(f) and Rules 4.3 clearly impose a duty on an attorney, during the course of his representation of a corporate client, to clarify his role when dealing with the corporation's Constituents if there is a conflict between the Constituent and the corporation and to correct any misunderstandings that may arise. This duty likely extends to former Constituents under Rule 4.3, insofar as they are "unrepresented."[75] While the Rules provide general guidance regarding a corporate counsel's ethical duties, they are silent with respect to the standards and procedures that should govern when and how to give an Upjohn warning.[76]

4. Adoption of the Model Rules by Various Jurisdictions

According to an ABA survey,[77] the Model Rules have been adopted to date in forty-nine jurisdictions: Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virgin Islands, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. California, Maine, and New York are the only states that do not have professional conduct rules that follow the ABA Model Rules.

[75] *See Upjohn Co. v. United States*, 449 U.S. at 394 & n.3 (declining to decide whether the attorney-client privilege should apply to communications with former employees); Annotation to Model Rules of Prof'l Conduct R. 43.

[76] For instance, Comment [11] to Rule 1.13(f), which provides that whether a warning is to be given will depend on the facts of each case, leaves an attorney with no more clarity than was provided in the *Upjohn* decision.

[77] *Available at* http://www.abanet.org/cpr/mrpc/alpha_states.html.

B. Illustrative Post-*Upjohn* Cases

Discussed here are four cases, decided after *Upjohn*, which shed added light regarding the standards for determining when Upjohn warnings are necessary and the contents of such warnings.

In *United States v. Stein*, the KPMG tax shelter case that was affirmed by the Second Circuit, the district court addressed an employee's claim that corporate counsel was personally representing her.[78] In that case, a partner at KPMG was questioned by counsel hired by the accounting firm in the course of an IRS investigation. The court noted that the partner did not recall receiving Upjohn warnings.[79] The court stressed that the question of whether a personal attorney-client relationship existed "could be avoided if counsel in these situations routinely made clear to employees that they represent the employer alone and that the employee has no attorney-client privilege with respect to his or her communications with employer-retained counsel."[80] Even without adequate warnings, however, the court concluded that no personal attorney-client relationship existed between the employee and corporate counsel.[81]

The Second Circuit addressed a similar issue in a case involving whether a campaign manager for the International Brotherhood of Teamsters had formed a personal attorney-client relationship with outside counsel hired to investigate the organization's fundraising activities.[82] The court highlighted counsel's failure to clarify that they did not represent the employee. The court then reminded outside counsel that "attorneys in all cases are required to clarify exactly whom they represent, and to highlight potential conflicts of interest to all concerned as early as

[78] 463 F.Supp.2d 459 (S.D.N.Y. 2006).

[79] *Id.* at 460.

[80] *Id.*

[81] *Id.* at 466.

[82] *United States v. Int'l Bhd. of Teamsters*, 119 F.3d 210, 217 (2d Cir. 1997).

possible."[83/] As in *Stein*, even without adequate Upjohn warnings, the court in this case determined that the employee could not assert a personal attorney-client privilege to prevent the disclosure of information obtained during the investigation.[84/]

In *In re Grand Jury Subpoena*,[85/] the Fourth Circuit emphasized the importance of clear Upjohn warnings. In that case, after performing an internal investigation that included employee interviews, America Online ("AOL") agreed to cooperate with the government and produce privileged documents related to the investigation.[86/] After their indictment on various federal criminal charges, three of the interviewed employees sought to prevent the disclosure by claiming that they had an attorney-client relationship with AOL's investigating attorneys and that they were unwilling to waive the resulting attorney-client privilege. AOL, by contrast, waived the privilege and was prepared to turn over the employee interview memoranda in order to secure cooperation credit with the Department of Justice.

To determine if the attorney-client privilege was held by the employees, the court analyzed whether the investigators' Upjohn warnings were adequate to prevent a reasonable person from believing that an attorney-client relationship existed.[87/] AOL's outside counsel, the investigators in the case, provided similar Upjohn warnings to each of the three employees who were interviewed. One of the warnings was as follows:

> We represent the company. These conversations are privileged, but the privilege belongs to the company and the company decides whether to

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[83/] *Id.*

[84/] *Id.*

[85/] 415 F.3d 333 (4th Cir. 2005).

[86/] *Id.* at 337.

[87/] *Id.* at 339.

> waive it. If there is a conflict, the attorney-client privilege belongs to the company.[88]

Further, the AOL outside counsel conducting that interview mentioned that "counsel 'could' represent [the employee] as well, 'as long as no conflict appeared.'"[89] After analyzing the warnings, which the court characterized as "watered down," the court nonetheless rejected the employees' argument that they could have reasonably believed that an attorney-client relationship with AOL's counsel had been formed. In reaching this conclusion, the court relied, in part, on the fact that the statements warned the employees that the corporation had the sole discretion to disclose the information.[90] The court also emphasized that the statement, "'we *can* represent you' is distinct from 'we *do* represent you.'"[91] Because the warnings, understood in context, prevented the employees from forming a reasonable belief that the investigating attorneys were representing them, the court ruled that AOL alone, not the employees, could elect to waive the privilege.[92]

Most recently, in *United States v. Nicholas*,[93] the district court in the Central District of California suppressed statements made by the Chief Financial Officer of Broadcom Corp. to outside company attorneys conducting an internal investigation on behalf of the company.[94] The investigation, which concerned allegations of illegal stock option backdating, was conducted by

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88/ *Id.* at 336.

89/ *Id.*

90/ *Id.* at 340.

91/ *Id.*

92/ *Id.*

93 606 F.Supp.2d 1109 (C.D.Cal. 2009), *appeal pending*, No. 09-50161 (9th Cir.).

94 *See also* Friedman, *Judge Slams Irell Firm for Ethics Lapses*, Los Angeles Daily Journal, Feb. 26, 2009, available at http://meetings.abanet.org/webupload/commupload/ CR301000/newsletterpubs/Court.pdf. and http://www.laobserved.com/biz/2009/02/sad_day_for_justice.php; Lyster, *Former Broadcom CFO Wins Round in Early Trial Jockeyin*, Orange County Business J., Feb. 27, 2009, available at http://www.ocbj.com/article.asp?aid=134715.

an outside law firm whose lawyers had represented the CFO personally in related and unrelated shareholder litigation. Broadcom later turned the CFO's interview by two law firm lawyers over to third parties – the Company's outside auditors, the SEC and the Department of Justice – without seeking the CFO's authorization. Following his indictment on federal securities fraud charges related to the backdating scheme, the CFO moved to suppress his interview contending that Broadcom and breached the attorney-client privilege through the unauthorized disclosure of his statements to third parties.

The district court, after conducting three days of hearings, agreed and ruled that the law firm had breached the CFO's attorney-client privilege. The court found that the facts demonstrated that the CFO was a client of the law firm because the firm had represented the CFO in his personal capacity, that the outside law firm therefore had two clients (Broadcom and the CFO), that the California Rules of Professional Responsibility[95] required that the law firm obtain the CFO's informed written consent before proceeding with its dual representation, that no such written consent had been obtained, and that the remedy for violating the Rules was the suppression of the interview and the referral of the law firm to the California State Bar for disciplinary proceedings.

The court rejected the argument that oral Upjohn Warnings supposedly provided to the CFO by the law firm's attorneys at the outset of the interview cured the dual representation issue. First, the court expressed its "serious doubts" whether Upjohn Warnings had ever been given to the CFO – based on the fact that the CFO did not remember being given the Warnings, that the Warnings were not memorialized in the lawyers' notes, and that no written record of the

[95] Cal. R. Prof Conduct 3-310(C).

Warnings existed.[96] Second, the court further noted that, even if Upjohn Warnings had been given, they were "woefully inadequate under the circumstances" because the lawyers never told the CFO that they were not the CFO's lawyers or that the CFO should consult with another lawyer.[97] And, "[m]ost importantly, neither [law firm lawyer] ever told [the CFO] that any statements he made to them could be shared with third parties, including the Government in a criminal investigation of him."[98] Finally, the court ruled that Upjohn Warnings contention was "irrelevant in light of the undisputed attorney-client relationship" between the CFO and the law firm. The court noted that the Warnings are:

> given to a non-client to advise the employee that he is not communicating with his personal lawyer, no attorney-client relationship exists, and any communication may be revealed to third parties if disclosure is in the best interest of the corporation.[99]

Nicholas supports a number of inferences: that the Warnings will not take the place of state and local ethics rules; that (when they work) they need to be complete; that they should disclose that information gathered during the interview may be disclosed to third parties; and that making a good record and following consistent practices when giving the Warnings can be critical.

But *Nicholas* does not create a requirement for written Upjohn Warnings, or that counsel obtain written acknowledgement that the Warnings have been provided. Rather, the case appears to be limited by its unique facts, which led that court to find that the law firm represented both the CFO and Broadcom, thereby obligating counsel to obtain the CFO's informed written

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[96] *United States v. Nicholas*, 606 F.Supp.2d at 1116.

[97] *Id.* at 1117.

[98] *Id.*

[99] *Id.*

consent under the applicable state ethics rule. Seen in this context, the case does not establish a new rule applicable in all situations when Upjohn Warnings are provided.

VI. CURRENT UPJOHN WARNING PRACTICES

Based on recent cases and applicable ethics rules, it is not altogether surprising that attorneys involved in internal investigations, or matters arising out of internal investigations, use different variations of Upjohn warnings, depending on the facts presented by the particular matter. Nonetheless, given the frequency of use of Upjohn warnings, a set of guidelines may be helpful.

The practices of attorneys who conduct internal investigations reveal several trends in the area of Upjohn warnings. First, some practitioners interviewed by the Association of Corporate Counsel seem concerned that the Upjohn warnings may discourage Constituent candor during an interview or harm the relationship between the Constituent and the corporation. In some cases, these concerns may lead the attorney to give a watered-down warning. Despite these fears, experiences of practitioners suggest that the Upjohn warning rarely causes a Constituent to refuse to answer questions. Most Constituents cooperate with the investigation even when it is against their interest to do so because the immediate consequence they face – potential termination for lack of cooperation – is regarded as the more immediate risk.

Second, Constituents typically ask counsel whether they need their own attorney. While views on this issue vary, most agree that counsel should not assure Constituents that they do not need their own counsel. Rather, counsel typically advise Constituents that counsel represents the corporation, and that the choice of counsel is a decision for the Constituent to make. According to recent commentary on the issue, "While many lawyers believe that employees, if given the opportunity, would almost always choose their own counsel, in fact the opposite is often the case. Employees in an investigation often begin with a view that their interests are aligned with the corporation and want to be viewed as team players."[100/]

Third, in some situations, corporate counsel advise Constituents whether counsel believe the interests of the corporation and the Constituent are aligned. But such advice necessarily depends on counsel's current knowledge of the facts, and counsel typically advise Constituents that the facts may change.

Fourth, practitioners seldom use written or formalized warnings (unless the issue of joint representation arises, as discussed in more detail below). Although written acknowledgment of the Upjohn warnings could eliminate Constituent confusion and rebut subsequent claims regarding privilege, a practice that may be invoked with greater frequency following the recent *Nicholas* case (discussed above) in cases where counsel have personally represented the Constituent, most corporate counsel use oral rather than written warnings. This choice is likely connected to ensuring Constituent cooperation.

Many corporate counsel believe that written warnings are too formal. Counsel do not want internal investigations to turn into a law enforcement interrogation, lest employee candor be stifled and the fact-finding process hindered. Constituents may be able to claim that they received inadequate warnings whenever the formalized warning is not followed precisely.

Fifth, situations also arise when corporate counsel advise Constituents that they jointly represent the corporation and the Constituent. A joint representation may be ethically possible when the facts show the absence of a conflict of interest between the corporation and the Constituent. The typical joint representation occurs following the completion of an internal investigation when the facts are better understood and when a regulatory inquiry has

[100/] *See* David B. Bayless, *Untangling the Ethical Issues of Internal Investigations*, GC CALIFORNIA MAGAZINE, Aug. 12, 2008, *available at* http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202423698079.

commenced. In that context, the corporation sometimes consents to having its corporate counsel represent both the corporation and its Constituents, provided no known conflict of interest exists.

The benefits of joint representation include the fact that both the company and the Constituent signal each other that they do not believe the employee's interests to be at odds with the company's interests. But known facts invariably change during the course of internal investigations; counsel cannot jointly represent parties with conflicting interests and must withdraw from representing one or both parties. To address this situation and to reduce the chances for ambiguity or confusion, corporate counsel typically advise Constituents, in writing, of the terms of the joint representation, and include Upjohn warnings as well.

One of the more common problems involving joint representations arises when one of the clients (usually the corporation) wants to waive the privilege and the Constituent does not. For instance, corporations have attempted to garner cooperation credit from government agencies through privilege waivers. To address the issue, the corporation sometimes seeks and secures approval from the Constituent at the commencement of the joint representation that the corporation can waive the privilege, and can choose to reveal information to third parties, including allowing information obtained from the Constituent to be revealed.

On the other hand, depending on the nature of the matter and the resources available to the corporation, some corporations seek to avoid the joint representation issue by arranging for separate counsel to represent one or more Constituents. In such cases, counsel for the corporation and the Constituents have entered into formal or informal joint defense arrangements to facilitate the sharing of information. The risk of such approach is that some government agencies have regarded the arrangement as evidencing a lack of cooperation by the corporations.[101]

VII. CONCLUSION

Internal investigations are fact-specific exercises. That means that no single set of Upjohn warnings will apply to all situations. Nevertheless, Upjohn warnings have value in creating reasonable expectations for corporations and their Constituents as to the scope and application of the attorney-client privilege.

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[101] The Memorandum issued by then-Deputy Attorney General Thompson in 2003 was explicit on that point. Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003). The more recent Principles of Federal Prosecution of Business Organizations issued by the Department of Justice on August 28, 2008 now provide, at Section 9-28.730 (Obstructing the Investigation), a somewhat more nuanced view of the issue. They state:

> [T]he mere participation by a corporation in a joint defense agreement does not render the corporation ineligible to receive cooperation credit, and prosecutors may not request that a corporation refrain from entering into such agreements. Of course, the corporation may wish to avoid putting itself in the position of being disabled, by virtue of a particular joint defense or similar agreement, from providing some relevant facts to the government and thereby limiting its ability to seek such cooperation credit. Such might be the case if the corporation gathers facts from employees who have entered into a joint defense agreement with the corporation, and who may later seek to prevent the corporation from disclosing the facts it has acquired. Corporations may wish to address this situation by crafting or participating in joint defense agreements, to the extent they choose to enter them, that provide such flexibility as they deem appropriate.

Available at http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf.

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Attachment C

U.S. Department of Justice, U.S. Attorneys' Manual Chapter 9-28.000, "Principles of Federal Prosecution of Business Organizations," August 2008.

9-28.000 PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS [FN1]

9-28.100 Duties of Federal Prosecutors and Duties of Corporate Leaders

The prosecution of corporate crime is a high priority for the Department of Justice. By investigating allegations of wrongdoing and by bringing charges where appropriate for criminal misconduct, the Department promotes critical public interests. These interests include, to take just a few examples: (1) protecting the integrity of our free economic and capital markets; (2) protecting consumers, investors, and business entities that compete only through lawful means; and (3) protecting the American people from misconduct that would violate criminal laws safeguarding the environment.

In this regard, federal prosecutors and corporate leaders typically share common goals. For example, directors and officers owe a fiduciary duty to a corporation's shareholders, the corporation's true owners, and they owe duties of honest dealing to the investing public in connection with the corporation's regulatory filings and public statements. The faithful execution of these duties by corporate leadership serves the same values in promoting public trust and confidence that our criminal cases are designed to serve.

A prosecutor's duty to enforce the law requires the investigation and prosecution of criminal wrongdoing if it is discovered. In carrying out this mission with the diligence and resolve necessary to vindicate the important public interests discussed above, prosecutors should be mindful of the common cause we share with responsible corporate leaders. Prosecutors should also be mindful that confidence in the Department is affected both by the results we achieve and by the real and perceived ways in which we achieve them. Thus, the manner in which we do our job as prosecutors—including the professionalism we demonstrate, our willingness to secure the facts in a manner that encourages corporate compliance and self- regulation, and also our appreciation that corporate prosecutions can potentially harm blameless investors, employees, and others—affects public perception of our mission. Federal prosecutors recognize that they must maintain public confidence in the way in which they exercise their charging discretion. This endeavor requires the thoughtful analysis of all facts and circumstances presented in a given case. As always, professionalism and civility play an important part in the Department's discharge of its responsibilities in all areas, including the area of corporate investigations and prosecutions.

[new August 2008]

9-28.200 General Considerations of Corporate Liability

A. **General Principle:** Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate, results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to be a force for positive change of corporate culture, and a force to prevent, discover, and punish serious crimes.

B. **Comment:** In all cases involving corporate wrongdoing, prosecutors should consider the factors discussed further below. In doing so, prosecutors should be aware of the public benefits that can flow from indicting a corporation in appropriate cases. For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal misconduct that is pervasive throughout a particular industry, and thus an indictment can provide a unique opportunity for deterrence on a broad scale. In addition, a corporate indictment may result in specific deterrence by changing the culture of the indicted corporation and the behavior of its employees. Finally, certain crimes that carry with them a substantial risk of great public harm—*e.g.*, environmental crimes or sweeping financial frauds—may be committed by a business entity, and there may therefore be a substantial federal interest in indicting a corporation under such circumstances.

In certain instances, it may be appropriate, upon consideration of the factors set forth herein, to resolve a corporate criminal case by means other than indictment. Non-prosecution and deferred prosecution agreements, for example, occupy an important middle ground between declining prosecution and obtaining the conviction of a corporation. These agreements are discussed further in USAM 9-28.1000. Likewise, civil and regulatory alternatives may be appropriate in certain cases, as discussed in USAM 9-28.1100.

Where a decision is made to charge a corporation, it does not necessarily follow that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. Because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, particularly if it relates to high-level corporate officers, even in the face of an offer of a corporate guilty plea or some other disposition of the charges against the corporation.

Corporations are "legal persons," capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents. To hold a corporation liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should not limit their focus solely to individuals or the corporation, but should consider both as potential targets.

Agents may act for mixed reasons—both for self-aggrandizement (both direct and indirect) and for the benefit of the corporation, and a corporation may be held liable as long as one motivation of its agent is to benefit the corporation. *See United States v. Potter*, 463 F.3d 9, 25 (1st Cir. 2006) (stating that the test to determine whether an agent is acting within the scope of employment is "whether the agent is performing acts of the kind which he is authorized to perform, and those acts are motivated, at least in part, by an intent to benefit the corporation."). In *United States v. Automated Medical Laboratories, Inc.*, 770 F.2d 399 (4th Cir. 1985), for example, the Fourth Circuit affirmed a corporation's conviction for the actions of a subsidiary's employee despite the corporation's claim that the employee was acting for his own benefit, namely his "ambitious nature and his desire to ascend the corporate ladder." *Id.* at 407. The court stated, "Partucci was clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being and its lack of difficulties with the FDA." *Id.; see also United States v. Cincotta*, 689 F.2d 238, 241-42 (1st Cir. 1982) (upholding a corporation's conviction, notwithstanding the substantial personal benefit reaped by its miscreant agents, because the fraudulent scheme required money to pass through the corporation's treasury and the fraudulently obtained goods were resold to the corporation's customers in the corporation's name).

Moreover, the corporation need not even necessarily profit from its agent's actions for it to be held liable. In *Automated Medical Laboratories*, the Fourth Circuit stated:

> [B]enefit is not a "touchstone of criminal corporate liability; benefit at best is an evidential, not an operative, fact." Thus, whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation. The basic purpose of requiring that an agent have acted with the intent to benefit the corporation, however, is to insulate the corporation from criminal liability for actions of its agents which may be *inimical* to the interests of the corporation or which may have been undertaken solely to advance the interests of that agent or of a party other than the corporation.

770 F.2d at 407 (internal citation omitted) (quoting *Old Monastery Co. v. United States*, 147 F.2d 905, 908 (4th Cir. 1945)).

[new August 2008]

9-28.300 Factors to Be Considered

A. **General Principle:** Generally, prosecutors apply the same factors in determining whether to charge a corporation as they do with respect to individuals. *See* USAM 9-27.220 *et seq*. Thus, the prosecutor must weigh all of the factors normally considered in the sound exercise of prosecutorial judgment: the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of noncriminal approaches. *See id.* However, due to the nature of the corporate "person," some additional factors are present. In conducting an investigation, determining whether to bring charges, and negotiating plea or other agreements, prosecutors should consider the following factors in reaching a decision as to the proper treatment of a corporate target:

   1. the nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime (see USAM 9-

28.400);

2. the pervasiveness of wrongdoing within the corporation, including the complicity in, or the condoning of, the wrongdoing by corporate management (see USAM 9-28.500);

3. the corporation's history of similar misconduct, including prior criminal, civil, and regulatory enforcement actions against it (see USAM 9-28.600);

4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents (see USAM 9-28.700);

5. the existence and effectiveness of the corporation's pre-existing compliance program (see USAM 9-28.800);

6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies (see USAM 9-28.900);

7. collateral consequences, including whether there is disproportionate harm to shareholders, pension holders, employees, and others not proven personally culpable, as well as impact on the public arising from the prosecution (see USAM 9-28.1000);

8. the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and

9. the adequacy of remedies such as civil or regulatory enforcement actions (see USAM 9-28.1100).

B. Comment: The factors listed in this section are intended to be illustrative of those that should be evaluated and are not an exhaustive list of potentially relevant considerations. Some of these factors may not apply to specific cases, and in some cases one factor may override all others. For example, the nature and seriousness of the offense may be such as to warrant prosecution regardless of the other factors. In most cases, however, no single factor will be dispositive. In addition, national law enforcement policies in various enforcement areas may require that more or less weight be given to certain of these factors than to others. Of course, prosecutors must exercise their thoughtful and pragmatic judgment in applying and balancing these factors, so as to achieve a fair and just outcome and promote respect for the law.

In making a decision to charge a corporation, the prosecutor generally has substantial latitude in determining when, whom, how, and even whether to prosecute for violations of federal criminal law. In exercising that discretion, prosecutors should consider the following statements of principles that summarize the considerations they should weigh and the practices they should follow in discharging their prosecutorial responsibilities. In doing so, prosecutors should ensure that the general purposes of the criminal law—assurance of warranted punishment, deterrence of further criminal conduct, protection of the public from dangerous and fraudulent conduct, rehabilitation of offenders, and restitution for victims and affected communities—are adequately met, taking into account the special nature of the corporate "person."

[new August 2008]

9-28.400 Special Policy Concerns

A. General Principle: The nature and seriousness of the crime, including the risk of harm to the public from the criminal misconduct, are obviously primary factors in determining whether to charge a corporation. In addition, corporate conduct, particularly that of national and multi-national corporations, necessarily intersects with federal economic, tax, and criminal law enforcement policies. In applying these Principles, prosecutors must consider the practices and policies of the appropriate Division of the Department, and must comply with those policies to the extent required by the facts presented.

B. Comment: In determining whether to charge a corporation, prosecutors should take into account federal law enforcement priorities as discussed above. See USAM 9-27.230. In addition, however, prosecutors must be aware of the specific policy goals and incentive programs established by the respective Divisions and regulatory agencies. Thus, whereas natural persons may be given incremental degrees of credit (ranging from immunity to lesser charges to sentencing considerations) for turning themselves in, making statements against their penal interest, and cooperating in the government's investigation of their own and others' wrongdoing, the same approach may not be appropriate in all circumstances with respect to corporations. As an example, it is entirely proper in many investigations for a prosecutor to consider the corporation's pre-indictment conduct, *e.g.*, voluntary disclosure, cooperation, remediation or restitution, in determining whether to seek an indictment. However, this would not necessarily be appropriate in an antitrust investigation, in which antitrust violations, by definition, go to the heart of the corporation's business. With this in mind, the Antitrust Division has established a firm policy, understood in the business community, that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government. As another example, the Tax Division has a strong preference for prosecuting responsible individuals, rather than entities, for corporate tax offenses. Thus, in determining whether or not to charge a corporation, prosecutors must consult with the Criminal, Antitrust, Tax, Environmental and Natural Resources, and National Security Divisions, as appropriate.

[new August 2008]

9-28.500 Pervasiveness of Wrongdoing Within the Corporation

is therefore held responsible for the acts of such persons fairly attributable to it. Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees, or by all the employees in a particular role within the corporation, or was condoned by upper management. On the other hand, it may not be appropriate to impose liability upon a corporation, particularly one with a robust compliance program in place, under a strict *respondeat superior* theory for the single isolated act of a rogue employee. There is, of course, a wide spectrum between these two extremes, and a prosecutor should exercise sound discretion in evaluating the pervasiveness of wrongdoing within a corporation.

B. Comment: Of these factors, the most important is the role and conduct of management. Although acts of even low-level employees may result in criminal liability, a corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged. As stated in commentary to the Sentencing Guidelines:

> Pervasiveness [is] case specific and [will] depend on the number, and degree of responsibility, of individuals [with] substantial authority ... who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an organization.

USSG § 8C2.5, cmt. (n. 4).

[new August 2008]

9-28.600 The Corporation's Past History

A. General Principle: Prosecutors may consider a corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it, in determining whether to bring criminal charges and how best to resolve cases.

B. Comment: A corporation, like a natural person, is expected to learn from its mistakes. A history of similar misconduct may be probative of a corporate culture that encouraged, or at least condoned, such misdeeds, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and it either had not taken adequate action to prevent future unlawful conduct or had continued to engage in the misconduct in spite of the warnings or enforcement actions taken against it. The corporate structure itself (*e.g.*, the creation or existence of subsidiaries or operating divisions) is not dispositive in this analysis, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates may be considered, if germane. *See* USSG § 8C2.5(c), cmt. (n. 6).

[new August 2008]

9-28.700 The Value of Cooperation

A. General Principle: In determining whether to charge a corporation and how to resolve corporate criminal cases, the corporation's timely and voluntary disclosure of wrongdoing and its cooperation with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider, among other things, whether the corporation made a voluntary and timely disclosure, and the corporation's willingness to provide relevant information and evidence and identify relevant actors within and outside the corporation, including senior executives.

Cooperation is a potential mitigating factor, by which a corporation—just like any other subject of a criminal investigation—can gain credit in a case that otherwise is appropriate for indictment and prosecution. Of course, the decision not to cooperate by a corporation (or individual) is not itself evidence of misconduct, at least where the lack of cooperation does not involve criminal misconduct or demonstrate consciousness of guilt (*e.g.*, suborning perjury or false statements, or refusing to comply with lawful discovery requests). Thus, failure to cooperate, in and of itself, does not support or require the filing of charges with respect to a corporation any more than with respect to an individual.

B. Comment: In investigating wrongdoing by or within a corporation, a prosecutor is likely to encounter several obstacles resulting from the nature of the corporation itself. It will often be difficult to determine which individual took which action on behalf of the corporation. Lines of authority and responsibility may be shared among operating divisions or departments, and records and personnel may be spread throughout the United States or even among several countries. Where the criminal conduct continued over an extended period of time, the culpable or knowledgeable personnel may have been promoted, transferred, or fired, or they may have quit or retired. Accordingly, a corporation's cooperation may be critical in identifying potentially relevant actors and locating relevant evidence, among other things, and in doing so expeditiously.

This dynamic—*i.e.*, the difficulty of determining what happened, where the evidence is, and which individuals took or promoted putatively illegal corporate actions—can have negative consequences for both the government and the corporation that is the subject or target of a government investigation. More specifically, because of corporate attribution principles concerning actions of corporate officers and employees (*see, e.g., supra* section II), uncertainty about exactly who authorized or directed apparent corporate misconduct can inure to the detriment of a corporation. For example, it may not matter under the law which of several possible executives or leaders in a chain of command approved of or authorized criminal conduct; however, that information if known might bear on the propriety of a particular disposition short of indictment of the corporation. It may not be in the interest of a corporation or the government for a charging decision to be made in the absence of such information, which might occur if, for example, a statute of limitations were relevant and authorization by any one of the officials were enough to justify a charge under the law. Moreover, and at a minimum, a protracted government investigation of such an issue could, as a collateral consequence, disrupt the corporation's business operations or even depress its stock price.

For these reasons and more, cooperation can be a favorable course for both the government and the corporation. Cooperation benefits the government—and ultimately shareholders, employees, and other often blameless victims—by allowing prosecutors and federal agents, for example, to avoid protracted delays, which compromise their ability to quickly uncover and address the full extent of widespread corporate crimes. With cooperation by the corporation, the government may be able to reduce tangible losses, limit damage to reputation, and preserve assets for restitution. At the same time, cooperation may benefit the corporation by enabling the government to focus its investigative resources in a manner that will not unduly disrupt the corporation's legitimate business operations. In addition, and critically, cooperation may benefit the corporation by presenting it with the opportunity to earn credit for its efforts.

[new August 2008]

9-28.710 Attorney-Client and Work Product Protections

The attorney-client privilege and the attorney work product protection serve an extremely important function in the American legal system. The attorney-client privilege is one of the oldest and most sacrosanct privileges under the law. *See Upjohn v. United States*, 449 U.S. 383, 389 (1981). As the Supreme Court has stated, "[i]ts purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice." *Id.* The value of promoting a corporation's ability to seek frank and comprehensive legal advice is particularly important in the contemporary global business environment, where corporations often face complex and dynamic legal and regulatory obligations imposed by the federal government and also by states and foreign governments. The work product doctrine serves similarly important goals.

For these reasons, waiving the attorney-client and work product protections has never been a prerequisite under the Department's prosecution guidelines for a corporation to be viewed as cooperative. Nonetheless, a wide range of commentators and members of the American legal community and criminal justice system have asserted that the Department's policies have been used, either wittingly or unwittingly, to coerce business entities into waiving attorney-client privilege and work-product protection. Everyone agrees that a corporation may freely waive its own privileges if it chooses to do so; indeed, such waivers occur routinely when corporations are victimized by their employees or others, conduct an internal investigation, and then disclose the details of the investigation to law enforcement officials in an effort to seek prosecution of the offenders. However, the contention, from a broad array of voices, is that the Department's position on attorney-client privilege and work product protection waivers has promoted an environment in which those protections are being unfairly eroded to the detriment of all.

The Department understands that the attorney-client privilege and attorney work product protection are essential and long- recognized components of the American legal system. What the government seeks and needs to advance its legitimate (indeed, essential) law enforcement mission is not waiver of those protections, but rather the facts known to the corporation about the putative criminal misconduct under review. In addition, while a corporation remains free to convey non-factual or "core" attorney-client communications or work product—if and only if the corporation voluntarily chooses to do so—prosecutors should not ask for such waivers and are directed not to do so. The critical factor is whether the corporation has provided the facts about the events, as explained further herein.

[new August 2008]

9-28.720 Cooperation: Disclosing the Relevant Facts

Eligibility for cooperation credit is not predicated upon the waiver of attorney-client privilege or work product protection. Instead, the sort of cooperation that is most valuable to resolving allegations of misconduct by a corporation and its officers, directors, employees, or agents is disclosure of the relevant *facts* concerning such misconduct. In this regard, the analysis parallels that for a non-corporate defendant, where cooperation typically requires disclosure of relevant factual knowledge and not of discussions between an individual and his attorneys.

Thus, when the government investigates potential corporate wrongdoing, it seeks the relevant facts. For example, how and when did the alleged misconduct occur? Who promoted or approved it? Who was responsible for committing it? In this respect, the investigation of a corporation differs little from the investigation of an individual. In both cases, the government needs to know the facts to achieve a just and fair outcome. The party under investigation may choose to cooperate by disclosing the facts, and the government may give credit for the party's disclosures. If a corporation wishes to receive credit for such cooperation, which then can be considered with all other cooperative efforts and circumstances in evaluating how fairly to proceed, then the corporation, like any person, must disclose the relevant facts of which it has knowledge.[FN2]

(a) Disclosing the Relevant Facts—Facts Gathered Through Internal Investigation

Individuals and corporations often obtain knowledge of facts in different ways.

An individual knows the facts of his or others' misconduct through his own experience and perceptions. A corporation is an artificial construct that cannot, by definition, have personal knowledge of the facts. Some of those facts may be reflected in documentary or electronic media like emails, transaction or accounting documents, and other records. Often, the corporation gathers facts through an internal investigation. Exactly how and by whom the facts are gathered is for the corporation to decide. Many corporations choose to collect information about potential misconduct through lawyers, a process that may confer attorney-client privilege or attorney work product protection on at least some of the information collected. Other corporations may choose a method of fact- gathering that does not have that effect—for example, having employee or other witness statements collected after interviews by non-attorney personnel. Whichever process the corporation selects, the government's key measure of cooperation must remain the same as it does for an individual: has the party timely disclosed the relevant facts about the putative misconduct? That is the operative question in assigning cooperation credit for the disclosure of information—*not* whether the corporation discloses attorney-client or work product materials. Accordingly, a corporation should receive the same credit for disclosing facts contained in materials that are not protected by the attorney- client privilege or attorney work product as it would for disclosing identical facts contained in materials that are so protected.[FN3] On this point the Report of the House Judiciary Committee, submitted in connection with the attorney-client privilege bill passed by the House of Representatives (H.R. 3013), comports with the approach required here:

> [A]n ... attorney of the United States may base cooperation credit on the facts that are disclosed, but is prohibited from basing cooperation credit upon whether or not the materials are protected by attorney-client privilege or attorney work product. As a result, an entity that voluntarily discloses should receive the same amount of cooperation credit for disclosing facts that happen to be contained in materials not protected by attorney-client privilege or attorney work product as it would receive for disclosing identical facts that are contained in materials protected by attorney-client privilege or attorney work product. There should be no differentials in an assessment of cooperation (i.e., neither a credit nor a penalty) based upon whether or not the materials disclosed are protected by attorney-client privilege or attorney work product.
>
> H.R. Rep. No. 110-445 at 4 (2007).

In short, so long as the corporation timely discloses relevant facts about the putative misconduct, the corporation may receive due credit for such cooperation, regardless of whether it chooses to waive privilege or work product protection in the process.[FN4] Likewise, a corporation that does not disclose the relevant facts about the alleged misconduct—for whatever reason—typically should not be entitled to receive credit for cooperation.

Two final and related points bear noting about the disclosure of facts, although they should be obvious. First, the government cannot compel, and the corporation has no obligation to make, such disclosures (although the government can obviously compel the disclosure of certain records and witness testimony through subpoenas). Second, a corporation's failure to provide relevant information does not mean the corporation will be indicted. It simply means that the corporation will not be entitled to mitigating credit for that cooperation. Whether the corporation faces charges will turn, as it does in any case, on the sufficiency of the evidence, the likelihood of success at trial, and all of the other factors identified in Section III above. If there is insufficient evidence to warrant indictment, after appropriate investigation has been completed, or if the other factors weigh against indictment, then the corporation should not be indicted, irrespective of whether it has earned cooperation credit. The converse is also true: The government may charge even the most cooperative corporation pursuant to these Principles if, in weighing and balancing the factors described herein, the prosecutor determines that a charge is required in the interests of justice. Put differently, even the most sincere and thorough effort to cooperate cannot necessarily absolve a corporation that has, for example, engaged in an egregious, orchestrated, and widespread fraud. Cooperation is a relevant potential mitigating factor, but it alone is not dispositive.

(b) Legal Advice and Attorney Work Product

Separate from (and usually preceding) the fact-gathering process in an internal investigation, a corporation, through its officers, employees, directors, or others, may have consulted with corporate counsel regarding or in a manner that concerns the legal implications of the putative misconduct at issue. Communications of this sort, which are both independent of the fact-gathering component of an internal investigation and made for the purpose of seeking or dispensing legal advice, lie at the core of the attorney-client privilege. Such communications can naturally have a salutary effect on corporate behavior—facilitating, for example, a corporation's effort to comply with complex and evolving legal and regulatory regimes.[FN5] Except as noted in subparagraphs (b)(i) and (b)(ii) below, a corporation need not disclose and prosecutors may not request the disclosure of such communications as a condition for the corporation's eligibility to receive cooperation credit.

Likewise, non-factual or core attorney work product—for example, an attorney's mental impressions or legal theories—lies at the core of the attorney work product doctrine. A corporation need not disclose, and prosecutors may not request, the disclosure of such attorney work product as a condition for the corporation's eligibility to receive cooperation credit.

(i) Advice of Counsel Defense in the Instant Context

Occasionally a corporation or one of its employees may assert an advice-of-counsel defense, based upon communications with in- house or outside counsel that took place prior to or contemporaneously with the underlying conduct at issue. In such situations, the defendant must tender a legitimate factual basis to support the assertion of the advice-of-counsel defense. *See, e.g., Pitt v. Dist. of Columbia*, 491 F.3d 494, 504-05 (D.C. Cir. 2007); *United States v. Wenger*, 427 F.3d 840, 853-54 (10th Cir. 2005); *United States v. Cheek*, 3 F.3d 1057, 1061-62 (7th Cir. 1993). The

Department cannot fairly be asked to discharge its responsibility to the public to investigate alleged corporate crime, or to temper what would otherwise be the appropriate course of prosecutive action, by simply accepting on faith an otherwise unproven assertion that an attorney—perhaps even an unnamed attorney—approved potentially unlawful practices. Accordingly, where an advice-of-counsel defense has been asserted, prosecutors may ask for the disclosure of the communications allegedly supporting it.

(ii) Communications in Furtherance of a Crime or Fraud

Communications between a corporation (through its officers, employees, directors, or agents) and corporate counsel that are made in furtherance of a crime or fraud are, under settled precedent, outside the scope and protection of the attorney- client privilege. *See United States v. Zolin*, 491 U.S. 554, 563 (1989); *United States v. BDO Seidman, LLP*, 492 F.3d 806, 818 (7th Cir. 2007). As a result, the Department may properly request such communications if they in fact exist.

[new August 2008]

9-28.730 Obstructing the Investigation

Another factor to be weighed by the prosecutor is whether the corporation has engaged in conduct intended to impede the investigation. Examples of such conduct could include: inappropriate directions to employees or their counsel, such as directions not to be truthful or to conceal relevant facts; making representations or submissions that contain misleading assertions or material omissions; and incomplete or delayed production of records.

In evaluating cooperation, however, prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees or providing counsel to employees, officers, or directors under investigation or indictment. Likewise, prosecutors may not request that a corporation refrain from taking such action. This prohibition is not meant to prevent a prosecutor from asking questions about an attorney's representation of a corporation or its employees, officers, or directors, where otherwise appropriate under the law.[FN6] Neither is it intended to limit the otherwise applicable reach of criminal obstruction of justice statutes such as 18 U.S.C. § 1503. If the payment of attorney fees were used in a manner that would otherwise constitute criminal obstruction of justice—for example, if fees were advanced on the condition that an employee adhere to a version of the facts that the corporation and the employee knew to be false—these Principles would not (and could not) render inapplicable such criminal prohibitions.

Similarly, the mere participation by a corporation in a joint defense agreement does not render the corporation ineligible to receive cooperation credit, and prosecutors may not request that a corporation refrain from entering into such agreements. Of course, the corporation may wish to avoid putting itself in the position of being disabled, by virtue of a particular joint defense or similar agreement, from providing some relevant facts to the government and thereby limiting its ability to seek such cooperation credit. Such might be the case if the corporation gathers facts from employees who have entered into a joint defense agreement with the corporation, and who may later seek to prevent the corporation from disclosing the facts it has acquired. Corporations may wish to address this situation by crafting or participating in joint defense agreements, to the extent they choose to enter them, that provide such flexibility as they deem appropriate.

Finally, it may on occasion be appropriate for the government to consider whether the corporation has shared with others sensitive information about the investigation that the government provided to the corporation. In appropriate situations, as it does with individuals, the government may properly request that, if a corporation wishes to receive credit for cooperation, the information provided by the government to the corporation not be transmitted to others—for example, where the disclosure of such information could lead to flight by individual subjects, destruction of evidence, or dissipation or concealment of assets.

[new August 2008]

9-28.740 Offering Cooperation: No Entitlement to Immunity

A corporation's offer of cooperation or cooperation itself does not automatically entitle it to immunity from prosecution or a favorable resolution of its case. A corporation should not be able to escape liability merely by offering up its directors, officers, employees, or agents. Thus, a corporation's willingness to cooperate is not determinative; that factor, while relevant, needs to be considered in conjunction with all other factors.

[new August 2008]

9-28.750 Qualifying for Immunity, Amnesty, or Reduced Sanctions Through Voluntary Disclosures

In conjunction with regulatory agencies and other executive branch departments, the Department encourages corporations, as part of their compliance programs, to conduct internal investigations and to disclose the relevant facts to the appropriate authorities. Some agencies, such as the Securities and Exchange Commission and the Environmental Protection Agency, as well as the Department's Environmental and Natural Resources Division, have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions. Even in the absence of a formal program, prosecutors may consider a corporation's timely and voluntary disclosure in evaluating the adequacy of the corporation's compliance program and its management's commitment to the compliance program. However, prosecution and economic policies specific to the industry or statute may require prosecution notwithstanding a corporation's willingness to cooperate. For example, the Antitrust Division has a policy of offering amnesty only to the first corporation to agree to cooperate. Moreover, amnesty, immunity, or reduced sanctions may not be appropriate where the corporation's business is permeated with fraud or other crimes.

[new August 2008]

9-28.760 Oversight Concerning Demands for Waivers of Attorney-Client Privilege or Work Product Protection By Corporations Contrary to This Policy

The Department underscores its commitment to attorney practices that are consistent with Department policies like those set forth herein concerning cooperation credit and due respect for the attorney-client privilege and work product protection. Counsel for corporations who believe that prosecutors are violating such guidance are encouraged to raise their concerns with supervisors, including the appropriate United States Attorney or Assistant Attorney General. Like any other allegation of attorney misconduct, such allegations are subject to potential investigation through established mechanisms.

[new August 2008]

9-28.800 Corporate Compliance Programs

A. General Principle: Compliance programs are established by corporate management to prevent and detect misconduct and to ensure that corporate activities are conducted in accordance with applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal misconduct undertaken by its officers, directors, employees, or agents. In addition, the nature of some crimes, *e.g.*, antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.

B. Comment: The existence of a corporate compliance program, even one that specifically prohibited the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior. See United States v. Basic Constr. Co.*, 711 F.2d 570, 573 (4th Cir. 1983) ("[A] corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if ... such acts were against corporate policy or express instructions."). As explained in *United States v. Potter*, 463 F.3d 9 (1st Cir. 2006), a corporation cannot "avoid liability by adopting abstract rules" that forbid its agents from engaging in illegal acts, because "[e]ven a specific directive to an agent or employee or honest efforts to police such rules do not automatically free the company for the wrongful acts of agents." *Id.* at 25-26. *See also United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1007 (9th Cir. 1972) (noting that a corporation "could not gain exculpation by issuing general instructions without undertaking to enforce those instructions by means commensurate with the obvious risks"); *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979) ("[A] corporation may be liable for acts of its employees done contrary to express instructions and policies, but ...the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation.").

While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. The Department has no formulaic requirements regarding corporate compliance programs. The fundamental questions any prosecutor should ask are: Is the corporation's compliance program well designed? Is the program being applied earnestly and in good faith? Does the corporation's compliance program work? In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal misconduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct; and any remedial actions taken by the corporation, including, for example, disciplinary action against past violators uncovered by the prior compliance program, and revisions to corporate compliance programs in light of lessons learned.[FN7] Prosecutors should also consider the promptness of any disclosure of wrongdoing to the government. In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are internal audit functions conducted at a level sufficient to ensure their independence and accuracy; and have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law. *See, e.g., In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968-70 (Del. Ch. 1996).

Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a "paper program" or whether it was designed, implemented, reviewed, and revised, as appropriate, in an effective manner. In addition, prosecutors should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts. Prosecutors also should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it. This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation.

Compliance programs should be designed to detect the particular types of misconduct most likely to occur in a particular corporation's line of business. Many corporations operate in complex regulatory environments outside the normal experience of criminal prosecutors. Accordingly, prosecutors should consult with relevant federal and state agencies with the expertise to evaluate the adequacy of a program's design and implementation. For instance, state and federal banking, insurance, and medical boards, the Department of Defense, the Department of Health and Human Services, the Environmental Protection Agency, and the Securities and Exchange Commission have considerable experience with compliance programs and can be helpful to a prosecutor in evaluating such programs. In addition, the Fraud Section of the Criminal Division, the Commercial Litigation Branch of the Civil Division, and the Environmental Crimes Section of the Environment and Natural Resources Division can assist United States Attorneys' Offices in finding the appropriate agency office(s) for such consultation.

[new August 2008]

9-28.900 Restitution and Remediation

A. **General Principle:** Although neither a corporation nor an individual target may avoid prosecution merely by paying a sum of money, a prosecutor may consider the corporation's willingness to make restitution and steps already taken to do so. A prosecutor may also consider other remedial actions, such as improving an existing compliance program or disciplining wrongdoers, in determining whether to charge the corporation and how to resolve corporate criminal cases.

B. **Comment:** In determining whether or not to prosecute a corporation, the government may consider whether the corporation has taken meaningful remedial measures. A corporation's response to misconduct says much about its willingness to ensure that such misconduct does not recur. Thus, corporations that fully recognize the seriousness of their misconduct and accept responsibility for it should be taking steps to implement the personnel, operational, and organizational changes necessary to establish an awareness among employees that criminal conduct will not be tolerated.

Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined wrongdoers, once those employees are identified by the corporation as culpable for the misconduct. Employee discipline is a difficult task for many corporations because of the human element involved and sometimes because of the seniority of the employees concerned. Although corporations need to be fair to their employees, they must also be committed, at all levels of the corporation, to the highest standards of legal and ethical behavior. Effective internal discipline can be a powerful deterrent against improper behavior by a corporation's employees. Prosecutors should be satisfied that the corporation's focus is on the integrity and credibility of its remedial and disciplinary measures rather than on the protection of the wrongdoers.

In addition to employee discipline, two other factors used in evaluating a corporation's remedial efforts are restitution and reform. As with natural persons, the decision whether or not to prosecute should not depend upon the target's ability to pay restitution. A corporation's efforts to pay restitution even in advance of any court order is, however, evidence of its acceptance of responsibility and, consistent with the practices and policies of the appropriate Division of the Department entrusted with enforcing specific criminal laws, may be considered in determining whether to bring criminal charges. Similarly, although the inadequacy of a corporate compliance program is a factor to consider when deciding whether to charge a corporation, that corporation's quick recognition of the flaws in the program and its efforts to improve the program are also factors to consider as to appropriate disposition of a case.

[new August 2008]

9-28.1000 Collateral Consequences

A. General Principle: Prosecutors may consider the collateral consequences of a corporate criminal conviction or indictment in determining whether to charge the corporation with a criminal offense and how to resolve corporate criminal cases.

B. Comment: One of the factors in determining whether to charge a natural person or a corporation is whether the likely punishment is appropriate given the nature and seriousness of the crime. In the corporate context, prosecutors may take into account the possibly substantial consequences to a corporation's employees, investors, pensioners, and customers, many of whom may, depending on the size and nature of the corporation and their role in its operations, have played no role in the criminal conduct, have been unaware of it, or have been unable to prevent it. Prosecutors should also be aware of non-penal sanctions that may accompany a criminal charge, such as potential suspension or debarment from eligibility for government contracts or federally funded programs such as health care programs. Determining whether or not such non-penal sanctions are appropriate or required in a particular case is the responsibility of the relevant agency, and is a decision that will be made based on the applicable statutes, regulations, and policies.

Virtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties, and the mere existence of such an effect is not sufficient to preclude prosecution of the corporation. Therefore, in evaluating the relevance of collateral consequences, various factors already discussed, such as the pervasiveness of the criminal conduct and the adequacy of the corporation's compliance programs, should be considered in determining the weight to be given to this factor. For instance, the balance may tip in favor of prosecuting corporations in situations where the scope of the misconduct in a case is widespread and sustained within a corporate division (or spread throughout pockets of the corporate organization). In such cases, the possible unfairness of visiting punishment for the corporation's crimes upon shareholders may be of much less concern where those shareholders have substantially profited, even unknowingly, from widespread or pervasive criminal activity. Similarly, where the top layers of the corporation's management or the shareholders of a closely-held corporation were engaged in or aware of the wrongdoing, and the conduct at issue was accepted as a way of doing business for an extended period, debarment may be deemed not collateral, but a direct and entirely appropriate consequence of the corporation's wrongdoing.

On the other hand, where the collateral consequences of a corporate conviction for innocent third parties would be significant, it may be appropriate to consider a non-prosecution or deferred prosecution agreement with conditions designed, among other things, to promote compliance with applicable law and to prevent recidivism. Such agreements are a third option, besides a criminal indictment, on the one hand, and a declination, on the other. Declining prosecution may allow a corporate criminal to escape without consequences. Obtaining a conviction may produce a result that seriously harms innocent third parties who played no role in the criminal conduct. Under appropriate circumstances, a deferred prosecution or non-prosecution agreement can help restore the integrity of a company's operations and preserve the financial viability of a corporation that has engaged in criminal conduct, while preserving the government's ability to prosecute a recalcitrant corporation that materially breaches the agreement. Such agreements achieve other important objectives as well, like prompt restitution for victims.[FN8] Ultimately, the appropriateness of a criminal charge against a corporation, or some lesser alternative, must be evaluated in a pragmatic and reasoned way that produces a fair outcome, taking into consideration, among other things, the Department's need to promote and ensure respect for the law.

[new August 2008]

9-28.1100 Other Civil or Regulatory Alternatives

A. **General Principle:** Non-criminal alternatives to prosecution often exist and prosecutors may consider whether such sanctions would adequately deter, punish, and rehabilitate a corporation that has engaged in wrongful conduct. In evaluating the adequacy of non-criminal alternatives to prosecution—*e.g.*, civil or regulatory enforcement actions—the prosecutor may consider all relevant factors, including:

   1. the sanctions available under the alternative means of disposition;
   2. the likelihood that an effective sanction will be imposed; and
   3. the effect of non-criminal disposition on federal law enforcement interests.

B. **Comment:** The primary goals of criminal law are deterrence, punishment, and rehabilitation. Non-criminal sanctions may not be an appropriate response to a serious violation, a pattern of wrongdoing, or prior non-criminal sanctions without proper remediation. In other cases, however, these goals may be satisfied through civil or regulatory actions. In determining whether a federal criminal resolution is appropriate, the prosecutor should consider the same factors (modified appropriately for the regulatory context) considered when determining whether to leave prosecution of a natural person to another jurisdiction or to seek non-criminal alternatives to prosecution. These factors include: the strength of the regulatory authority's interest; the regulatory authority's ability and willingness to take effective enforcement action; the probable sanction if the regulatory authority's enforcement action is upheld; and the effect of a non-criminal disposition on federal law enforcement interests. See USAM 9-27.240, 9-27.250.

[new August 2008]

9-28.1200 Selecting Charges

A. General Principle: Once a prosecutor has decided to charge a corporation, the prosecutor at least presumptively should charge, or should recommend that the grand jury charge, the most serious offense that is consistent with the nature of the defendant's misconduct and that is likely to result in a sustainable conviction.

B. Comment: Once the decision to charge is made, the same rules as govern charging natural persons apply. These rules require "a faithful and honest application of the Sentencing Guidelines" and an "individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the Federal criminal code, and maximize the impact of Federal resources on crime." See USAM 9-27.300. In making this determination, "it is appropriate that the attorney for the government consider, *inter alia*, such factors as the [advisory] sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range ...is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *Id.*

[new August 2008]

9-28.1300 Plea Agreements with Corporations

A. General Principle: In negotiating plea agreements with corporations, as with individuals, prosecutors should generally seek a plea to the most serious, readily provable offense charged. In addition, the terms of the plea agreement should contain appropriate provisions to ensure punishment, deterrence, rehabilitation, and compliance with the plea agreement in the corporate context. Although special circumstances may mandate a different conclusion, prosecutors generally should not agree to accept a corporate guilty plea in exchange for non-prosecution or dismissal of charges against individual officers and employees.

B. Comment: Prosecutors may enter into plea agreements with corporations for the same reasons and under the same constraints as apply to plea agreements with natural persons. See USAM 9-27.400-530. This means, *inter alia*, that the corporation should generally be required to plead guilty to the most serious, readily provable offense charged. In addition, any negotiated departures or recommended variances from the advisory Sentencing Guidelines must be justifiable under the Guidelines or 18 U.S.C. § 3553 and must be disclosed to the sentencing court. A corporation should be made to realize that pleading guilty to criminal charges constitutes an admission of guilt and not merely a resolution of an inconvenient distraction from its business. As with natural persons, pleas should be structured so that the corporation may not later "proclaim lack of culpability or even complete innocence." See USAM 9-27.420 (b)(4), 9-27.440, 9-27.500. Thus, for instance, there should be placed upon the record a sufficient factual basis for the plea to prevent later corporate assertions of innocence.

A corporate plea agreement should also contain provisions that recognize the nature of the corporate "person" and that ensure that the principles of punishment, deterrence, and rehabilitation are met. In the corporate context, punishment and deterrence are generally accomplished by substantial fines, mandatory restitution, and institution of appropriate compliance measures, including, if necessary, continued judicial oversight or the use of special masters or corporate monitors. *See* USSG §§ 8B1.1, 8C2.1, *et seq.* In addition, where the corporation is a government contractor, permanent or temporary debarment may be appropriate. Where the corporation was engaged in fraud against the government (*e.g.*, contracting fraud), a prosecutor may not negotiate away an agency's right to debar or delist the corporate defendant.

In negotiating a plea agreement, prosecutors should also consider the deterrent value of prosecutions of individuals within the corporation. Therefore, one factor that a prosecutor may consider in determining whether to enter into a plea agreement is whether the corporation is seeking immunity for its employees and officers or whether the corporation is willing to cooperate in the investigation of culpable individuals as outlined herein. Prosecutors should rarely negotiate away individual criminal liability in a corporate plea.

Rehabilitation, of course, requires that the corporation undertake to be law-abiding in the future. It is, therefore, appropriate to require the corporation, as a condition of probation, to implement a compliance program or to reform an existing one. As discussed above, prosecutors may consult with the appropriate state and federal agencies and components of the Justice Department to ensure that a proposed compliance program is adequate and meets industry standards and best practices. See USAM 9-28.800.

In plea agreements in which the corporation agrees to cooperate, the prosecutor should ensure that the cooperation is entirely truthful. To do so, the prosecutor may request that the corporation make appropriate disclosures of relevant factual information and documents, make employees and agents available for debriefing, file appropriate certified financial statements, agree to governmental or third-party audits, and take whatever other steps are necessary to ensure that the full scope of the corporate wrongdoing is disclosed and that the responsible personnel are identified and, if appropriate, prosecuted. See generally USAM 9-28.700. In taking such steps, Department prosecutors should recognize that attorney-client communications are often essential to a corporation's efforts to comply with complex regulatory and legal regimes, and that, as discussed at length above, cooperation is not measured by the waiver of attorney-client privilege and work product protection, but rather is measured by the disclosure of facts and other considerations identified herein such as making witnesses available for interviews and assisting in the interpretation of complex documents or business records.

These Principles provide only internal Department of Justice guidance. They are not intended to, do not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal. Nor are any limitations hereby placed on otherwise lawful litigative prerogatives of the Department of Justice.

[new August 2008]

FN 1. While these guidelines refer to corporations, they apply to the consideration of the prosecution of all types of business organizations, including partnerships, sole proprietorships, government entities, and unincorporated associations.

FN 2. There are other dimensions of cooperation beyond the mere disclosure of facts, of course. These can include, for example, providing non-privileged documents and other evidence, making witnesses available for interviews, and assisting in the interpretation of complex business records. This section of the Principles focuses solely on the disclosure of facts and the privilege issues that may be implicated thereby.

FN 3. By way of example, corporate personnel are typically interviewed during an internal investigation. If the interviews are conducted by counsel for the corporation, certain notes and memoranda generated from the interviews may be subject, at least in part, to the protections of attorney-client privilege and/or attorney work product. To receive cooperation credit for providing factual information, the corporation need not produce, and prosecutors may not request, protected notes or memoranda generated by the lawyers' interviews. To earn such credit, however, the corporation does need to produce, and prosecutors may request, relevant factual information—including relevant factual information acquired through those interviews, unless the identical information has otherwise been provided—as well as relevant non-privileged evidence such as accounting and business records and emails between non-attorney employees or agents.

FN 4. In assessing the timeliness of a corporation's disclosures, prosecutors should apply a standard of reasonableness in light of the totality of circumstances.

FN 5. These privileged communications are not necessarily limited to those that occur contemporaneously with the underlying misconduct. They would include, for instance, legal advice provided by corporate counsel in an internal investigation report. Again, the key measure of cooperation is the disclosure of factual information known to the corporation, not the disclosure of legal advice or theories rendered in connection with the conduct at issue (subject to the two exceptions noted in USAM 9-28.720(b)(i-ii)).

FN 6. Routine questions regarding the representation status of a corporation and its employees, including how and by whom attorneys' fees are paid, sometimes arise in the course of an investigation under certain circumstances—to take one example, to assess conflict-of-interest issues. Such questions can be appropriate and this guidance is not intended to prohibit such limited inquiries.

FN 7. For a detailed review of these and other factors concerning corporate compliance programs, see USSG § 8B2.1.

FN 8. Prosecutors should note that in the case of national or multi-national corporations, multi-district or global agreements may be necessary. Such agreements may only be entered into with the approval of each affected district or the appropriate Department official. See USAM 9-27.641.

Attachment D

Mark Kirschner, as Liquidation Trustee of Le-Nature's Liquidation Trust v. K&L Gates LLP, et. al., 2010 WL 5504811 (Allegheny Cty. Pa. Com. Pl. Dec. 28, 2010).

2010 WL 5504811 (Pa.Com.Pl.) (Trial Order)
Court of Common Pleas of Pennsylvania,
Civil Division.
Allegheny County

Marc KIRSCHNER, in his capacity as the Liquidation Trustee of Le-Nature's Liquidation Trust, Plaintiff,

v.

K&L GATES LLP; Sanford Ferguson, Pascarella & Wiker, LLP and Carl A. Wiker, Defendants.

No. GD09-015557.
December 28, 2010.

Civil Division

Opinion and Order of Court

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Honorable R. Stanton Wettick, Jr.

WETTICK, J.

The preliminary objections of K&L Gates LLP and Sanford Ferguson ("K&L") and the preliminary objections of Pascarella & Wiker, LLP and Carl A. Wiker ("Pascarella") seeking dismissal of each count within Plaintiff's First Amended Complaint are the subject of this Opinion and Order of Court.

The facts, as set forth in the Amended Complaint, are as follows:

This litigation arises out of the CEO's looting of Le-Nature's (a Delaware corporation) that led to an involuntary bankruptcy proceeding instituted in the United States Bankruptcy Court for the Western District of Pennsylvania. In the bankruptcy proceeding, the Court created the Le-Nature's Liquidation Trust which holds all assets and property of Le-Nature's, including any causes of action possessed by Le-Nature's. Plaintiff (Marc Kirschner) was appointed Trustee of this Trust.

Le-Nature's was founded in 1992 by Gregory J. Podlucky ("Podlucky"). Within a year of its formation, Le-Nature's produced a line of beverage products that included ice tea, lemonade, and juice-based drinks.

From the date of the formation through the institution of the bankruptcy proceedings, it appears that Podlucky was the sole shareholder of the company's common stock; he also served as its chief executive officer until days before the institution of the bankruptcy proceedings.

In 2000 and 2002, Le-Nature's issued shares of convertible preferred stock that were purchased by three investment funds. The certificates governing these shares granted to the holders of these shares the right to appoint directors to the Board, to approve all capital expenditures, and to compel a sale of Le-Nature's by no later than September 2006. [1]

After 2002, the corporation consisted of two groups of equity holders: Podlucky (who was looting the company) and the investors (holders of the preferred stock).

In August 2003, Le-Nature's outside auditor (Ernst & Young) was conducting a routine quarterly review of Le-Nature's finances. The review included a meeting with Le-Nature's chief financial officer, chief administrative officer, and vice president of administration. At this meeting, held on August 13, 2003, each stated that he or she had serious concerns about the accuracy of Le-Nature's sales figures.

On the next day, each of these persons submitted letters of resignation. In these letters, they expressed concern about the manner in which the business was being conducted. In his letter, the chief financial officer stated that Podlucky made it impossible for him to discharge his duties to the company because Podlucky maintained almost absolute control over the company's detailed financial records and denied him access to the documentation supporting the company's general ledger.

At the time of his resignation, the chief financial officer provided one of the independent directors with a list of his concerns. In addition, he informed the audit partner of Ernst & Young of the resignation letters.

The minority directors immediately discussed the need for an investigation. Thereafter, on August 22, 2003, Ernst & Young sent a letter advising Le-Nature's that Ernst & Young could not be associated with any financial statements until the allegations in the resignation letters were investigated by independent counsel.

On August 26, 2003, Le-Nature's Board of Directors consented to the creation of a Special Committee to conduct an investigation into the allegations and circumstances of the resignation of the three senior financial managers. The Special Committee which the Board created was composed of the three nonemployee directors on the Board who represented the interests of the minority shareholders. None was an employee.

The resolution creating the Special Committee authorized the Committee to hire legal counsel and accountants to assist in the investigation. On August 28, 2003, the Special Committee retained K&L to investigate the circumstances that led to the resignation of the three senior financial managers. Lead counsel was Sanford Ferguson, a defendant in these proceedings.

The terms of the engagement are set forth in a letter dated August 28, 2003 from Mr. Ferguson to the Chair of the Special Committee attached to Plaintiff's Amended Complaint as Exhibit A. The relevant portion of the letter reads as follows:

You have asked us to represent the Special Committee ("Special Committee") of Outside Directors of Le-Nature's Beverages, Inc. ("Company") in connection with a review of the circumstances attendant upon the recent resignation of three members of the finance staff of the Company.

It is our Firm's practice to confirm in writing the identity of any client whom we represent, the nature of our undertaking on behalf of that client and our billing and payment arrangements with respect to our legal services.

We understand that we are being engaged to act as counsel for the Special Committee and for no other individual or entity, including the Company or any affiliated entity, shareholder, director, officer or employee of the Company not specifically identified herein. We further understand that we are to assist the Committee in investigating the facts and circumstances surrounding the aforementioned resignations and assist the Special Committee in developing any findings and recommendations to be made to the full Board of the Company with respect thereto. The attorney-client relationship with respect to our work, including our work product, shall belong to the Committee. Only the Committee can waive any privilege rotating to such work.

Our firm currently represents Star Associates in connection with a contract dispute with the Company. This matter is substantively unrelated to the scope of the work of the Special Committee. We believe that our ongoing representation of Star Associates will not adversely affect our exercise of independent professional judgment on behalf of the Special Committee.

Nonetheless, we wilt establish a Chinese Wall between those of our personnel working on the Star Associates matter and those working on the Special Committee matter. In view of the ongoing duties of loyalty we would owe to both Star Associates and the Special Committee, we wish to confirm at the outset of our engagement by the Special Committee that you concur with our conclusions set forth above and that you waive any potential or actual conflict of interest relating thereto. Amended Complaint, Ex. A at 1-2.

K&L selected P&W, an accounting firm, to assist in the investigation. Exhibit B to Plaintiff's Amended Complaint is a September 12, 2003 retention letter from a partner of the accounting firm to Mr. Ferguson. The second paragraph of the letter sets forth P&W's understanding of its role:
UNDERSTANDING OF P&W's ROLE

It is understood that P&W is being retained to assist K&L as a financial expert related to the special investigation of certain transactions involving LeNature's, Inc. ("LeNature's"). P&W shall provide general consulting, financial, accounting, and investigative or other advice as requested by K&L to assist it in rendering legal advice to LeNature's. Acting as a consultant to counsel, we understand that all work and communications relating to this engagement are expected to be confidential and privileged and will be so treated unless otherwise directed by you, or required by law or court order.

Payment for P&W's services is governed by the following provision in the September 12, 2003 letter:

> P&W will render monthly invoices to K&L. K&L will then include our charges as part of its regular monthly invoices to LeNature's. We understand that under the terms of K&L's engagement by LeNature's, K&L's invoices are payable within thirty days of submission. We reserve the right to cease all work if any K&L invoice to LeNature's becomes past due, without regard to the status of our services or any related procedures. K&L will promptly pay our invoices as the funds therefore are received from LeNature's. It is understood that K&L will not be otherwise responsible for payment of fees and expenses to P&W, as such responsibility ultimately rests with Le-Nature's, Inc. Amended Complaint, Ex. B at 1-2.

The Amended Complaint sets forth factual allegations that would, if proven, establish that at the time of the investigation, the improper activities which the three former senior financial officers suspected to be taking place were, in fact, taking place. However, K&L did not discover the misconduct of Podlucky because its investigation fell below an acceptable standard of care for many reasons, including the narrowing of the scope of the investigation to less than what was required, reliance on uncorroborated explanations offered by Podlucky, the failure to demand backup writings (which were, in fact, nonexistent), and the failure to obtain bank account statements from Le-Nature's bank.

K&L furnished its Report, dated December 8, 2003, to the Special Committee.[2] On December 9, 2003, the Special Committee sent the Report, along with a covering Memo, to the Board of the Directors. This Memo (Exhibit D to Plaintiff's Amended Complaint) reads as follows:

The Special Committee of the Board of Directors of Le-Nature's Inc. ("Le-Nature's" or the "Company") hereby submits the report attached herein prepared by the Committee's Counsel. Kirkpatrick and Lockhart LLP ("K&L") and its financial consultants Pascarella & Wiker, LLP ("P&W").
The Special Committee was formed in August 2003 to investigate certain specific business transactions identified by three former Company employees (the "Employees"), all of whom resigned in mid-August 2003. The Special Committee consists of two outside directors who are representatives of the SW Pelham Fund, L.P. ("Pelham") and one director representing George K. Baum Merchant Banc, L.L.C. ("Baum").

Upon the advice of Counsel, the Committed limited the scope of its investigation to seven specific transactions Identified by the Employees as areas of concern and that could potentially impact the Company's financial statements. The Committee did not examine any underlying motives of the Employees, their relationship to other members of senior management, the Employees' job performance or their respective competencies in performing their specific job functions.

The Committee is pleased to report that K&L and P&W "found no evidence of fraud or malfeasance with respect to any of the transactions reviewed by it. Further Counsel found no evidence which suggests that the transactions identified by the Former Employees as being of concern had not been properly reported on Le-Nature's financial statements". This second finding is subject to a review by Le-Nature's independent auditors on two of the transactions: 1) a barter transaction described in Section IV (F)(3) of the attached report and 2) the accounting of a settlement payment with one of its vendors described in Section IV (B) of the report.

In the course of its review, Counsel uncovered some weaknesses in LeNature's management structure, specifically in the areas of segregation of duties and supporting documentation that need further review by the Board of Directors. Since the initial investment made by Pelham and Baum, the Company has augmented its senior management. The Company has completed its plant build out, added bottling manufacturing capabilities and expanded its sale and marketing expertise. The Special Committee has noticed an "esprit de corps" among current senior management in the aforementioned job areas. This same mindset, however, must extend to mangers in the finance department.

K&L recommends the following:

• A segregation of duties particularly in the areas of equipment purchases, tea leaf purchases and Bulk Tea Product Sates

• Adopting standards of supporting documentation and implement procedures to ensure that the documentation standards are consistently followed.

• The appointment of a permanent CFO and controller. These employees would be the architects for improving Le-Nature's financial infrastructure. A profile for the type of individuals needed and their specific duties can be found in Section, (C) of the report.

• Formation of Audit & Compensation Committees consisting of independent directors

• Establish segment reporting for Bulk Tea Sales and Ready-to-Drink Products

• Have greater familiarity with the financial condition of any of its vendors, specifically: Pollinger and Ritz Foods.

The Committee concurs strongly with all the recommendations outlined above.

We look forward to talking with the full Board of Directors on these recommendations and other findings of fact as soon as possible and to work with the Company in addressing the issues raised herein.

This Memo is an accurate summary of the Report. The first paragraph of the Report under Section V, Conclusions & Recommendations, reads as follows:

> Counsel found no evidence of fraud or malfeasance with respect to any of the transactions reviewed by it. Further, Counsel found no evidence which suggests that the transactions identified by the Former Employees as being of concern had not been properly reported on Le-Nature's financial statements, subject to a review by Le-Nature's independent auditors of (i) the accounting for the barter transaction described in Section IV(F)(3) above, and (ii) the extent to which the CCC settlement payments described in Section IV(B) above should be allocated between an amount (for the fair value of the equipment) and an expense (if, and to the extent that, the payments to CCC exceeded the fair value of the asset acquired). Amended Complaint, Ex. C at 30.

Thereafter, under the same heading, the Report contains three and a half pages of remedial actions that should be taken because of weaknesses in Le-Nature's management structure.

Plaintiff alleges that because K&L failed to discover the massive fraud, Podlucky was now armed with a clean bill of health that allowed him to continue looting the company, increasing its debt, and wasting funds on unnecessary transactions resulting in total damages of more than $500 million. At ¶3 of its Amended Complaint, plaintiff alleges that in 2002 the company reported net sales of more than $135 million while the actual net sales were less than $2 million.

In May 2006, the minority shareholders--represented by the independent directors on the Board--initiated an action in Delaware Chancery Court (*George K. Baum Capital Partners, L.P. v. Le-Nature's Inc.*, Civil Action No. 2158-N) (Del. Ch. 2006)) against Le-Nature's and its four inside directors in order to prevent Le-Nature's from building a facility in Florida. [3] In October 2006, the minority shareholders learned of an apparent forgery which led to the appointment of a custodian to operate the company on October 27, 2006. Within days, the custodian uncovered massive fraud that K&L should have uncovered.

On November 1, 2006, several of Le-Nature's creditors initiated involuntary liquidation proceedings under Chapter 7. On November 3, 2006, the custodian converted the proceeding to a Chapter 11 proceeding. On November 13, 2006, Le-Nature's remaining plant was closed and production never resumed.

Plaintiff alleges that if K&L had competently discharged its duties and obligations, Podlucky's massive looting would have ended in late 2003 or early 2004 because the independent directors would have obtained a court order closing down the company. The company would then have been liquidated as a failed company with significant assets.

In summary, this is a lawsuit instituted on behalf of the creditors of Le-Nature's. In Plaintiff's Brief in Opposition to the Preliminary Objections of Defendants K&L Gates, LLP, Sanford Ferguson, Pascarella & Wiker LLP, and Carl A. Wiker ("Plaintiff's Brief") at 41-42, plaintiff identifies the creditors as the sole or primary beneficiaries of any recovery. Plaintiff characterizes these creditors as the victims of the acts of the corrupt CEO and avers that recovery by the Trustee will increase the assets available to the creditors. Plaintiff contends that barring his claim would harm these innocent parties while protecting the professionals whose inexcusable misconduct caused enormous harm to the company.

I. *PRELIMINARY OBJECTIONS OF K&L*

A. *COUNT I-PROFESSIONAL NEGLIGENCE*

Plaintiff's first cause of action against K&L seeks recovery based on professional negligence. For two reasons, I am dismissing this cause of action: the absence of any obligations owed to "the corporation" and the absence of any losses.

1. *NO ATTORNEY-CLIENT RELATIONSHIP*

Plaintiff contends that K&L formed an attorney-client relationship with Le-Nature's; thus, the law firm owed an obligation to this corporation to exercise ordinary skill, care, and diligence in conducting the investigation. According to plaintiff, the investigation of possible mismanagement was being conducted by the Special Committee for the benefit of the corporation.

Plaintiff would liken this case to the situation in which information has come to the attention of the Board of Directors that a vice president in charge of the company's expansion in India may be purchasing property for the company at very inflated rates from sellers controlled by her relatives. The company appoints a special committee of three directors to conduct an investigation and report the results to the entire board. The committee hires a law firm with an office in India which fails to discover that the vice president is engaging in such activities. Three years later, it is discovered that she has been engaging in such conduct. During this three-year period, the company overpaid an additional $11 million in twelve transactions.

In this instance, I would find no merit to the position that K&L is taking in this case, that the only party that may sue is the subcommittee (which will never experience any losses). It would not matter that the engagement letter used language similar to the language of the engagement letter used in this case. A law firm cannot include language in an engagement letter that will immunize the firm from liability for malpractice. [4]

In this hypothetical, the alleged misconduct impacted each shareholder; no shareholder was involved in the misconduct; and the law firm knew that it was being retained to protect each shareholder from future misconduct. Thus, the corporation is an entity that may bring a malpractice action to recover losses sustained from the law firm's failure to discover the fraud.

The present case is very different from my hypothetical. In the present case, there are two groups of equity holders: Podlucky and the investors (holders of preferred stock). [5] The law firm would have understood that it was being hired to protect the investors (who are not involved in the operation of the company) by conducting an investigation into the manner in which Podlucky was operating the company. If the law firm's investigation was not competently performed, the investors are the only parties that may sue for any losses because the only role of the law firm was to protect their interests. [6]

Assume that as of December 8, 2003, Le-Nature's, while being looted, had a net worth of $6 million that would have been preserved if K&L had detected the fraud in December 2003. However, as of 2006, Le-Nature's debts far exceeded its assets.

Under this scenario, I can explain why K&L would owe $6 million to the investors: The Special Committee was created to protect the investments of the investors; the law firm knew that its mission was to do so; and the investors whom the law firm was hired to protect lost $6 million because of the failure of the law firm to protect the interests of the investors.

However, I cannot explain why the cause of action for malpractice should instead belong to a Trustee for the creditors--rather than the holders of the preferred stock. [7] Furthermore, I cannot explain why the law firm would owe money to any entity other than the entity it was hired to protect--the holders of the preferred stock.

Even if there may be some theory, not described by plaintiff, that would shift the law firm's responsibility to Le-Nature's creditors as of December 2003 upon a showing that the corporation was insolvent as of December 2003, recovery would be limited to what these 2003 creditors would have received if the business had been liquidated in December 2003 less payments subsequently received. There is no theory that would impose liability on K&L for losses of post-2003 creditors who had no relationship with Le-Nature's as of December 2003 and who had no knowledge of the 2003 investigation and report.

Assume that X hires a lawyer to advise X as to whether it is legal for X to purchase cigars made in Cuba through a Canadian wholesaler. The lawyer mistakenly states that it is legal. X borrows $1 million to establish six Cuban cigar bars in New York City. Eventually, the government closes down the bars and imposes a $150,000 fine. This causes the corporation to go out of business. Under a "but for" test, the law firm would be liable to the lender.

However, the scope of an attorney's obligations has never been measured by a but for test. [8] Under Pennsylvania case law, the only persons who may bring a legal malpractice action (subject to exceptions not applicable to this litigation-see *supra* n. 4) are clients. *Wachovia Bank, N.A. v. Ferretti,* 935 A.2d 565, 570 (Pa. Super. 2007). See, e.g., *Smith v. Griffiths,* 476 A.2d 22, 26 (Pa. Super. 1984), where the Court dismissed a legal malpractice action brought by the husband against his former wife's attorney because of the absence of an attorney-client relationship. Also see *Hess v. Fox Rothschild LLP,* 925 A.2d 798, 806 (Pa. Super. 2007) (to maintain a claim of legal malpractice, the plaintiff must show an attorney-client or analogous professional relationship with the defendant's attorney); and *Mentzer & Rhey, Inc. v. Ferrari,* 532 A.2d 484, 486 (Pa. Super. 1987) (in the absence of special circumstances, an attorney will be held liable for negligence only to his or her client).

If I reject plaintiff's contention that it was the corporation that retained K&L, plaintiff contends that I should find that an implied attorney-client relationship existed between the corporation and K&L. Under Pennsylvania law an implied attorney-client relationship exists, absent an express contract, where (1) the purported client seeks advice or assistance from the attorney; (2) the advice is within the attorney's professional competence; (3) the attorney expressly or implicitly agrees to render such assistance; and (4) the putative client reasonably believes the attorney was representing it. *Cost v. Cost,* 677 A.2d 1250, 1254 (Pa. Super. 1996).

However, there was no implied attorney-client relationship between K&L and the corporation because the engagement letter is an express contract. In addition, the investigation was not conducted to protect Podlucky's interests. It is conducted solely to protect the interests of the remaining equity holders. Podlucky did not reasonably believe that K&L was also representing his interests, which were in concealing his mismanagement of the company. [9] Since K&L was instructed by the investors to determine whether the other equity holder was looting the company, the investors would have reasonably believed that the law firm was representing their interests, and only these interests, in investigating where there was merit to concerns of mismanagement on the part of Podlucky.

In summary, the Trustee is not bringing this lawsuit on behalf of the investors whom K&L was retained to protect. It is these investors to whom K&L owed a duty of care and it is these investors who have a cause of action for legal malpractice.

2. *NO LOSSES*

My second reason for dismissing Count I is the absence of any losses to Le-Nature's caused by K&L's failure to detect mismanagement.

To prevail in a malpractice action, the plaintiff-client must establish that the failure of the defendant-attorney to exercise ordinary skill and knowledge was a proximate cause of actual damages to the plaintiff-client. *Wachovia, supra,* 935 A.2d at 570-71; and *Capital Care Corp. v. Hunt,* 847 A.2d 75, 82 (Pa. Super. 2004). In *Kituskie v. Corbman,* 714 A.2d 1027, 1030 (Pa. 1998), the Pennsylvania Supreme Court set aside a verdict in favor of the former client based on its ruling that collectibility of the judgment in the underlying case is a matter which should be considered in a legal malpractice case. It based its ruling on the principle that "the plaintiff in a legal malpractice action should only be compensated for his actual losses." *Id.*

Even if I assume that K&L's duty of care extended to each of the owners, including the looter, plaintiff must still describe losses which the corporation experienced from K&L's failure to detect Podlucky's mismanagement. Plaintiff has alleged that the corporation was insolvent when the Report was prepared in December 2003, but because the mismanagement was not discovered until December 2006, the corporation became much more insolvent. See ¶94 of Plaintiff's Amended Complaint in which plaintiff alleges:

> 94. If Defendants had conducted a proper investigation and had issued an appropriate report during the second half of 2003, Le-Nature's would have avoided Podlucky's massive looting of the Company and the several financings and leasing obligations misused by Podlucky and the other Insiders. Had they discharged their duties and obligations properly, Defendants would have informed the Independent Directors of the widespread fraud at the Company and the Independent Directors would have sought immediate judicial intervention and obtained in late 2003 or early 2004, the restraining and other orders secured in 2006. Such actions clearly would have prevented the unnecessary financings and closed down the Company, which would have liquidated a failed enterprise and preserved significant asset value.

While plaintiff contends that the increased insolvency is an actual corporate loss, plaintiff does not offer any explanation as to how an already insolvent company was harmed because its insolvency increased by more than $500 million between December 2003 and October 2006. Plaintiff simply alleges that as "a direct, proximate and foreseeable result of the Law Firm Defendants' wrongdoing, the Company has suffered substantial damages totaling more than $500 million that the Insiders looted from the Company or wasted on avoidable transactions after the issuance of the Report." Amended Complaint ¶107.

No Pennsylvania appellate court case law has considered whether increased insolvency constitutes a loss to the corporation. In support of his claim that the corporation (assuming that K&L's duties extended to the corporation) sustained losses measured by the difference between its indebtedness at the time of the malpractice and its indebtedness at the time the fraud was discovered, plaintiff relies on case law of other jurisdictions which have considered similar claims measuring losses in this fashion.

However, before I discuss the case law of other jurisdictions considering deepening insolvency, I will explain why I am not considering claims of creditors or shareholders in discussing whether the corporation experienced any losses as a result of K&L's failure to detect mismanagement in December 2003.

Settled case law provides that a trustee has no standing to pursue the direct claims of creditors. *Caplin v. Marine Midland Grace Trust Co. of New York,* 92 S.Ct. 1678 (1972); *Trenwick America Litigation Trust v. Ernst & Young,* 906 A.2d 168 (Del. Ch. 2006), aff'd 931 A.2d 438 (Del. 2007). This means, for example, that claims of a creditor based on §552 of the *Restatement (Second) of Torts* (which requires a showing that the creditor was aware of and relied on the K&L Report) would belong to and must be raised by the creditor. [10]

This litigation does not address the interests of the shareholders because their claims must be raised through actions which they institute. Furthermore, even if the trustee could sue for harm that shareholders experienced as a result of increased insolvency, in this case the shareholders were not harmed by the increased insolvency. Their interests had no value as of the date K&L submitted its Report. See ¶94 of the Amended Complaint.at page 15 of this Opinion.

While no Pennsylvania appellate courts have used this terminology, there is considerable case law in other jurisdictions that have addressed trustees' (or receivers') claims of "deepening insolvency." Some trustees have referred to their deepening insolvency claim as a separate cause of action. Others have referred to the claim as a theory of damages. Regardless of whether deepening insolvency is characterized as a separate cause of action or only as a theory of damages, it appears to be the position of trustees that if they show that a person, through fraud or negligence, has been responsible for prolonging the life of an insolvent corporation, this corporation is entitled to recover from this person the full amount of the increased insolvency.

As I previously stated, under Pennsylvania law, in a legal malpractice action the attorney is liable only for actual losses that the client sustained. Thus, even assuming that K&L represented the corporation and that its actions prolonged the corporation's life, the initial question I ask in considering the "deepening insolvency" case law, upon which plaintiff relies, is "how is a corporation that is already too insolvent to survive at the time of the malpractice harmed by becoming more insolvent?"

Plaintiff addressed K&L's contention that plaintiff has not described a legally cognizable injury in Plaintiff's Brief at 43-47. In his Brief, plaintiff states that the bankrupt corporation suffered more than $500 million in damages in the form of increased liabilities and losses and looting of corporate funds and that "there can be no dispute that, under Pennsylvania law, professionals and other defendants can be held liable for increased corporate liabilities proximately caused by their negligence and other wrongdoing." *Id.* at 43. However, the only case law that the Trustee cites in support of his position that the company may recover from K&L the full amount of increased liabilities and losses and looting of corporate funds are several opinions of the United States Court of Appeals for the Third Circuit, two decisions of the Federal District Court for the Western District of Pennsylvania in which the judges based their rulings on the opinions of the Court of Appeals for the Third Circuit, and an unreported memorandum opinion of a single judge in proceedings in the Commonwealth Court.

Since plaintiff, in lieu of offering any explanations as to how increased insolvency constitutes harm to an already insolvent corporation, describes cases that will, according to plaintiff, support his position, I will now consider the case law upon which plaintiff relies. In considering this case law, I am not attempting to determine whether this case law supports plaintiff's position but rather whether this case law furnishes a satisfactory explanation for treating the increased amount of insolvency as a measure of actual harm that the corporation experienced. In other words, if the case law which plaintiff cites does not offer a satisfactory explanation for treating increased insolvency as a measure of an injury to the corporation, I will not follow the case law because it is inconsistent with Pennsylvania case law which provides that the plaintiff in a legal malpractice action may recover only actual losses.

Between 2001 and 2010, the Court of Appeals for the Third Circuit has considered deepening insolvency claims of trustees or receivers of corporations looted through Ponzi schemes in four. cases. My discussion of these cases goes from the earliest to the latest.

In *Special Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001), two lease-financing corporations, which were operated as a Ponzi scheme by the sole shareholder, filed for bankruptcy. The committee of creditors appointed by the bankruptcy trustee brought claims against several parties, including an independent underwriter (Lafferty). Lafferty sought dismissal on the ground that the corporations did not experience any losses from Lafferty's actions because the corporations were already insolvent at the time of his misconduct.

This litigation was governed by Pennsylvania law. The Court concluded that the Pennsylvania Supreme Court would permit recovery of damages under a theory of deepening insolvency. This was characterized as a separate cause of action.

While the Court appeared to state that the measure of damages is the amount of the deepening insolvency, it offered the following explanation in support of its position that the theory is essentially sound: [11]

Under federal bankruptcy law, insolvency is a financial condition in which a corporation's debts exceed the fair market value of its assets. U.S.C. § 101(32). Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. For example, to the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation. See Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 487 (5th ed. 1996) ("[B]y issuing risky debt, [a corporation] give[s] lawyers and the court system a claim on the firm if it defaults."). When brought on by unwieldy debt, bankruptcy also creates operational limitations which hurt a corporation's ability to run its business in a profitable manner. *See id.* at 488-89. Aside from causing actual bankruptcy, deepening insolvency can undermine a corporation's relationships with its customers, suppliers, and employees. The very threat of bankruptcy, brought about through fraudulent debt, can shake the confidence of parties dealing with the corporation, calling into question its ability to perform, thereby damaging the corporation's assets, the value of which often depends on the performance of other parties. See Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking,* 38 Vill. L.Rev. 1461, 1479-80 (1993). In addition, prolonging an insolvent corporation's life through bad debt may simply cause the dissipation of corporate assets.

These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt. 267 F.3d at 349-50.

In the case of *In re CitX Corporation, Inc.*, 448 F.3d 672 (3d Cir. 2006), an insolvent Internet company involved in a Ponzi scheme used financial statements compiled by an accounting firm to attract investors. After the company spent the investors' money and incurred millions of dollars more in debt, it filed for bankruptcy. The bankruptcy trustee sued the accounting firm for, *inter alia,* malpractice and deepening insolvency.

The Court ruled that the trial court had correctly granted summary judgment as to the trustee's deepening insolvency cause of action. The trustee had raised only a negligence action against the accountant. The Court, while stating that only a court *en banc* could overrule *Lafferty's* interpretation of Pennsylvania-law as approving an economic tort of deepening insolvency for fraudulent conduct, ruled that *Lafferty* applies only to fraudulent conduct and that a claim of negligence cannot sustain a deepening insolvency cause of action. [12] *Id.* at 680-81.

The Court next considered whether deepening solvency is a viable theory of damages for negligence. It stated that while the Court in *Lafferty* concluded that deepening insolvency was a valid Pennsylvania cause of action, it never held that deepening insolvency was a valid theory of damages for an independent cause of action. Any statements in *Lafferty* "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice." *Id.* at 677.

In 2008 in *Thabault v. Chait,* 541 F.3d 512 (3d Cir. 2008) (which applied New Jersey law), the Commissioner of Insurance of Vermont, serving as a receiver of Ambassador Insurance, brought a professional malpractice claim against an accounting firm, alleging that it failed to disclose the insolvency of Ambassador. According to the Court, the Commissioner presented a traditional malpractice claim, proving to the jury that but for the accountant's negligence, Ambassador would not have continued to write insurance policies. The jury awarded damages based on the losses incurred from writing new business that Ambassador would have been prevented from writing if a proper auditing report had been submitted: [13]

According to PwC, this amount represents an increase in the liabilities of the Estate and a loss to Ambassador's policyholders, not a distinct injury to Ambassador. Further, the unpaid portion on these claims is an increase in the liabilities of Ambassador and a loss to policyholders. Today we hold that an increase in liabilities is a harm to the company and the law provides a remedy when a plaintiff proves a negligence cause of action.

Under the facts of this case, we are satisfied that a jury could properly hold PwC liable for damages under traditional negligence and malpractice principles. Accepting PwC's invitation to prevent a plaintiff from recovering damages in a negligence action where there has been reference to deepening insolvency, would require us to ignore well-settled New Jersey tort law doctrine, which we are not inclined to do. We hold that traditional damages, stemming from. actual harm of a defendant's negligence, do not become invalid merely because they have the effect of increasing a corporation's insolvency. *Id.* at 523.

In 2010 in *Marion v. TDI Inc.*, 591 F.3d 137 (3d Cir. 2010), the Court of Appeals for the Third Circuit again considered a complaint based on new money invested in a Ponzi scheme after the date of the alleged misconduct. The trial court affirmed the jury's award which corresponded to the sums owed on new money invested in the scheme after the date of the alleged wrongdoing. The Court of Appeals reversed. The only portion of the Opinion that sheds any light on "deepening insolvency" was a ruling that liability cannot be imposed on a party for increasing short-term liquidity. *Id.* at 150.

I now consider the two opinions of the United States District Court for the Western District of Pennsylvania which plaintiff cites.

In the *Official Committee of Unsecured Creditors of Allegheny Health, Education and Research Foundation v. Price Waterhouse Coopers, LLP,* No. 2:00 cv 684, 2007 WL 141059 (W.D. Pa., 2007), the defendant accounting firm or its predecessors provided accounting and auditing services to Allegheny Health, Education and Research Foundation ("AHERF"). On July 21, 1998, AHERF filed for bankruptcy under Chapter 11. The Committee of Unsecured Creditors contended that the accountant violated numerous core auditing standards which caused AHERF's statements of operations and balance sheets for the fiscal years 1996 and 1997 to be materially misstated. The Court granted the accounting firm's motion for summary judgment under the doctrine of *in pari delicto.* The Opinion briefly addressed the accounting firm's claim for summary judgment, based on the *In re Citx* holding that deepening insolvency is not a separate cause of action. The Court stated:
In the instant action, the Committee alleges "independent caus[es] of action" in the form of professional negligence, breach of contract, and aiding and abetting breach of fiduciary duty, which, if viable, give AHERF a "remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits." Therefore, PwC is not entitled to summary judgment based upon the holding in *CitX. Id.* at 7.

In the case of *In re Le-Nature's Inc. v. Wachovia Capital Markets LLC,* No. 2:09-mc-00162, 2009 WL 3571331 (W.D. Pa. 2009), Le-Nature's trustee sued third parties (Krones) that assisted Podlucky in obtaining loans which prolonged Le-Nature's life, thereby enabling Podlucky to dissipate more assets and increase corporate debt.

Krones sought dismissal on the ground that the Court of Appeals for the Third Circuit no longer recognizes deepening insolvency as a basis for awarding a trustee the amount of the increased insolvency. The Court stated that the trustee is not seeking. deepening insolvency damages for any of his claims and that he is not asserting an independent deepening insolvency cause of action.

> First, Kirschner clearly states in his opposition brief, that his complaint does not assert an independent "deepening insolvency" claim, and based on my review of the complaint, I concur. Indeed, the term "deepening insolvency" does not appear anywhere in the complaint. In addition, Kirschner states in his opposition brief that he is not seeking deepening insolvency damages for any of his claims. Moreover, as explained above, *CitX* does *not* preclude an otherwise available recovery where a complaint asserts a cause of action that provides for a remedy for increased liabilities, decreased fair asset value, or lost profits. 448 F.3d at 678. To the contrary, if available under applicable law, damages for an increase in a corporation's liabilities, decrease in its fair asset value, or lost profits, all remain available regardless of the impact on the solvency calculation.

Plaintiff also relies on a single-judge unreported Memorandum Opinion entered in *Ario v. Deloitte & Touche LLP,* No; 734 M.D. 2002, 2008 W.L. 6626953 (Pa. Cmwlth. 2008). Under §65.37 of the Internal Operating Procedures of the Pennsylvania Superior Court and §414 of the Internal Operating Procedures of the Commonwealth Court, unreported opinions may not be cited or considered. [14] Thus, the Opinion of this court does not consider that Memorandum Opinion.

I am not sure where the Third Circuit/Western District of Pennsylvania case law stands. Possibly, the trustee may now recover the amount of the increased insolvency if the trustee--rather than talking about deepening insolvency--uses the magic words that traditional principles of tort law provide a remedy to a corporation for the increase in its indebtedness. However, as I previously stated, my issue is not how plaintiff would fare under the case law upon which plaintiff relies but, rather, whether this case law offers any explanation as to how an already insolvent corporation with no hope of survival is damaged by additional debt. This case law offers no explanation.

I find to be very persuasive--and believe that the Pennsylvania appellate courts will also do so--the Opinion of the Court of Chancery of Delaware, New Castle County, in *Trenwick America Litigation Trust, supra,* 906 A.2d 168, *aff'd* 931 A.2d 438 (Del. 2007), that rejected the concept of deepening insolvency.

The Court began its discussion of the claims of the Litigation Trust that the corporation's officers and directors, by prolonging the life of the corporation, are liable for the corporation's increased insolvency by stating:

The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorious academic ring that tends to dull the mind to the concept's ultimate emptiness. 906 A.2d at 204.

In its rejection of deepening insolvency, the Court stated:

Moreover, the fact of insolvency does not render the concept of "deepening insolvency" a more logical one than the concept of "shallowing profitability." That is, the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain, why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one. If in either setting the directors remain responsible to exercise their business judgment considering the company's business context, then the appropriate tool to examine the conduct of the directors is the traditional fiduciary duty ruler. No doubt the fact of insolvency might weigh heavily in a court's analysis of, for example, whether the board acted with fidelity and care in deciding to undertake more debt to continue the company's operations, but that is the proper role of insolvency, to act as an important contextual fact in the fiduciary, duty metric. In that context, our law already requires the directors of an insolvent corporation to consider, as fiduciaries, the interests of the corporation's creditors who, by definition, are owed more than the corporation has the wallet to repay. [15]

In this case, the Litigation Trust has not stated a viable claim for breach of fiduciary duty. It may not escape that failure by seeking to have this court recognize a loose phrase as a cause of action under our law, when that recognition would be inconsistent with the principles shaping our state's corporate law. In so ruling, I reach a result consistent with a growing body of federal jurisprudence, which has recognized that those federal courts that became infatuated with the concept did not look closely enough at the object of their ardor. *Id.* at 205-06 (footnotes omitted).

At footnote 105, the *Trenwick* Opinion (*Id.* at 206-07 n. 105) cited Sabin Willett, *The Shallows of Deepening Insolvency,* 60 Bus. Law 549 (2005), as providing detailed reasons not to recognize deepening insolvency as a cause of action. [16]

In the opening paragraph of this article, the author states: "Whether deepening insolvency is a cause of action or merely a damage theory remains a little murky, but the notion that a firm sustains harm when its insolvency deepens now goes unchallenged by all save heretics and cranks." *Id.* at 549. In the second paragraph, he states that the phrase "deepening insolvency" seems to have evolved from dictum in a 1983 decision of the United States Court of Appeals for the Seventh Circuit (*Schacht v. Brown,* 711 F.2d 1343, 1350 (7th Cir. 1983)), where the Court rejected a defense "with a ringing phrase: '[T]he corporate body is ineluctably damaged by the deepening of its insolvency.' " Willet, *supra,* at 550 (footnote omitted).

Beginning at page 561, the article addresses whether deepening insolvency is a form of corporate harm at all. The author begins by considering the constituencies who might claim an injury as the firm's insolvency deepens: equity holders, discrete claims of creditors, and claims of the corporation. [17]

With respect to shareholders, the author states that because we are exploring deepening insolvency, the corporation is insolvent at the start of the analysis. This means that the interests of the equity holders have already been wiped out before the wrongdoing occurred.

With respect to discrete claims of creditors, the article states that when a corporation is insolvent, creditors may be injured by additional debt. If the sale of a corporation's assets will generate a 50% distribution for holders of claims today, at least some of the creditors will be harmed if the asset values deteriorate tomorrow. However, creditors are not the corporation; that they may suffer harm as a corporation's insolvency deepens does not mean that the corporation does. The author cites the Supreme Court ruling in *Caplin, supra,* that a trustee may not bring claims of individual creditors. Bus. Law at 562.

With respect to claims of the corporation, the article recognizes that the corporation is a legal person that enjoys benefits and sustains harm. Thus, the issue is whether an insolvent corporation is itself harmed if it becomes more insolvent.

The author begins with the statement of the Seventh Circuit that is the genesis of the notion that a corporation is harmed by deepening insolvency: "The corporate body is ineluctably damaged by the deepening of its insolvency." The author describes *ineluctably* as "one of those magic ministerial adverbs-- useful for *ipse dixits* where analysis is wanting." *Id.* at 563. He states that in attempting to determine whether there is harm, "one must look beyond adverbs to the nouns and verbs of economics. The slate is remarkably clean." *Id.*

The article describes *Lafferty* as perhaps the leading decision on the issue of deepening insolvency. *Lafferty* identified four possible harms to the corporation (see pages 19-20 of this Opinion): the first harm--increased debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation and creating operational limits which hurt a corporation's ability to run its business in a profitable manner; the second harm--deepening insolvency can undermine a corporation's relationships with its customers, suppliers, and employees; the threat of bankruptcy can shake the confidence of parties dealing with the corporation; the third harm-- prolonging an insolvent corporation's life may cause the dissipation of corporate assets; and the fourth harm-delayed disclosure harms shareholders who might lose their right to dissolve the corporation in order to cut their losses. *Lafferty, supra,* 267 F.3d at 349-50.

As to the first harm, the writer states that it will be the plaintiff's burden to show the debtor could have avoided Chapter 11 had its insolvency not increased and to show that the company would have fared better outside of insolvency. Willet, *supra,* at 565.

As to the second harm, the author states that *Lafferty* had it backwards. It is not the threat of bankruptcy that shakes the confidence of vendors, suppliers, and others. It is the company's insolvency that is straining these relationships. The essence of the deepening insolvency complaint is that the defendant wrongfully prolonged life through a scheme to cover up its true financial condition. This would have improved the debtor's reputation. *Id.* at 565-66.

The third harm--that the company is harmed because it did not file for bankruptcy soon enough--is characterized by the author as a somersault. The author recognizes that there can be harm in a narrow range of cases where more assets would have been available to creditors through an earlier liquidation. However, the author states that this harm is to the beneficiaries of that liquidation--the creditors. "The corporation is no more one of them than the deceased is a beneficiary at the reading of his will." *Id.* at 566.

The fourth theory of harm fails because, as I previously stated, the shareholders. had no equity at the time of the original insolvency.

The allegations in the Amended Complaint that the company would have been liquidated if K&L had uncovered the mismanagement (¶94 of the Amended Complaint set forth at page 15 of this Opinion) eliminate any claims based on the first, second, and fourth harms. With respect to the third harm, the Amended Complaint does not raise any claims for losses to creditors, owed money in December 2003, as a result of less assets being available to these creditors at liquidation. Thus, I need not decide whether this is a viable claim and if so, whether the Trustee may bring this claim.

Both *Trenwick* and *Shallows of Deepening Insolvency* were relied on in the Opinion of Judge Posner in *Fehribach v. Ernst & Young LLP,* 493 F.3d 905 (7th Cir. 2007). In that case, the trustee's claim was based on allegations that if the accounting firm had prepared an accurate audit report, the managers of the company would have realized that the company had no future and would have immediately liquidated, averting costs of $3 million the company incurred as a result of its continued operation. The

Court stated that this claim was based on a theory of deepening insolvency. "As originally formulated, the theory was premised on the notion that borrowing after a company becomes insolvent would 'ineluctably' hurt the shareholders. *Schacht v. Brown,* 711 F.2d 1343, 1350 (7th Cir. 1983). That was a puzzling suggestion because by hypothesis a company harmed by *deepening insolvency* was insolvent before the borrowing spree, so what had the shareholders to lose?" 493 F.3d at 908.

Fehribach recognized two situations in which the shareholders would have claims: (1) upon a showing that the corporation, while insolvent in the sense of being unable to pay its bills, would be worth more liquidated than the sum of its liabilities, and (2) if provided an earlier disclosure of the insolvency, the corporation would have been able to survive in a reorganized form. Neither situation was present in *Fehribach.* The shareholders lost their entire investment when the company became insolvent so they had nothing to lose from the increased insolvency. The only possible losers were the corporation's creditors. The Court indicated that, depending on state law, the trustee might have been able to sue for the amount of the reduced liquidation value of the corporation.

In re Greater Southeast Community Hospital Corp. I v. Tuft, 353 B.R. 324 (Bankr. D.D.C. District of Columbia 2006), is one of the few cases that accepted the concept of deepening insolvency as a valuable theory of damages while rejecting the trustee's claim that the amount of the increased insolvency is the measure of damages:

Alberts seeks to recover for "the increased amount of insolvency suffered by the [d]ebtors" (Compl.¶ 370). This calculation might have represented a fair valuation of the harm caused to the *creditors* of DCHC (assuming that the debt was never repaid), but Alberts has no standing to protect creditors' interests. Instead, he will need to prove that DCHC and its subsidiary corporations were actually harmed by the defendants' allegedly excessive borrowing habits, and then quantify that harm. The damages arising from these injuries (if proven) may be larger or smaller than the amount of excess debt acquired by the debtors, but they will almost certainly not be the same. *Id.* at 338 (footnotes omitted).

Because of its ruling that increased insolvency is not a measure of damages, the Court required the bankrupt corporation and its subsidiary corporations to prove that they were "actually harmed by defendants' allegedly excessive borrowing habits and then quantify that harm." At footnote 12, the Court described what the trustee will need to show:.

Put another way, Alberts will need to quantify the impact of the debt accumulated by the debtors due to the defendants' actions on the debtors' business operations, not the amount of debt incurred. Specifically, he will need to show that the debtors' chances of falling into bankruptcy increased due to the defendants' actions (and then quantify the costs of bankruptcy for the debtors), that the defendants' conduct prevented the debtors from performing in a profitable manner (and then quantify the cost to the debtors caused by that impairment), or that the defendants' actions forced the debtors to dissipate corporate assets that would have been retained otherwise (and then quantify the value of those assets). As the court noted in *Latin Investment,* these calculations "pose serious problems" for a plaintiff like Alberts, 168 B.R. at 5, "but should not in [themselves] affect the decision as to dismissal. *Id.*" 353 B.R. at 338 n. 1.2.

At footnote 13, the Court said that if the evidence shows that the debtors would have failed even without the massive borrowing, the trustee may not be able to recover anything at all. *Id.*

In summary, what a rule achieves that uses increased insolvency as the measure of damages to the corporation from the failure of a law firm to discover mismanagement is to require the law firm to make payments to the corporation in an amount that will fully reimburse those post-2003 vendors and service providers left holding the bag when the Ponzi scheme collapsed. [18] Since this is what the rule achieves, this must be the purpose of the rule. However, not a single case of which I am aware has defended the rule on the ground that this is a purpose that the law should achieve.

Even assuming that it was the corporation that retained K&L, future creditors who had been duped were not constituents of the corporate body that K&L was representing. Except for a "but for" test that has never been the law of Pennsylvania, there is no link between the Report of the law firm and the losses of those new creditors left holding the bag. The Report of the law firm did not influence their decisions to lend or to provide services to Le-Nature's. They did not in any way rely on the Report in making their decisions because they were not aware of the Report and, in fact, did not even know of the investigation. Consequently, the losses of the new creditors were not caused by K&L's malpractice.

In addition, there is no privity between the law firm and persons who had no connection with the corporation on the date the Report was prepared (e.g., new creditors). Where there is no privity, under established law, the law firm can be liable only in limited situations upon a showing of reliance on the law firm's Report. See *Restatement (Second) of Torts* §552.

For these reasons, I am dismissing plaintiff's professional negligence count.

B. *COUNT II*

Count II is a breach of contract claim based on allegations that through the engagement letter K&L formed an attorney-client relationship with Le-Nature's through which K&L agreed to assist the Special Committee. The facts do not support the claim that Le-Nature's hired K&L to assist the Special Committee. [19]

K&L's contract was with the Special Committee composed of the directors representing the interests of the holders of the preferred stock. There are no other interests that K&L would have been reasonably expected to protect. Since the members of the Special Committee had no interest in retaining counsel to protect any interests other than the interests of the holders of the preferred stock and since it would have been obvious to the law firm that its responsibilities were only to protect the interests of the preferred shareholders (i.e., not the interests of the other equity holder), under basic contract principles, K&L is liable only to the entities whose interests it was retained to protect.

Where the writing does not expressly provide that a third party is a beneficiary, under §302 of the *Restatement (Second) of Contracts (1979),* a third party is a beneficiary of a promise only if recognition of a right of performance in the beneficiary is appropriate to effectuate the intention of the parties and the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance. See *Burks v. Federal Insurance Co.*, 883 A.2d 1086, 1087-89 (Pa. Super. 2005); *Scarpitti v. Webone,* 609 A.2d 147, 150 (Pa. 1992). For the reasons set forth in the above paragraph, the allegations in Plaintiff's First Amended Complaint cannot support a finding that the parties to the contract (K&L and the Special Committee) intended for Le-Nature's to have a right of performance or that the circumstances indicated that K&L intended to give Le-Nature's the benefit of the promised performance.

Also, for the reasons given in my discussion of Count I, the Amended Complaint does not describe any harm that the corporation suffered as a result of K&L's breach of a duty to exercise reasonable care.

C. *COUNT III*

Count III is a breach of fiduciary duty claim against K&L. I am dismissing this count for the following reasons:

First, in the absence of double dealing (which is not pled), a law firm's duties to its clients are governed only by contract and tort law. Second, for the reasons previously stated, any fiduciary duty which the law firm owed was owed only to the members of the Special Committee and to the three holders of the preferred stock.

Third, for the reasons stated in my discussion of Count I, the Amended Complaint does not describe any harm that the corporation suffered as a result of any breach of fiduciary duty.

D. *COUNT IV*

Count IV is a negligent misrepresentation claim raised against both K&L and Pascarella. At this time, I consider only the claim raised against K&L. Under Pennsylvania law, the elements which must be proven for such a wrong to be shown are: (1) a misrepresentation of a material fact; (2) the representor must either know of the misrepresentation, must make the misrepresentation without knowledge as to its truth or falsity or must make the representation under circumstances in which he ought to have known of its falsity; (3) the representor must intend the representation to induce another to act on it; and (4) injury must result to the party acting in justifiable reliance on the misrepresentation. *Gibbs v. Erst,* 647 A.2d 882, 890 (Pa. 1994).

Plaintiff alleges that K&L knew that its Report would be provided to the Special Committee and to the entire Board of Directors and that the company, its Board of Directors, and the Special Committee justifiably relied on the misrepresentations within the Report. As a result of the misrepresentations, the independent directors did not discover and could not have reasonably discovered the fraud until the 2006 investigation.

I am dismissing this count for several reasons.

First, the misrepresentations were not relied on by the Podlucky directors-they either knew of, or did not want to know of, the mismanagement. The only persons who relied on the misrepresentations were the clients of K&L, namely the members of the Special Committee and those investors whom they represented. Plaintiff states that "the Insiders were not the sole officers, directors and shareholders of the company. Rather, Le-Nature's had three Independent Directors and Minority Shareholders who were not informed of the wrongdoing, did not participate in the wrongdoing, would have stopped the wrongdoing if they had known about it, did not reasonably discover the fraud until November, 2006 ...." Plaintiff's Reply Brief at 10.

Second, K&L did not intend for any persons, other than the members of the Special Committee and the investors that they represented, to act on its representations regarding evidence of mismanagement.

Third, it is far from clear that a person who cannot pursue a malpractice action against an attorney may expand the scope of a lawyer's responsibilities through a negligent misrepresentation claim.

Fourth, for the reasons given in my discussion of Count I, the Amended Complaint does not describe any harm that the corporation suffered as a result of K&L's breach of a duty to exercise reasonable care.

E. *VICARIOUS LIABILITY/RESPONDEAT SUPERIOR*

Plaintiff contends that the employees of Pascarella were agents and/or servants of K&L for whom K&L is legally responsible under the doctrine of vicarious liability.

It does not matter whether or not K&L is responsible for the conduct of Pascarella because of my rulings that K&L owed obligations only to the members of the Special Committee and the persons whose interests they represented.

Also, for the reasons given in my discussion of Count I, the Amended Complaint does not describe any harm that the corporation suffered as a result of the breach by K&L and its agents of a duty to exercise reasonable care.

II. *PRELIMINARY OBJECTIONS OF PASCARELLA*

A. *COUNT IV--NEGLIGENT MISREPRESENTATION*

There are no allegations within the pleadings which would support a finding that Pascarella made representations to anyone other than K&L. Plaintiff's Amended Complaint does not allege that Pascarella signed the Report, that it delivered the Report to the Special Committee or the Board, or that it made any communications to the Special Committee or the Board regarding the accuracy of the Report.

B. *COUNT V--BREACH OF CONTRACT*

Plaintiff alleges that Pascarella signed a Retention Agreement with K&L on September 12, 2003. He further alleges that pursuant to this Retention Agreement, Pascarella expressly acknowledged the duties it owed to Le-Nature's pursuant to its retention to assist K&L in the investigation. Furthermore, Le-Nature's paid for the services of this. accounting firm.

I am dismissing plaintiff's breach of contract claim raised against Pascarella because there was no contract between Le-Nature's and Pascarella. The only contract that Pascarella executed was between Pascarella and K&L. The contract stated that Pascarella was being retained to assist K&L as a consultant to counsel and that it understood that its monthly invoices would be paid by Le-Nature's pursuant to the terms of K&L's engagement by Le-Nature's. The contract does not provide or suggest that either Pascarella or K&L intended to give the benefit of the performance to anyone other than possibly the members of the Special Committee and the preferred shareholders.

In addition, for the reasons given in my discussion of Count I, the Amended Complaint does not describe any harm that. the corporation suffered as a result of Pascarella's breach of a duty to exercise reasonable care.

ORDER OF COURT

On this 28 day of December, 2010, it is ORDERED that defendants' preliminary objections in the nature of a demurrer are sustained, and all counts of plaintiff's complaint are dismissed as to all defendants.

BY THE COURT:

<<signature>>

WETTICK, J.

Footnotes

1 With the appointment of the three additional directors, the Board consisted of four members selected by Podlucky and three members selected by the investors.

2 This Report is attached to Plaintiff's Amended Complaint as Exhibit C.

3 In the initial complaint filed in those proceedings, the holders of the preferred stock (apparently believing that the company had considerable value) alleged that Podlucky, as part of a plan to coerce the holders of the preferred stock to sell to Podlucky at a bargain price, intended to build this third facility in order to discourage potential purchasers of Le-Nature's from making their highest and best offers.

4 Section 51(3) of the *Restatement (Third) of the Law Governing Lawyers* (2000), provides that a lawyer owes a duty of care to a nonclient when (a) the lawyer knows the client intends that the lawyers services benefit the nonclient, (b) such a duty will not significantly impair the lawyer's performance of obligations to the client, and (c) the absence of such a duty would make enforcement of those obligations to the client unlikely.

5 See Amended Complaint, Ex. C at 2, December 8, 2003 Report which states that Gregory J. Podlucky is the sole common stock holder. Also see LeNature's Notice of Removal, No. 06-25454-BM, Doc. 12 at 1-2, ¶3 (Bankr. W.D.Pa. 2006) which describes the action in Delaware Chancery Court at Civil Action No. 2158-N as involving "a dispute between the original common shareholder and [the owners of] preferred shares of the Debtor, who are locked in a dispute for control of the operations of the Reputed Debtor."

6 It is possible that a law firm could also be liable to a creditor who read and relied on the December 8, 2003 Report under *Restatement (Second) of Torts* §552. However, the creditor would need to bring its own lawsuit against the law firm by filing a complaint which alleged material facts supporting recovery under §552.

7 In this case, I am not aware of any suit brought by the preferred shareholders. The allegations in the Amended Complaint indicate that their claims had no value as of December 2003 because the claims of the creditors, as of December 2003, exceeded the value of the assets of the corporation.

8 Also, under settled principles of tort law, a remote party cannot recover economic losses caused by another's negligence. *Aikens v. Baltimore and Ohio Railroad Co.*, 501 A.2d 277 (Pa. Super. 1985).

9 Plaintiff's statement that K&L was representing Podlucky's interests is difficult to reconcile with the fact that during this investigation, Podlucky was represented by outside counsel (First Amended Complaint ¶13).

10 In ruling that a trustee may not raise claims of a creditor, the *Caplin* Opinion stated that the creditor should be permitted to make its own assessment of the respective advantages and disadvantages not only of litigation, but also of the various theories of litigation. 92 S.Ct. at 1687.

11 It was unnecessary for the Court to address the plaintiff's deepening insolvency claims because the Court affirmed the lower court's dismissal of the lawsuit under the *in pari delicto* doctrine.

12 The Court also stated that nothing that was said in *Lafferty* compels any extension of the doctrine beyond cases governed by Pennsylvania law. *Id.* at 680-81.

13 In an insurance setting, policyholders are not in a position to investigate the solvency of insurance companies. They rely on a state Department of Insurance to protect their interests in this heavily regulated industry. Consequently, if an auditor misleads the Insurance Department, thereby causing harm to policyholders, the law should allow the Insurance Commissioner to act on behalf of policyholders. This would appear to be the basis for the ruling in *Thabault* that recovery was permitted under well-settled New Jersey tort law doctrine.

14 Also §414 provides that a single-judge opinion, even if reported, shall be cited only for its persuasive value, not as a binding precedent.

15 Under Delaware case law when a company has reached the point of insolvency, the corporation's directors are said to owe fiduciary duties to the company's creditors. *Id.* at 205 n. 104.

16 Westlaw refers to 24 decisions citing this article.

17 I am not aware of any case law that includes employees as constituencies of a corporation.

18 However, the case law does not describe who would be the beneficiaries of a payment to the corporation in the amount of the increased insolvency. Example: At the date of the Report, the corporation has assets of $1 million and liabilities of $10 million. At the date the mismanagement is discovered, the corporation has no assets and indebtedness of $20 million. Under this scenario, the existing creditors have been injured in an amount of $1 million. If the new creditors were bringing their own action, they would seek the remaining $9 million. I question whether the corporation would divide the $10 million payment in this fashion.

19 In his Reply to Brief of Defendants Pascarella & Wiker LLP and Carl A. Wiker in Opposition to Plaintiff's Preliminary Objections to Defendants' Preliminary Objections (Plaintiff's Reply Brief) at 10, plaintiff states: "The Independent Directors took affirmative steps to determine if fraud existed, and thus hired K&L Gates and P&W to ferret out any wrongdoing."

End of Document

Attachment E

Mark Kirschner, as Liquidation Trustee of Le-Nature's Liquidation Trust v. K&L Gates LLP, et. al., 46 A.3d 737 (Pa. Super. Ct., May 14, 2012).

46 A.3d 737
Superior Court of Pennsylvania.

Mark KIRSCHNER, in his capacity as the Liquidation Trustee of the Le–Nature's Liquidation Trust, Appellant
v.
K & L GATES LLP, Sanford Ferguson, Pascarella & Wiker, LLP, and Carl A. Wiker.

Argued Oct. 25, 2011. | Filed May 14, 2012. | Reargument Denied July 19, 2012.

Synopsis
Background: After initiation of involuntary bankruptcy proceedings against corporation due to receiver's uncovering of massive fraud, bankruptcy trustee brought professional negligence action against law firm and investigative company, which had previously been retained to investigate allegations of fraud. The Court of Common Pleas, Allegheny County, Civil Division, No. GD–09–015557, Wettick, J., dismissed action. Trustee appealed.

Holdings: The Superior Court, No. 154 WDA 2011, Musmanno, J., held that:

[1] attorney-client relationship existed between firm and corporation;

[2] trustee sufficiently alleged, to defeat preliminary objection, firm's breach of contract based on a contract for legal representation of corporation;

[3] trustee sufficiently alleged, to defeat preliminary objection, that firm and investigative company had master-servant relationship, as would allow for vicarious liability of firm; and

[4] defense of imputation, under in pari delicto theory, did not bar action.

Reversed and remanded.

West Headnotes (22)

[1] **Pleading**
Nature and office of demurrer, and pleadings demurrable

A preliminary objection in the nature of a demurrer is properly granted where the contested pleading is legally insufficient. Rules Civ.Proc., Rule 1028(a)(4), 42 Pa.C.S.A.

[2] **Pleading**
Scope of Inquiry and Matters Considered on Demurrer in General

Preliminary objections in the nature of a demurrer require the court to resolve the issues solely on the basis of the pleadings; no testimony or other evidence outside of the complaint may be considered to dispose of the legal issues presented by the demurrer. Rules Civ.Proc., Rule 1028(a)(4), 42 Pa.C.S.A.

[3] **Appeal and Error**
Pleadings and rulings thereon

In determining whether the trial court properly sustained preliminary objections, the appellate court must examine the averments in the complaint, together with the documents and exhibits attached thereto, in order to evaluate the sufficiency of the facts averred. Rules Civ.Proc., Rule 1028(a)(4), 42 Pa.C.S.A.

2 Cases that cite this headnote

[4] **Appeal and Error**
Extent of Review Dependent on Nature of Decision Appealed from
Appeal and Error
Rulings on Motions Relating to Pleadings

Reviewing court will reverse the trial court's decision regarding preliminary objections only where there has been an error of law or abuse of discretion; when sustaining the trial court's ruling will result in the denial of claim or a dismissal of suit, preliminary objections will be sustained only where the case is free and clear of doubt. Rules Civ.Proc., Rule 1028(a)(4), 42 Pa.C.S.A.

1 Cases that cite this headnote

[5] **Attorney and Client**
⇨What constitutes a retainer
Corporations and Business Organizations
⇨Committees

Attorney-client relationship existed between firm retained to investigate alleged corporate mismanagement and corporation, as required to support legal malpractice claim, even though retention letter expressly identified special committee of board of directors as client; as committee of the board, special committee had fiduciary duty to act in best interests of not only the shareholders but also the corporation, board authorized special committee to retain firm to conduct investigation "on behalf of the company," under law of state of incorporation, board could not authorize special committee to act solely on behalf of investors, and cover memorandum for firm's findings set forth specific findings and recommendations for corporation.

[6] **Attorney and Client**
⇨Damages and costs

Damages sought by bankruptcy trustee for corporation, in professional negligence action against firm, were appropriate traditional tort damages rather than deepening insolvency damages, in case arising out of firm's failure to uncover massive fraud at corporation after being retained to investigate alleged fraud, even if corporation was already insolvent at time firm prepared its report, where damages sought included corporation's increased liabilities, and decreased asset values and losses.

[7] **Attorney and Client**
⇨Elements of malpractice or negligence action in general

When it is alleged that an attorney has breached his professional obligations to his client, an essential element of a professional negligence cause of action is proof of actual loss.

[8] **Damages**
⇨Discretion as to amount of damages
Damages
⇨Extent of damage in general

Once the fact that damages occurred has been established in a professional negligence claim, the jury is permitted to determine the extent of those damages; nevertheless, the plaintiff has the burden of presenting sufficient evidence by which damages can be determined on some rational basis and other than by pure speculation or conjecture.

[9] **Negligence**
⇨Proximate Cause

Proximate cause must be determined by the judge and it must be established before the question of actual cause is put to the jury.

[10] **Negligence**
⇨Substantial factor

To determine proximate causation, the question is whether the defendant's conduct was a substantial factor in producing the injury.

[11] **Negligence**
Proximate Cause

Unless the evidence is such that reasonable people cannot disagree, the question of whether a defendant's conduct is the cause of the plaintiff's injury or loss is for the jury.

[12] **Attorney and Client**
Acts and omissions of attorney in general

Bankruptcy trustee for corporation sufficiently alleged, to defeat preliminary objection, firm's breach of contract based on a contract for legal representation of corporation, in case in which firm was retained to investigate potential fraud at corporation and failed to uncover massive fraud, where trustee averred that firm employee misrepresented his investigation expertise, firm improperly limited scope of its investigation, firm allowed director who was suspected of fraud to play integral role in investigation, and firm failed to discover specific suspicious and fraudulent activities.

[13] **Attorney and Client**
Acts and omissions of attorney in general

A claim based on breach of an attorney-client agreement is a contract claim, and the attorney's liability must be assessed under the terms of the contract.

1 Cases that cite this headnote

[14] **Attorney and Client**
Skill and care required

An attorney who agrees for a fee to represent a client is by implication agreeing to provide that client with professional services consistent with those expected of the profession at large.

1 Cases that cite this headnote

[15] **Attorney and Client**
Nature of attorney's duty

Fiduciary duty existed between law firm and corporation, as would support breach of fiduciary duty claim, in case in which firm was hired to investigate alleged fraud by corporate director, where attorney-client relationship existed between firm and corporation.

[16] **Attorney and Client**
Nature of attorney's duty
Attorney and Client
Acting for party adversely interested

An attorney who undertakes representation of a client owes that client both a duty of competent representation and the highest duty of honesty, fidelity, and confidentiality; such duty demands undivided loyalty and prohibits the attorney from engaging in conflicts of interest, and breach of such duty is actionable.

[17] **Attorney and Client**
Pleading and evidence
Fraud
Reliance and inducement and action thereon

Bankruptcy trustee for corporation sufficiently alleged, to defeat preliminary objection, that law firm and investigative company retained by law firm provided information that it knew would be relied on in corporation's business endeavors, as required to state claim for negligent misrepresentation, in case in which firm was retained to investigate potential fraud at corporation and failed to uncover massive fraud, where trustee averred that firm and investigative company drafted and edited a report which contained numerous misrepresentations, that investigative company confirmed its understanding that information provided in report would be used to give legal advice to corporation, and complaint specifically identified the alleged material misrepresentations.

[18] **Attorney and Client**
⇐Partnership of attorneys; law firms
Labor and Employment
⇐Scope of Employment

Bankruptcy trustee for corporation sufficiently alleged, to defeat preliminary objection, that law firm and investigative company had master-servant relationship, as would allow for vicarious liability of firm for investigative company's alleged negligence in investigation of fraud at corporation, in case in which firm was retained to investigate potential fraud at corporation and failed to uncover massive fraud, where trustee alleged that investigative company was selected to assist firm as financial expert, that firm dictated parameters of investigative company's work on daily basis, that firm set interview schedules, provided assignments and deadlines to investigative company and approved methods employed by investigative company, that firm selectively communicated investigative company's findings to corporation, and that firm included investigative company's charges as part of firm's monthly invoices to corporation.

[19] **Contracts**
⇐Agreement for Benefit of Third Person

Corporation was an intended third-party beneficiary of contract between law firm and investigative company, after law firm was retained to investigate alleged fraud by corporate director and law firm then retained investigative company, where retention letter for investigative company expressly acknowledged its understanding that it was retained to assist in investigation of certain transactions involving corporation and that its assistance would help firm provide legal advice to corporation.

[20] **Contracts**
⇐Agreement for Benefit of Third Person

In order for a third party beneficiary to have standing to recover on a contract, both contracting parties must have expressed an intention that the third party be a beneficiary, and that intention must have affirmatively appeared in the contract itself.

[21] **Contracts**
⇐Agreement for Benefit of Third Person

In order for one to achieve third party beneficiary status in regard to a contract, that party must show that both parties to the contract so intended, and that such intent was within the parties' contemplation at the time the contract was formed.

[22] **Action**
⇐Illegal or immoral transactions
Bankruptcy
⇐In general; standing

Defense of imputation, under in pari delicto theory, did not bar action by bankruptcy trustee of corporation against law firm and investigative company, alleging failure to uncover massive fraud orchestrated by corporation's top executive after firm was retained to investigate such fraud, where trustee alleged that firm and investigative company did not act in good faith in conducting investigation, and any material misrepresentations of corporate financial information, so as to hide executive's looting of company, did not provide any benefit to corporation.

Attorneys and Law Firms

***740** Roy E. Leonard, Pittsburgh, Hector Torres, New York, New York and Cara M. Ciuffani, New York, New York, for appellant.

Craig D. Singer, Washington, D.C., for Ferguson and K & L Gates, appellees.

Patricia L. Dodge, Pittsburgh, for Pascarella & Wiker and Wiker, appellees.

BEFORE: MUSMANNO, ALLEN and MUNDY, JJ.

Opinion

OPINION BY MUSMANNO, J.:

Mark Kirschner ("Trustee"), in his capacity as the Liquidation Trustee of the Le–Nature's Liquidation Trust,[1] appeals from the Order sustaining the Preliminary Objections to the Amended Complaint filed on behalf of K & L Gates LLP and Sanford Ferguson ("Ferguson") (collectively, "K & L Gates"), and Pascarella & Wiker, LLP ("P & W"), and Carl A. Wiker (collectively, "Defendants"). We reverse the Order of the trial court and remand for further proceedings.

***741** The facts, as alleged in Trustee's Amended Complaint, are as follows. In 1992, Greg Podlucky ("Podlucky") founded Le–Nature's, Inc. ("Le–Nature's"), a Delaware corporation. Amended Complaint at ¶ 30. Le–Nature's held itself out as an innovator in the bottled beverage industry, in particular, its use of cutting edge technologies and distribution methods. *Id.* at ¶ 31.

In 2000 and in 2002, Le–Nature's issued over eight million shares of convertible preferred stock. *Id.* at ¶ 32. Two investment funds purchased shares: SW Pelham Fund, L.P. (affiliated with Smith Whiley & Company) (the "Pelham Fund"), and the George K. Baum Employee Equity Fund, L.P. (Affiliated with George K. Baum Merchant Banc, L.L.C.) (the "Baum Funds") (the Pelham Fund and the Baum Funds hereinafter collectively referred to as the "Minority Shareholders"). *Id.* The amended certificate governing the shares granted the Minority Shareholders the right to appoint directors ("Independent Directors") to the Board of Directors of Le–Nature's. Also on the Board were Podlucky and certain interested corporate officers (collectively, the "Inside Directors") (Inside Directors and Independent Directors collectively referred to as the "Board of Directors" or "Board"). *Id.* The Independent Directors were to approve all extraordinary capital expenditures and compel a sale of Le–Nature's by no later than September 2006. *Id.*

In August 2003, Ernst & Young ("E & Y"), Le–Nature's auditor, conducted its quarterly review of Le–Nature's financial statements. *Id.* at ¶ 33. Richard J. Lipovich ("Lipovich"), the E & Y audit partner responsible for the audit, met with Chief Financial Officer ("CFO") John Higbee ("Higbee"), Chief Administrative Officer ("CAO") Jennifer Fabry ("Fabry"), and Vice President of Administration Stacy Juchno ("Juchno") (collectively, "Senior Financial Managers"). *Id.* During the August 13, 2003 meeting, Lipovich solicited the concerns of Le–Nature's Senior Financial Managers regarding the company's financial activities, inquiring whether the Senior Financial Managers suspected fraudulent activity. *Id.* Such inquiries were part of standard E & Y audit procedures. *Id.* At this meeting, each member of Le–Nature' Senior Financial Managers expressed concerns about the accuracy of Le–Nature's sales figures. *Id.*

The next day, Higbee, a veteran auditor with more than 20 years of experience, resigned. *Id.* at ¶ 34. Fabry and Juchno also submitted written resignation letters to Le–Nature's Chief Executive Officer ("CEO"), Podlucky. *Id.* In their resignation letters, the Senior Financial Managers stated that they suspected Podlucky of engaging in improper conduct with Le–Nature's tea suppliers, equipment vendors and certain customers. *Id.* The Senior Financial Managers expressed serious concerns about recent "unusual" transactions "surrounding bulk tea sold in tankers and about possible unlawful collusion between Podlucky and the suppliers, vendors and customers." *Id.* In particular, the Senior Financial Managers reported a large increase in tea inventory and raw material, and the extraordinary level of "equipment deposits." *Id.*

In his resignation letter, CFO Higbee explained that he repeatedly had asked Podlucky for access to documentation supporting Le–Nature's general ledger details. *Id.* at ¶ 35. Podlucky's refusal, according to Higbee, constituted "an astonishing and extremely improper restriction for any chief executive officer to impose upon a company's chief financial officer." *Id.* Higbee explained that by conducting business transactions "without any normal review by others, such as ***742** the CFO," Podlucky had rendered it impossible for Higbee to discharge his duties and responsibilities to Le–Nature's. *Id.* In conclusion, Higbee stated to Podlucky,

> I consider 1) the absolute control you maintain over the Company's detail[ed] financial records[,] 2) the lack of checks and balances related to deposits on equipment[,] 3) the lack of checks and balances related to deposits on tea leaf [, and] 4) the lack of checks and balances related to the sale of bulk tea concentrate and bulk tea leaf to be material weaknesses in the Company's internal controls.

Id.

Upon being informed of the concerns of Senior Financial Managers and their resignations, E & Y wrote a letter requesting that Le–Nature's hire "competent independent legal counsel to conduct a thorough and complete investigation of the allegation made by the [Senior Financial Managers]." *Id.* at ¶ 37 (emphasis omitted) (quoting E & Y Letter, 8/22/03). E & Y further advised Le–Nature's that, because of the resignations of the Senior Financial Managers, E & Y

> [would] be unable to be associated with any unaudited interim financial statements or historical audited financial statements, including issuing any consents or comfort letters, until the allegations are investigated thoroughly by independent counsel, we complete our review of the report of the investigation, we perform any additional procedures we consider necessary in the circumstances, and we interview the former employees[.]

Amended Complaint at ¶ 37 (emphasis omitted) (quoting E & Y Letter, 8/22/03).

On August 26, 2003, the Le–Nature's Board of Directors passed a unanimous consent resolution ("Resolution") declaring that it was "*in the best interest of the Company* to appoint a special committee of independent directors to conduct an investigation into the reasons underlying the resignations of the Senior Financial Managers." *Id.* at ¶ 38 (emphasis added). Accordingly, the Board of Directors unanimously consented to the creation of a special committee (the "Special Committee") to investigate the circumstances underlying the resignation of the Senior Financial Managers. *Id.* Of particular note, the Board's Resolution authorized the Special Committee to "provide findings and recommendations to the Board of Directors as a result of such investigation." Amended Complaint, Exhibit E (Resolution), at 1. The Board of Directors authorized the Special Committee to retain legal counsel and accountants "to assist in the investigation." Amended Complaint at ¶ 38 (emphasis added).

The Board appointed three independent, non-employee directors to serve on the Special Committee. *Id.* at ¶ 39. Lacking the expertise necessary to conduct internal corporate investigations, the Special Committee determined that "it was critical to retain *on behalf of the company,* legal counsel with experience in conducting such investigations." *Id.* at ¶ 40 (emphasis added). Ferguson, a partner at K & L Gates, represented to the members of the Special Committee "that he personally possessed precisely the type of investigative experience required by the Special Committee." *Id.* Relying on Ferguson's representations, the Special Committee retained K & L Gates to conduct the Le–Nature's investigation "*on behalf of the Company.*" *Id.* (emphasis added). At its first meeting on August 28, 2003, the Special Committee authorized K & L Gates to investigate the circumstances underlying the resignation of the Senior Financial Managers. *Id.* at ¶ 41.

***743** By a letter dated August 28, 2003 ("Retention Letter") to the Special Committee, K & L Gates confirmed its understanding of the scope of and nature of its engagement. The Retention Letter provided, in relevant part, as follows:

> You have asked us to represent the Special Committee ("Special Committee") of the Outside directors of Le–Nature's Beverages, Inc. ("Company") in connection with a review of the circumstances attendant upon the recent resignation of three members of the finance staff of the company.
>
> It is our Firm's practice to confirm in writing the identity of the client whom we represent, the nature of

our undertaking on behalf of that client and our billing and payment arrangements with respect to our legal services.

We understand that we are being engaged to act as counsel for the special committee and for no other individual or entity, including the Company or any affiliated entity, shareholder, director, officer or employee of the Company not specifically identified herein. We further understand that we are to assist the Committee in investigating the facts and circumstances surrounding the aforementioned resignations and assist the Special Committee in developing any findings and recommendations to be made to the full Board of the Company with respect thereto. The attorney-client relationship with respect to our work, including our work product, shall belong to the Committee. Only the Committee can waive any privilege relating to such work.

Our firm currently represents Star Associates in connection with a contract dispute with the Company. This matter is substantively unrelated to the scope of the work of the Special Committee. We believe that our ongoing representation of Star Associates will not adversely affect our exercise of independent professional judgment on behalf of the Special Committee. Nonetheless, we will establish a "Chinese Wall" between those of our personnel working on the Star Associates matter and those working on the Special Committee matter. In view of the ongoing duties of loyalty we would owe to both Star Associates and the Special Committee, we wish to confirm at the outset of our engagement by the Special Committee that you concur with our conclusions set forth above and that you waive any potential or actual conflict of interest relating thereto.

...

It is our Firm's practice to render statements for professional services and related charges on a monthly basis. We will expect payment to be made within thirty days of your receipt of our statement, without regard to the outcome of any matter. In the event that our statements are not timely paid, we reserve the right to suspend our services until satisfactory payment arrangements are made or, if necessary, to terminate such services. Our clients, of course, may terminate our services at any time.

Id., Ex. A at 1–2 (emphasis added).

Subsequently, K & L Gates retained P & W to assist in the investigation. P & W confirmed its understanding of the engagement in a letter to K & L Gates, dated September 12, 2003 (the "P & W Retention Letter"). The P & W Retention Letter provided, in relevant part, as follows:

UNDERSTANDING OF P & W'S ROLE

It is understood that P & W is being retained to assist K & L [Gates] as a financial expert related to the special investigation of certain transactions involving ***744** Le[-]Nature's, Inc. [ ] **P & W shall provide general consulting, financial accounting, and investigative or other advice as requested by K & L [Gates] to assist it in rendering legal advice to Le [-]Nature's.** Acting as a consultant to counsel, we understand that all work and communications relating to this engagement are expected to be confidential and privileged and will be so treated unless otherwise directed by you, or required by law or court order.

STAFFING AND FEES

...

P & W will render monthly invoices to K & L [Gates]. K & L [Gates] will then include our charges as part of its regular monthly invoices to Le[-]Nature's. We understand that under the terms of K & L [Gates's] engagement by Le [-]Nature's, K & L [Gates's] invoices are payable within thirty days of submission. We reserve the right to cease all work if any K & L [Gates] invoice to Le[-]Nature's becomes past due, without regard to the status of our services or any related procedures. K & L [Gates] will promptly pay our invoices as the funds therefore are received from Le[-]Nature's. It is understood that K & L [Gates] will not be otherwise responsible for payment of fees and expenses to P & W, as such responsibility ultimately rests with Le [-]Nature's, Inc.

Id., Ex. B at 1–2 (emphasis added).

The Special Committee provided K & L Gates with, *inter alia,* the August 22, 2003 letter from E & Y, which requested that Le–Nature's conduct a competent, independent and thorough investigation of allegations made by the Senior Financial Managers. *Id.* at ¶¶ 36, 41. Ferguson led the investigation for K & L Gates. *Id.* at ¶ 42. Details of the investigation will be discussed in greater detail, *infra.*

On November 25, 2003, the Defendants provided a draft of their Report to Podlucky. *Id.* at ¶ 75. Podlucky was not a member of the Special Committee. *Id.* Notwithstanding the fact that the Special Committee had not received the

Report, Podlucky immediately called a meeting of the Board of Directors for the purpose of discussing the draft Report. *Id.* Podlucky also provided comments on the draft Report to K & L Gates. *Id.* On December 5, 2003, K & L Gates provided the draft Report to the Special Committee. *Id.*

P & W approved the Report, which Ferguson then signed, representing that the Defendants "found no evidence of fraud or malfeasance with respect to any of the transactions" subject to the investigation. *Id.* at ¶¶ 76, 77 (emphasis omitted) (quoting Report at 1). The Special Committee attached a cover memorandum ("Memorandum") to the Report. Amended Complaint at ¶ 77. The Memorandum, which was reviewed by K & L Gates, stated the following:

> The Special Committee of the Board of Directors of [Le–Nature's] hereby submits the report attached herein prepared by the Committee's Counsel, [K & L Gates,] and its financial consultants[, P & W].
>
> The Special Committee was formed in August 2003 to investigate certain specific business transactions identified by three former [Le–Nature's Senior Financial Officer], all of whom resigned in mid-August 2003. The Special Committee consists of two outside directors who are representatives of the [Pelham Fund,] and one director representing [the Baum Fund].
>
> Upon the advice of [K & L Gates], the [Special] Committee limited the scope of its investigation to seven specific transactions identified by the [Senior Financial Managers] as areas of concern and ***745** that could potentially impact [Le–Nature's] financial statements....
>
> The Committee is pleased to report that K & L [Gates] and P & W "found no evidence of fraud or malfeasance with respect to any of the transactions reviewed by it. Further[, K & L Gates] found no evidence which suggests that the transactions identified by the [Senior Financial Managers] as being of concern had not been properly reported on Le[-]Nature's financial statements." ...

Memorandum at 1. The Memorandum included the recommendations proposed by K & L Gates. *Id.* at 2. The Memorandum concluded with the following pronouncement:

> The [Special] Committee concurs strongly with all the recommendations outlined above.
>
> We look forward to talking with the full Board of Directors on these recommendations and other findings of fact as soon as possible and to work with the Company in addressing the issues raised herein.

Id.

Throughout their investigation, the Defendants failed to uncover the massive fraud being perpetrated by Podlucky. Amended Complaint at ¶ 79. Podlucky and his senior managers continued to "loot" Le–Nature's, incurring further corporate debt and wasting corporate funds on avoidable transactions. *Id.* Podlucky and his senior management used the "no evidence of fraud" finding in the Report to retain their senior positions at Le–Nature's. *Id.*

However, between January 2004 and November 2006, Podlucky and his senior managers employed fraudulent schemes involving almost $200 million in equipment deposits. *Id.* at ¶ 80. Le–Nature's continued to add to its debt by, *inter alia,* building and commencing operations at unnecessary facilities. *Id.* at ¶¶ 81–83. In September 2006, Le–Nature's obtained a $285 million replacement line of credit through Wachovia. *Id.* at ¶ 83. Through 2005, Le–Nature's long-term secured debt increased to $275 million. *Id.* at ¶ 84. Le–Nature's continued borrowing funds, thereby substantially leveraging its assets and balance sheet. *Id.* at ¶ 84. By the end of 2005, Le–Nature's had production facilities in Latrobe, Pennsylvania and Phoenix, Arizona. *Id.* at ¶ 85. In late 2005, the Independent Directors learned that Podlucky intended to build a third facility in Florida. *Id.*

In May 2006, the Minority Shareholders of Le–Nature's, who were represented on the Board by the Independent Directors, commenced in Delaware Chancery Court an injunctive action against Le–Nature's and its four inside directors.[2] *Id.* The Chancery Court granted a preliminary injunction enjoining Le–Nature's from certain actions, including making capital expenditures outside the ordinary course of business, *i.e.,* in excess of $1,000, without the approval of the Minority Shareholders. *Id.*

Subsequently, in September 2006, Podlucky requested the assistance of Ferguson in preparing an initial public offering ("IPO") of Le–Nature's stock. *Id.* at ¶ 86. Ferguson, with the assistance of K & L Gates's London, England, office, commenced work on the IPO. *Id.* However, prior to October 19, 2006, the Independent Directors learned of a new allegation of fraud involving Le–Nature's. *Id.* at ¶ 87. A financial institution alleged that Le–Nature's ***746** had forged American International Group ("AIG") letters relating to the purchase of equipment for the company. *Id.* At the request of the Minority Shareholders, the Chancery Court granted a

Temporary Restraining Order enjoining Le–Nature's from (a) making or incurring expenditures exceeding $1,000 without Board authorization; (b) accessing, tampering with or destroying any Le–Nature's' property; (c) selling, leasing or disposing of Company assets; (d) making or committing the Company to make any loans, advancements or investments; or (e) causing or committing the Company to incur any debt. *Id.*

Because the Temporary Restraining Order precluded Podlucky from proceeding with Le–Nature's IPO, Podlucky placed Ferguson in charge of negotiating with the Minority Shareholders to vacate the Chancery Court's Order. *Id.* at ¶ 88. Unable to reach an agreement, the Minority Shareholders and Independent Directors filed an application for the appointment of a receiver for Le–Nature's. *Id.*

On October 27, 2006, the Delaware Chancery Court appointed Kroll Zolfo Cooper, Inc. ("Kroll"), as custodian of Le–Nature's, placing it in charge of management and operations. *Id.* at ¶ 89. Within several days, Kroll uncovered massive fraud at Le–Nature's. *Id.* On November 1, 2006, Steven G. Panagos, a Kroll managing director, filed an affidavit with the Delaware Chancery Court setting forth the evidence of the financial fraud he had discovered at Le–Nature's. *Id.* at ¶ 90.

On November 1, 2006, several of Le–Nature's creditors initiated involuntary bankruptcy proceedings against Le–Nature's under Chapter 7 of the United States Bankruptcy Code, 11 U.S.C.A. § 101 *et seq.* Amended Complaint at ¶ 91. Kroll converted the proceedings from Chapter 7 to Chapter 11. *Id.* On July 8, 2008, the Bankruptcy Court issued an Order confirming a liquidation plan for Le–Nature's. *Id.* at ¶ 23. In accordance with the liquidation plan and the Bankruptcy Court's confirmation Order, the Bankruptcy Court created the Le–Nature's Liquidation Trust ("Trust") and appointed Trustee. *Id.* Under the liquidation plan, all assets and property of Le–Nature's, including all claims and causes of action, were conveyed to and retained by the Trust. *Id.* Trustee also uncovered the massive fraud perpetrated by Podlucky and other insiders. *Id.* at ¶ 93.

On September 9, 2009, Trustee filed, in the Court of Common Pleas of Allegheny County, a Civil Complaint against Defendants. Defendants filed Preliminary Objections demurring to all counts, after which Trustee filed an Amended Complaint. Again, Defendants filed Preliminary Objections demurring to the counts averred in the Amended Complaint. Trustee filed a response to Defendant's Preliminary Objections, and an objection to one of the Preliminary Objections filed by P & W. After oral argument, on December 28, 2010, the trial court entered an Order sustaining Defendants' Preliminary Objections and dismissing all counts of Trustee's Amended Complaint. Trial Court Order, 12/28/10. Thereafter, Trustee filed the instant timely appeal, followed by a court-ordered Concise Statement of matters complained of on appeal, in accordance with Pa.R.A.P. 1925(b).

On appeal, Trustee presents the following claims for our review:

> 1. Whether the Trial Court erred in dismissing [Trustee's] professional negligence claim against K & L Gates despite (a) the existence of an express or implied attorney-client relationship between [Le–Nature's] and K & L Gates and (b) [Trustee's] allegation that K & L Gates's wrongdoing directly and proximately *747 caused cognizable and recoverable damages to [Le–Nature's] under Pennsylvania Law[?]
>
> 2. Whether the Trial Court erred in dismissing [Trustee's] breach of contract claim against K & L Gates despite [Trustee's] allegations of facts showing a contractual relationship between K & L Gates and [Le–Nature's] (either through the Special Committee or as a third-party beneficiary) and that the Company suffered damages resulting from the breach of contract[?]
>
> 3. Whether the Trial Court erred in dismissing [Trustee's] breach of fiduciary duty claim against K & L Gates where [Trustee] alleges facts establishing that K & L Gates owed a fiduciary duty to [Le–Nature's], which suffered damages as a result of the breach of that duty[?]
>
> 4. Whether the Trial Court erred in dismissing [Trustee's] negligent misrepresentation claim against [D]efendants despite [Trustee's] factual allegations that [D]efendants were professional firms in the business of supplying information, who provided false information concerning the absence of any evidence of fraud, and that [Le–Nature's], to its substantial financial harm, justifiably relied on their false information[?]
>
> 5. Whether the Trial Court erred in dismissing [Trustee's] vicarious liability claim against K & L Gates for the actions of P & W[,] despite [Trustee's] allegations of fact showing that a principal-agent or master-servant relationship was formed between K & L Gates and P & W[?]
>
> 6. Whether the Trial Court erred in dismissing [Trustee's] breach of contract claim against P & W despite allegations of fact showing that [Le–Nature's]

> was a third-party beneficiary of the K & L Gates–P & W agreement[?]
>
> 7. Whether [D]efendants' other preliminary objections, not addressed by the trial court's Opinion, are meritless or improper[?]

Brief for Appellant at 3–4.

[1] [2] [3] [4] As an initial matter, we are cognizant that "[a] preliminary objection in the nature of a demurrer is properly granted where the contested pleading is legally insufficient." *Cardenas v. Schober,* 783 A.2d 317, 321 (Pa.Super.2001) (citing Pa.R.C.P. 1028(a)(4)).

> "Preliminary objections in the nature of a demurrer require the court to resolve the issues solely on the basis of the pleadings; no testimony or other evidence outside of the complaint may be considered to dispose of the legal issues presented by the demurrer." [*Cardenas,* 783 A.2d] at 321–22. (citation omitted). All material facts set forth in the pleading and all inferences reasonably deducible therefrom must be admitted as true. *Id.* at 321.
>
> In determining whether the trial court properly sustained preliminary objections, the appellate court must examine the averments in the complaint, together with the documents and exhibits attached thereto, in order to evaluate the sufficiency of the facts averred. The impetus of our inquiry is to determine the legal sufficiency of the complaint and whether the pleading would permit recovery if ultimately proven. This Court will reverse the trial court's decision regarding preliminary objections only where there has been an error of law or abuse of discretion. When sustaining the trial court's ruling will result in the denial of claim or a dismissal of suit, preliminary objections will be sustained only where the case is free and clear of doubt.

***748** *Cooper v. Frankford Health Care Sys.,* 960 A.2d 134, 143–44 (Pa.Super.2008) (quoting *Hess v. Fox Rothschild, LLP,* 925 A.2d 798, 805–06 (Pa.Super.2007), in turn quoting *Brosovic v. Nationwide Mut. Ins. Co.,* 841 A.2d 1071, 1073 (Pa.Super.2004)). This Court will not reverse a trial court's decision to sustain preliminary objections unless there has been an error of law or abuse of discretion. *Cornerstone Land Dev. Co. of Pittsburgh LLC v. Wadwell Group,* 959 A.2d 1264, 1266 (Pa.Super.2008).

[5] Trustee first claims that the trial court erred in dismissing his legal malpractice/professional negligence claim against K & L Gates. Brief for Appellant at 20. In dismissing that cause of action, the trial court concluded that Trustee cannot establish a professional negligence claim against K & L Gates because of (a) the absence of an express or implied attorney-client relationship between K & L Gates and Le–Nature's, and (b) the absence of any losses to Le–Nature's caused by K & L Gates's failure to detect mismanagement. Trial Court Opinion, 12/28/10, at 13–14 We first review whether the averments of the Amended Complaint, taken as true, establish the existence of an attorney-client relationship between K & L Gates and Le–Nature's.

"A cause of action for legal malpractice contains three elements: the plaintiff's employment of the attorney or other grounds for imposition of a duty; the attorney's neglect to exercise ordinary skill and knowledge; and the occurrence of damage to the plaintiff proximately caused by the attorney's misfeasance." *Epstein v. Saul Ewing LLP,* 7 A.3d 303, 313 (Pa.Super.2010). Whether a duty exists under a particular set of facts is a question of law. *Campisi v. Acme Mkts.,* 915 A.2d 117, 119 (Pa.Super.2006). On questions of law, our standard of review is *de novo* and our scope of review is plenary. *Epstein,* 7 A.3d at 313.

While the trial court recognized the existence of an express contract between K & L Gates and the Special Committee, the trial court concluded that the K & L Gates was retained "solely to protect the interests of the remaining equity holders[,]" *i.e.,* the investors, and not Le–Nature's. Trial Court Opinion, 12/28/10, at 13. In so holding, the trial court stated the following:

> Since [K & L Gates] was instructed *by the investors* to determine whether the other equity holder [*i.e.,* Podlucky,] was looting the company, the investors would have reasonably believed that the law firm was representing their interests, and only these interests, in investigating whether there was merit to the concerns of mismanagement on the part of Podlucky.
>
> In summary, the Trustee is not bringing this lawsuit on behalf of the investors whom [K & L Gates] was retained to protect. It is these investors to whom [K & L Gates] owed a duty of care and it is these investors who have a cause of action for malpractice.

Id. at 13–14 (emphasis added). We disagree. Contrary to the trial court's determination, the Amended Complaint avers the existence of an attorney-client relationship between K & L Gates and Le–Nature's.

As set forth above, the Retention Letter identified an attorney-client relationship between K & L Gates and the Special Committee. Although Le–Nature's is not identified as a client in the Retention Letter, Pennsylvania courts have recognized that

> [a]bsent an express contract, an implied attorney-client relationship will be found if 1) the purported client sought advice or assistance from the attorney; 2) the ***749** advice sought was within the attorney's professional competence; 3) the attorney expressly or impliedly agreed to render such assistance; and 4) it is reasonable for the putative client to believe the attorney was representing him."

Cost v. Cost, 450 Pa.Super. 685, 677 A.2d 1250, 1254 (1996).

In reviewing Trustee's claim of an attorney-client relationship between K & L Gates and Le–Nature's, we are cognizant that Le–Nature's is a Delaware corporation. Delaware law provides that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. 8 Del. C. § 141(a). In discharging this function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173, 179 (Del.1986). The Delaware Supreme Court has held that "[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable." *Paramount Communications, Inc. v. QVC Network, Inc.,* 637 A.2d 34, 51 (Del.1994). In this context, we review the nature of the duty undertaken by K & L Gates.

The averments of the Amended Complaint, taken as true, establish that Le–Nature's, acting through its Board and the Board's Special Committee, sought the legal advice and assistance of K & L Gates. Specifically, Le–Nature's sought K & L Gates's legal advice and assistance in investigating allegations of fraud, and in preparing findings and recommendations for action to be taken by Le–Nature's.

According to the Amended Complaint, the Board of Directors determined that it was in the best interests of Le–Nature's to create a special committee of the Board, which would investigate the allegations of fraud at Le–Nature's, and the resignations of the Senior Financial Managers. Amended Complaint at ¶ 38. Under Delaware law, a board of directors of a Delaware corporation may designate a committee, consisting of one or more directors of the corporation. 8 Del. C. § 141(c)(2). "Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation...." *Id.*

As a committee of the Board, the Special Committee had the fiduciary duty to act in the best interests of not only the shareholders, but also the corporation.[3] *See Revlon,* 506 A.2d at 179 (holding that directors owe fiduciary duties of care and loyalty to the corporation and shareholders). The Special Committee was vested with the power and authority of the Board to manage this specific aspect of the company's business affairs. *See* 8 Del. C. § 141(c)(2); *see also* Amended Complaint at ¶ 38, Exhibit E. Thus, the Special Committee acted on behalf of the Board and Le–Nature's in its investigation.

By its Resolution, the Board authorized the Special Committee to retain counsel to conduct an investigation "on behalf of the company." Amended Complaint at ¶ 38, Exhibit E (Resolution). K & L Gates was provided with a copy of the Board's Resolution. *See* Amended Complaint, Exhibit C (Report), at 4 (referencing the attached Resolution in the Report). Under Delaware law, the Board could not authorize ***750** the Special Committee to act solely on behalf of investors. Such authorization would violate the Board's fiduciary duty to Le–Nature's. *See Revlon,* 506 A.2d at 179 (holding that directors owe fiduciary duties of care and loyalty to the corporation *and* its shareholders and invalidating contracts that limit the exercise of such duties). Further, under Delaware law, the Special Committee only could act in the best interests of Le–Nature's *and* its shareholders. *See* 8 Del. C. § 141(c)(2) (providing that a committee of the board may exercise all of the powers of the board in the management and business affairs of the company); *Revlon,* 506 A.2d at 179.

According to the averments in the Amended Complaint, K & L Gates agreed to provide legal advice and assistance to Le–Nature's, through its Special Committee. K & L Gates's Retention Letter confirmed that (a) K & L Gates would provide legal assistance in investigating the fraud allegations; (b) K & L Gates would assist in preparing findings and recommendations; and (c) the findings and recommendations would be presented to the Board of Le–Nature's. Amended Complaint, Exhibit A (Retention Letter). In conformity with this undertaking, K & L Gates retained P & W to provide, *inter alia,* consulting, financial and investigative advice to K & L Gates "to **assist it in rendering legal advice to Le[-]Nature's.**" Amended Complaint, Exhibit B (P & W Retention Letter) (emphasis added). K & L Gates agreed to bill Le–Nature's for its fees and those of P & W. Amended Complaint, Exhibit B (P & W Retention Letter).

Thus, the Amended Complaint avers that Le–Nature's, through a Special Committee of the Board of Directors, sought the legal advice and assistance of K & L Gates, and K & L Gates agreed to provide such advice and assistance. Specifically, Le–Nature's sought K & L Gates's legal advice and assistance in investigating allegations of fraud at Le–Nature's, and in preparing findings and recommendations in this regard. The parties do not dispute that the legal advice and assistance sought by Le–Nature's was within the professional competence of K & L Gates.

The averments of the Amended Complaint, taken as true, also establish that Le–Nature's reasonably believed that K & L Gates represented the *company's* interests. In addition to the foregoing, the Amended Complaint asserts that K & L Gates provided a draft of its Report not only to the Special Committee, but also to Podlucky. Amended Complaint at ¶ 75. Podlucky was not a member of the Special Committee. *See id.* at ¶ 39 (listing the directors appointed to the Special Committee).

After Ferguson signed and the Special Committee approved the final Report, the Special Committee forwarded it to the Board of Directors. *Id.* at ¶ 76. The cover memorandum attached to the final Report, which was reviewed by K & L Gates and directed to the Board of Directors, represented that K & L Gates found no evidence of fraud or malfeasance in the transactions reviewed. *Id.* at ¶ 78, Exhibit D. The cover memorandum further set forth K & L Gates's specific findings and recommendations for Le–Nature's. *Id.* By its actions, K & L Gates's confirmed that its duty extended beyond the Special Committee. Thus, these averments, in conjunction with the foregoing, establish the reasonableness of Le–Nature's belief that K & L represented the *company's* best interests, not just those of the Special Committee.

In summary, we conclude that the Trustee has averred the existence of an attorney-client relationship sufficient to impose a duty upon K & L Gates to Le–Nature's. The Amended Complaint and its exhibits ***751** establish that (1) Le–Nature's, through its Board and Special Committee, sought K & L Gates's legal advice and assistance in investigating alleged fraudulent transactions and preparing findings/recommendations for the Le–Nature's Board; (2) the investigation of financial fraud and the preparation of findings and recommendations was within the professional competence of K & L Gates; (3) K & L Gates agreed to render such assistance to Le–Nature's, through its Board and Special Committee; and (4) it was reasonable for Le–Nature's to believe that K & L Gates was representing it in the investigation of fraud and the preparation of findings/recommendations. *See Cost,* 677 A.2d at 1254.

[6] Trustee also challenges the trial court's conclusion that the Amended Complaint fails to aver cognizable and compensable damages to Le–Nature's. Brief for Appellant at 29–30. The trial court rejected Trustee's claim for damages because Le–Nature's was insolvent at the time K & L Gates prepared its Report in December 2003:[4]

> While [Trustee] contends that the increased insolvency is an actual corporate loss, [Trustee] does not offer any explanation as to how an already insolvent company was harmed because its insolvency increased by more than $500 million between December 2003 and October 2005....
>
> *Id.* at 15. The trial court specifically observed that Le–Nature's *shareholders* were not harmed by the increased insolvency, as their interests had no value as of the date K & L Gates submitted its Report. *Id.* The trial court further rejected Trustee's claim for damages to the corporation, equating it to a claim for "deepening insolvency." *Id.* The trial court then rejected "deepening insolvency" as a legal basis for an award of tort damages:
>
>> [The trial court] find[s] to be very persuasive—and believe[s] that the Pennsylvania appellate courts will also do so—the Opinion of the Court of Chancery of Delaware, New Castle County, in *Trenwick America Litigation Trust* [*v. Ernst & Young,* 906 A.2d 168 (Del.Ch.2006), *aff'd* 931 A.2d 438 (Del.2007)], that rejected the concept of deepening insolvency.
>
> Trial Court Opinion, 12/28/10, at 24. Contrary to the trial court's analysis, our review of the Amended Complaint discloses that Trustee does not claim damages for "deepening insolvency." Further, the damages claimed by Trustee are cognizable and compensable.

[7] [8] When it is alleged that an attorney has breached his professional obligations to his client, an essential element of the cause of action is proof of actual loss. *Sabella v.*

Milides, 992 A.2d 180, 187 (Pa.Super.2010). Once the fact that damages occurred has been established, the jury is permitted to determine the extent of those damages. *Curran v. Stradley, Ronon, Stevens & Young,* 361 Pa.Super. 17, 521 A.2d 451, 455 (1987). Nevertheless, "the plaintiff has the burden of presenting sufficient evidence by which damages can be determined on some rational basis and other than by pure speculation or conjecture." *Id.*

Federal courts have coined the phrase "deepening insolvency" in describing the damages incurred by an already insolvent corporation. In ***752** *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.,* 267 F.3d 340 (3d Cir.2001),[5] which arose out of the bankruptcy of two lease financing corporations that purportedly operated as a "Ponzi scheme," the Third Circuit Court of Appeals described "deepening insolvency" as a type of "injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." *Id.* at 347. The concept presumes that, in taking on additional unpayable debt, a corporation might be harmed by operational limitations, strained corporate relationships, diminution of corporate assets, and the legal and administrative costs of bankruptcy. *Id.* at 349–50. The Third Circuit Court of Appeals predicted that where "deepening insolvency" causes damage to corporate property, the Pennsylvania Supreme Court would provide a remedy by recognizing a deepening insolvency cause of action. *Id.* at 351.

Five years later, the Third Circuit Court of Appeals clarified its decision in *Lafferty:*

> In [*Lafferty*], we concluded that deepening insolvency was a valid Pennsylvania cause of action. Although we did describe deepening insolvency as a "type of injury," and a "theory of injury," we never held that it was a valid theory of *damages* for an independent cause of action. Those statements in *Lafferty* were in the context of a deepening insolvency *cause of action.* They should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice.

Seitz v. Detweiler, Hershey and Assoc., P.C. (In re CitX Corp.), 448 F.3d 672, 676 (3d Cir.2006) (emphasis added) (citations omitted). However, the Court of Appeals observed that "[w]here an independent cause of action gives a firm a remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits, then the firm may recover, without reference to the incidental impact upon the solvency calculation." *Id.* at 678 (citation omitted).

In *CitX,* the federal appeals court (and the trial court herein) referred to an article frequently quoted on the subject of "deepening insolvency": Sabin Willet, *The Shallows of Deepening Insolvency,* 60 Bus. Lawyer 549 (2005). As this article explains,

> injury to solvency is an incident to the harm, not the harm itself. If the [corporation] lost asset value through defendant's conversion of property, the law measures damage; if through breach of contract, commission of tort, breach of fiduciary duty, or fraudulent transfer, the law already measures damage. The damages may include the insult to asset values ... or the accumulation of a liability.... Depending on the underlying law, the damage may or may not also include lost profits.... Solvency analysis will be incidental to all of these damage analyses. It may so happen that the diminished asset value, new liability, or lost profits that measures the damage also measures precisely the deepening of the firm's insolvency. *The point is that insolvency analysis adds nothing to the measure of damages the law already allows.*

Id. at 575 (emphasis added).

Since *CitX,* the Third Circuit continues to recognize the validity of traditional tort damages, even when those damages increase a corporation's insolvency. *See* ***753** *Thabault v. Chait,* 541 F.3d 512, 523 (3d Cir.2008) (recognizing as cognizable traditional tort damages even when the corporation is insolvent); *see also id.* at 525 (recognizing that an increase in liabilities is a harm to the company); *Fehribach v. Ernst & Young LLP,* 493 F.3d 905, 909 (7th Cir.2007) (recognizing that the defendant auditors owed a duty to the company, and that the duty does not "evaporate just because the client is bankrupt and any benefits from suing will accrue to its creditors.").

We find the rationale expressed by the federal appeals court in *CitX* and *Thabault* helpful to our determining the type of damages sought by Trustee. Our review of the Amended Complaint discloses that Trustee has not claimed "deepening insolvency," either as a separate cause of action or as a separate theory of damages. Trustee does not allege that Le–Nature's insolvency at the time of the alleged tortious conduct created additional damages or negated the harm caused by the allegedly tortious conduct. Rather, Trustee seeks tort damages for Le–Nature's increased liabilities, decreased asset values and losses proximately caused by the professional negligence of K & L Gates. Amended Complaint at ¶¶ 22, 79–84, 94, 107.

Upon review, we conclude that Trustee seeks traditional tort damages. The fact of Le–Nature's insolvency does not negate the harm allegedly resulting from K & L Gates's professional negligence. *See* 37 Pennsylvania Law Encyclopedia, Torts § 4, at 120 (1961) (recognizing the basic legal principle in this Commonwealth that "for every legal wrong there must be a correlative legal right."). Accordingly, we conclude that Trustee has averred legally compensable and cognizable damages for the alleged professional negligence.[6]

[9] Trustee also argues that the averments of the Amended Complaint establish that K & L Gates's professional negligence proximately caused the harm alleged. Brief for Appellant at 38. Proximate cause must "be determined by the judge and it must be established before the question of actual cause is put to the jury." *Brown v. Philadelphia College of Osteopathic Med.,* 760 A.2d 863, 868 (Pa.Super.2000). "Proximate causation" in a legal malpractice action has been defined as "that which, in a natural and continuous sequence, unbroken by any sufficient intervening cause, produced injury, and without which the result would not have occurred." *Fiorentino v. Rapoport,* 693 A.2d 208, 217 (Pa.Super.1997) (citation omitted).

[10] [11] To determine proximate cause, "the question is whether the defendant's conduct was a 'substantial factor' in producing the injury." *Brown,* 760 A.2d at 869. A defendant will not be found to have had a duty to prevent a harm that was not a reasonably foreseeable result of the prior negligent conduct. *Fiorentino,* 693 A.2d at 217 (citation omitted). Unless the evidence is such that reasonable people cannot disagree, the question of whether a defendant's conduct is the cause of the plaintiff's injury or loss is for the jury. *Curran,* 521 A.2d at 454.

The trial court concluded that Trustee had failed to establish proximate causation, because *the creditors* did not rely on K & L Gates's Report in making their decisions, as they were unaware of the Report. Trial Court Opinion, 12/28/10, at 31–32. The trial court concluded that "[c]onsequently, the losses of the new creditors were not caused by K & L [Gates's] malpractice." *Id.* at 32. However, as set ***754** forth above, Trustee brings this cause of action on behalf of Le–Nature's, not its creditors. Thus, we consider whether the Amended Complaint establishes that the professional negligence of K & L Gates proximately caused harm to Le–Nature's.

To determine whether any breach of duty proximately caused a plaintiff's damages, this Court looks to whether a reasonable person would infer that the injury was the natural and probable result of defendant's breach of duty. *Commerce Bank v. First Union Nat. Bank,* 911 A.2d 133, 142 (Pa.Super.2006). Regarding proximate causation, the Amended Complaint avers that if K & L Gates properly had performed its duty to Le–Nature's, *i.e.,* by conducting a proper investigation and issuing an appropriate report,

> Le–Nature's would have avoided Podlucky's massive looting of the Company and the several financings and leasing obligations misused by Podlucky and the other Insiders. Had they discharged their duties and obligations properly, Defendants would have informed the Independent Directors of the widespread fraud at the Company and the Independent Directors would have sought immediate judicial intervention and obtained in late 2003 or early 2004, the restraining and other orders secured in 2006. Such actions clearly would have prevented the unnecessary financings and closed down the Company, which would have liquidated a failed enterprise and preserved significant asset value.

Amended Complaint at ¶ 94.

According to the Amended Complaint, Podlucky's fraud and looting were occurring during the investigation, and continued unimpeded as a result of K & L Gates's deficient investigation. *Id.* at ¶ 79. The Amended Complaint asserts that, as a direct result of K & L Gates's deficient investigation and misleading report, the Independent Directors were misled into a belief that the allegations of improper conduct were unfounded. *Id.* at ¶

96. In addition, the Amended Complaint alleges that K & L Gates concealed the wrongdoing, causing the Independent Directors to relax their vigilance. *Id.* at ¶ 97. The Amended Complaint avers that

> [a]s a direct, proximate and foreseeable result of [K & L Gates's] wrongdoing, [Le–Nature's] has suffered substantial damages totaling more than $500 million that the Insiders looted from the Company or wasted on avoidable transactions after the issuance of the Report.

Id. at ¶ 107. According to the Amended Complaint, these damages were reasonably foreseeable and K & L Gates's malpractice enabled Podlucky and the interested directors to continue their fraudulent activity. *Id.* at ¶ 109.

K & L Gates was retained to investigate the exact type of injury being inflicted upon Le–Nature's. By negligently conducting its investigation, K & L Gates affirmatively caused harm to Le–Nature's, by concealing the looting of the Company and wrongdoing by Podlucky, and affirmatively representing that no evidence of fraud or misconduct existed. The foregoing allegations are sufficient to establish that K & L Gates's malpractice was a substantial factor in causing harm to Le–Nature's in the form of increased liabilities, decrease in the value of assets, additional looting of the company and corporate waste, all of which were permitted to continue because of the malpractice. Because the Amended Complaint alleges that the looting of the company and waste were ongoing, we cannot conclude as a matter of law that the alleged damages were too remote.

For these reasons, we conclude that the trial court erred in sustaining the Preliminary Objections of K & L Gates as to ***755** Count I—Professional Negligence. Trustee's Amended Complaint avers a *prima facie* cause of action for professional negligence against K & L Gates.[7]

[12] Trustee next claims that the trial court erred in dismissing Trustee's breach of contract claim against K & L Gates. Brief for Appellant at 44. In rejecting Trustee's breach of contract claim, the trial court concluded that K & L Gates's contract was with the Special Committee, and that "[t]here are no other interests that K & L [Gates] would have been reasonably expected to protect." Trial Court Opinion, 10/28/10, at 32. As a basis for its conclusion, the trial court incorrectly opined that the Special Committee represented the interests of the holders of Le–Nature's preferred stock, and that it would have been obvious to K & L Gates that its responsibilities were to protect the interests of the preferred shareholders. *Id.* The trial court also concluded that Le–Nature's was not a third-party beneficiary of K & L Gates's agreement with the Special Committee, and that the Amended Complaint fails to describe any harm to Le–Nature's caused by K & L Gates's breach of its duty of reasonable care. *Id.* at 33.

[13] [14] A breach of contract action involves (1) the existence of a contract, (2) a breach of a duty imposed by the contract, and (3) damages. *Zokaites Contr., Inc. v. Trant Corp.,* 968 A.2d 1282, 1287 (Pa.Super.2009). A claim based on breach of an attorney-client agreement is a contract claim, and the attorney's liability must be assessed under the terms of the contract. *Fiorentino,* 693 A.2d at 213. "[A]n attorney who agrees for a fee to represent a client is by implication agreeing to provide that client with professional services consistent with those expected of the profession at large." *Wachovia Bank, N.A. v. Ferretti,* 935 A.2d 565, 571 (Pa.Super.2007) (citation omitted).

As discussed above, the Amended Complaint avers the existence of an agreement between K & L Gates and Le–Nature's. Specifically, K & L Gates agreed to provide its professional services to Le–Nature's, in the form of an investigation of fraud and certain improper financial transactions. K & L Gates's Retention Letter confirmed that (a) K & L Gates would provide legal assistance in investigating the fraud allegations; (b) K & L Gates would assist in preparing findings and recommendations; and (c) the findings and recommendations would be presented to the Board of Le–Nature's. Amended Complaint, Exhibit A (Retention Letter). K & L Gates billed Le–Nature's for its services and Le–Nature's paid for those services. Amended Complaint at ¶ 42. Confirming the nature of K & L Gates's agreement with Le–Nature's, K & L Gates retained P & W to provide, *inter alia,* consulting, financial and investigative advice to K & L Gates **"to assist it in rendering legal advice to Le[-]Nature's."** Amended Complaint, Exhibit B (P & W Retention Letter) (emphasis added).

The Amended Complaint also avers that K & L Gates breached the duty imposed under the agreement when it failed to provide Le–Nature's with professional services consistent with those expected of the profession at large. In support, the Amended Complaint avers, *inter alia,* that

> (a) Ferguson misrepresented his investigation expertise, and he directed a librarian ***756** at his law firm to identify and obtain copies of articles discussing how a corporate investigation should be conducted, *see* Amended Complaint at ¶ 44;

(b) Despite the serious allegations and resignations of the Senior Financial Managers, and the widespread nature of the allegations, K & L Gates improperly limited the scope of its investigation to a number of discrete transactions; *see id.* at ¶ 49;

(c) Despite allegations that virtually all of the suspected improper activity implicated Podlucky, K & L Gates allowed Podlucky to play an integral role in the investigation, including allowing Podlucky to control the documents that would be produced in the investigation and the process for interviewing witnesses, *see id.* at ¶ 50;

(d) Despite allegations that virtually all of the suspected improper activity implicated Podlucky, K & L Gates channeled all document requests through Podlucky, and knew that he failed to produce all of the requested documents, *see id.* at 51;

(e) Despite allegations that virtually all of the suspected improper activity implicated Podlucky, K & L Gates deferred to Podlucky for his explanations and assistance in investigating the improper activities, and repeatedly relied upon those uncorroborated explanations, *see id.;*

(f) Despite allegations that virtually all of the suspected improper activity implicated Podlucky, K & L Gates agreed to provide Podlucky or his attorney with a description of the topics that K & L Gates intended to address during employee interviews, "thus enabling Podlucky to coach those witnesses before their interviews[,]" *see id.* at ¶ 52; and

(g) K & L Gates conducted only limited non-employee interviews, improperly accepting Podlucky's pretextual reasoning, and acceded to Podlucky's unreasonable demand prohibiting follow-up interviews regarding material matters in the investigation, *see id.*

The Amended Complaint also identifies specific suspicious and fraudulent activities and transactions that should have been discovered by K & L Gates, had it conducted the promised investigation. *Id.* at ¶¶ 53–73.

The Amended Complaint further avers that K & L Gates breached its duties and obligations under the contract by, *inter alia,* failing to fulfill the engagement they agreed to undertake pursuant to the contract; improperly limiting the scope of the investigation and accepting limitations on the investigation; improperly permitting the suspected wrongdoers to dictate and limit the manner in which the investigation was conducted; improperly failing to interview material third-party witnesses and obtain independent third-party documentation regarding the challenged transactions; improperly relying on corporate insiders' self-serving and uncorroborated presentations; improperly suspending the investigation before it was completed; issuing a false and misleading Report despite being provided with substantial evidence of improper conduct and indications of fraud, and despite being provided with forged and backdated documents. *Id.* at ¶ 116.

Additionally, the Amended Complaint alleges that K & L Gates's breach caused Le–Nature's to suffer actual damages totaling more than $500 million, which the insiders looted from the Company or wasted on avoidable transactions. *Id.* at ¶ 118. According to the Amended Complaint, the damages were reasonably foreseeable and could not have been discovered by Le–Nature's with the exercise of due diligence until the Kroll investigation. *Id.* at ¶ 120.

***757** Based upon the foregoing, we conclude that the trial court erred in sustaining K & L Gates's preliminary objection as to Count II–Breach of Contract. The Amended Complaint avers a legally sufficient breach of contract action against K & L Gates.

[15] Trustee next claims that the trial court improperly dismissed his claim that K & L Gates breached its fiduciary duty to Le–Nature's. Brief for Appellant at 48. According to Trustee, the Amended Complaint alleges the existence of a fiduciary relationship between K & L Gates and the Company, "and that K & L Gates's negligent failure to act in good faith and solely for the benefit of the Company was a real factor in [Le–Nature's] harm." *Id.* (citing Amended Complaint at ¶¶ 123–32). Trustee contends that the trial court erred in concluding that K & L Gates's fiduciary duty, if any, was owed only to the Special Committee and Minority Shareholders, not Le–Nature's. Brief for Appellant at 48. Thus, Trustee claims that the Amended Complaint establishes a fiduciary duty owed by K & L Gates to Le–Nature's. *Id.* We agree.

[16] "It is axiomatic that an attorney who undertakes representation of a client owes that client both a duty of competent representation and the highest duty of honesty, fidelity, and confidentiality." *Capital Care Corp. v. Hunt,* 847 A.2d 75, 84 (Pa.Super.2004). Such duty demands undivided loyalty and prohibits the attorney from engaging in conflicts of interest, and breach of such duty is actionable. *Maritrans GP, Inc. v. Pepper, Hamilton & Scheetz,* 529 Pa. 241, 602 A.2d 1277, 1283 (1992). In *Maritrans,* our Supreme Court drew support from the United States Supreme Court, which set forth the following observations in an early decision:

> There are few of the business relations of life involving a higher trust and confidence than those of attorney and client or, generally speaking, one more honorably and faithfully discharged; few more anxiously guarded by the law, or governed by sterner principles of morality and justice; and it is the duty of the court to administer them in a corresponding spirit, and to be watchful and industrious, to see that confidence thus reposed shall not be used to the detriment or prejudice of the rights of the party bestowing it.

Id. (quoting *Stockton v. Ford,* 52 U.S. (11 How.) 232, 247, 13 L.Ed. 676 (1850)).

The Amended Complaint asserts the existence of a fiduciary duty owed by K & L Gates to Le–Nature's, based upon their attorney-client relationship. Amended Complaint at ¶ 124. As discussed *supra,* the allegations of the Amended Complaint and its exhibits establish the existence of an attorney-client relationship between Le–Nature's and K & L Gates. The Amended Complaint avers that (1) Le–Nature's (through its Board and Special Committee) sought K & L Gates's legal advice and assistance in investigating alleged fraudulent transactions and preparing findings/recommendations for the Le–Nature's Board and, ultimately, Le–Nature's; (2) the investigation of financial fraud and the preparation of findings and recommendations was within the professional competence of K & L Gates; (3) K & L Gates agreed to render such assistance to Le–Nature's, through its Board and Special Committee; and (4) it was reasonable for Le–Nature's to believe that K & L Gates was representing it in the investigation of fraud and the preparation of findings/recommendations. *See Cost,* 677 A.2d at 1254. Based upon the existence of an attorney-client relationship, we conclude that the trial court erred when it determined that no fiduciary relationship ***758** existed between Le–Nature's and K & L Gates.

Further, the Amended Complaint avers that K & L Gates breached its fiduciary duty by failing to act in good faith in accordance with the standard of care ordinarily provided by professionals when providing legal representation. Amended Complaint at ¶ 124; *see Maritrans GP, Inc.,* 602 A.2d at 1283 (describing the fiduciary duty owed by attorneys to their clients and stating that "attorneys are bound ... to perform their fiduciary duties properly. Failure to so perform gives rise to a cause of action ... [and] ... such duty demands undivided loyalty and prohibits the attorney from engaging in conflicts of interest, and breach of such duty is actionable."). The Amended Complaint asserts, *inter alia,* that K & L Gates breached its duty of care by not conducting a reasonable and competent investigation; by violating its duty of undivided loyalty by becoming beholden to the principal suspected wrongdoer, Podlucky; by allowing Podlucky and other insiders to become clients of the law firm; by allowing Podlucky to dictate the manner of conducting the investigation, including allowing Podlucky to control interviews and document requests; by providing a false and misleading report. Amended Complaint at ¶¶ 125–27.

Finally, the Amended Complaint avers that K & L Gates's breach of its fiduciary duty was a substantial factor in causing Le–Nature's to sustain more than $500 million in damages, such damages were proximately caused by K & L Gates's breach of its fiduciary duty, and the damages were foreseeable. *Id.* at ¶¶ 128, 129. Based upon the foregoing, we conclude that Count III of the Amended Complaint, alleging a breach of fiduciary duty, is legally sufficient. Accordingly, we conclude that the trial court erred in dismissing this count of the Amended Complaint.

[17] Trustee next claims that the trial court improperly dismissed his claim of negligent misrepresentation against Defendants. Brief for Appellant at 50. According to Trustee, the trial court premised its ruling on its findings that "the only persons who relied on the Report and its misrepresentations were the Minority Shareholders[.]" *Id.* (citing Trial Court Opinion, 12/28/10, at 35). Trustee challenges this conclusion, and further challenges the trial court's conclusion that a claim of negligent misrepresentation cannot be made in the absence of an attorney-client relationship. Brief for Appellant at 50.

As set forth above, we conclude that the Amended Complaint has averred the existence of an attorney-client relationship between Le–Nature's and K & L Gates. Further, the Amended Complaint avers a sufficient basis upon which to hold K & L Gates and P & W liable for negligent misrepresentation.

In *Bilt–Rite Contrs., Inc. v. Architectural Studio,* 581 Pa. 454, 866 A.2d 270 (2005), the Pennsylvania Supreme Court adopted Restatement (Second) of Torts Section 552 as the law in Pennsylvania "where information is negligently supplied by one in the business of supplying information[.]" *Bilt–Rite Contrs.,* 866 A.2d at 287. Section 552, entitled "Information Negligently Supplied for the Guidance of Others," provides, in relevant part, as follows:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise ***759** reasonable care or competence in obtaining or communicating the information.
>
> (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered
>
> > (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
> >
> > (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Restatement (Second) of Torts § 552. In adopting Section 552, our Supreme Court explained that

> Section 552 sets forth the parameters of a duty owed when one supplies information to others, for one's own pecuniary gain, where one intends or knows that the information will be used by others in the course of their own business activities. The tort is narrowly tailored, as it applies only to those businesses which provide services and/or information that they know will be relied upon by third parties in their business endeavors, and it includes a foreseeability requirement, thereby reasonably restricting the class of potential plaintiffs. The Section imposes a simple reasonable man standard upon the supplier of the information. As is demonstrated by the existing case law from Pennsylvania and other jurisdictions, and given the tenor of modern business practices with fewer generalists and more experts operating in the business world, business persons have found themselves in a position of increasing reliance upon the guidance of those possessing special expertise. Oftentimes, the party ultimately relying upon the specialized expertise has no direct contractual relationship with the expert supplier of information, and therefore, no contractual recourse if the supplier negligently misrepresents the information to another in privity. And yet, the supplier of the information is well aware that this third party exists (even if the supplier is unaware of his specific identity) and well knows that the information it has provided was to be relied upon by that party. Section 552 is not radical or revolutionary; reflecting modern business realities, it merely recognizes that it is reasonable to hold such professionals to a traditional duty of care for foreseeable harm.

Bilt–Rite, 866 A.2d at 285–86. Here, Trustee has asserted that Defendants negligently provided information that it know will be relied upon Le–Nature's in its business endeavors, and that said reliance was foreseeable.

According to the Amended Complaint, P & W acknowledged its understanding that "P & W is being retained to assist K & L as a financial expert related to the special investigation of certain transactions involving Le[-]Nature's, Inc. [ ] **P & W shall provide general consulting, financial accounting, and investigative or other advice as requested by K & L to assist in it rendering legal advice to Le[-]Nature's."** Amended Complaint, Ex. B, at 1 (emphasis added). P & W further confirmed that its fees would be paid by Le–Nature's. Amended Complaint, Ex. B, at 1–2. Thus, P & W expressly confirmed its understanding that the information it provided would ultimately be used to give legal advice to Le–Nature's and Le–Nature's would pay for this information.

The Amended Complaint alleges that K & L Gates and P & W drafted and edited the Report, which contained numerous misrepresentations. Amended Complaint at ¶¶ 135, 136. The Amended Complaint specifically identifies the alleged material ***760** misrepresentations made by Defendants in the Report. *Id.* at ¶¶ 136, 137. According to the Amended Complaint, Defendants knew/reasonably should have known that the alleged misrepresentations were false and misleading, and that Le–Nature's, through its Board and Special Committee, would rely on those misrepresentations. *Id.* at ¶¶ 138–40. The averments of the Amended Complaint claim that Le–Nature's justifiably relied upon the misrepresentations and that the negligent misrepresentations foreseeably and proximately caused more than $500 million in damages. *Id.* at ¶ ¶ 141–43.

Thus, the Amended Complaint avers a legally sufficient cause of action for negligent misrepresentation. On this basis, we reverse the trial court's dismissal of Count IV of the Amended Complaint, which claimed negligent misrepresentation against Defendants.

[18] Trustee next claims that the trial court erred in dismissing his vicarious liability claim against K & L Gates. Brief for Appellant at 53. Specifically, Trustee challenges the trial court's statement that "[i]t does not matter whether or not K & L [Gates] is responsible for the conduct of [P & W] because of [the trial court's] rulings that K & L [Gates] owed obligations only to the members of the Special Committee and the persons whose interests they represented." *Id.* (quoting Trial Court Opinion, 12/28/10, at 36).

Trustee claims that K & L Gates is vicariously liable for P & W's negligence based on a principal-agent or master-servant relationship. Brief for Appellant at 53. According to Trustee, the Amended Complaint alleges facts demonstrating the excessive control exercised over P & W by K & L Gates. *Id.* at 54. Of note, Trustee directs our attention to allegations that K & L Gates instructed P & W as to the tasks and its responsibilities; that K & L Gates could terminate the hourly employees of P & W; that P & W was required to seek advance approval from K & L Gates regarding its investigative methods; and that P & W funneled its requests for additional company documents through K & L Gates. *Id.; see also* Amended Complaint at ¶¶ 43, 167.

K & L Gates counters by directing our attention to the trial court's conclusion that it owed no duties to Le–Nature's and that Le–Nature's suffered no cognizable injury. Brief for Appellees (K & L Gates and Ferguson) at 53–54. K & L Gates further argues that it is not liable for P & W's actions as a matter of law. *Id.* at 54. In support, K & L Gates contends that "no legal basis exists for imposing vicarious liability on a lawyer if an independent expert he retains should fail to satisfy the standard of care applicable to *the expert's* profession." *Id.* (emphasis in original).

In its Opinion, the trial court rejected Trustee's claim of vicarious liability against K & L Gates, and stated the following:

> It does not matter whether or not K & L is responsible for the conduct of [P & W] because of my rulings that K & L owed obligations only to the members of the Special Committee and the persons whose interests they represented.
>
> Also, for the reasons given in my discussion of Count I, the Amended Complaint does not describe any harm that the corporation suffered as a result of the breach by K & L [Gates] and its agents of a duty to exercise reasonable care.

Trial Court Opinion, 12/28/10, at 36.

As set forth above, we conclude that the Amended Complaint avers a legally sufficient basis for concluding that K & L Gates owed a duty to Le–Nature's, and that K & L Gates's breach of that duty proximately caused harm to Le–Nature's. ***761** We further conclude that Le–Nature's has asserted a viable cause of action holding K & L Gates vicariously liable for the negligence of P & W.

Initially, we observe that

> not every relationship of principal and agent creates vicarious responsibility in the principal for acts of the agent. A principal and agent can be in the relationship of a master and servant, or simply in the status of two independent contractors. If a particular agent is not a servant, the principal is not considered a master who may be held vicariously liable for the negligent acts of the agent.... A servant, in law, is a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control. It is not ... the fact of actual interference or exercise of control by the employer, but the existence of the right or authority to interfere or control, which renders one a servant rather than an independent contractor. It is the exclusive function of the jury to determine, from the evidence, the precise nature of the relationship,

> except where the facts are not in dispute, in which latter event the question becomes one for determination by the court.

Myszkowski v. Penn Stroud Hotel, 430 Pa.Super. 315, 634 A.2d 622, 625 (1993) (citations and quotation marks omitted). *Accord Valles v. Albert Einstein Med. Ctr.,* 758 A.2d 1238, 1244 (Pa.Super.2000).

Here, the allegations of the Amended Complaint, taken as true, establish the existence of a master-servant relationship between K & L Gates and P & W. The Amended Complaint avers that P & W was selected to assist K & L Gates as a financial expert in investigating certain transactions involving Le–Nature's; that K & L Gates dictated the parameters of P & W's work on a daily basis; that K & L Gates set the interview schedules, provided assignments and deadlines to P & W for the work; that K & L Gates approved the investigative methods employed by P & W; and that K & L Gates selectively communicated P & W's findings to Le–Nature's; and that K & L Gates would include P & W's charges as part of K & L Gates's monthly invoices to Le–Nature's. Amended Complaint a ¶ 143.

The Amended Complaint further avers that K & L Gates controlled the tasks and responsibilities of P & W and its employees during the investigation; that K & L Gates could terminate P & W's hourly employees assigned to the investigation; that P & W funneled its requests for documents through K & L Gates; that K & L Gates dictated to P & W the schedule for the investigation including meetings, interview and deadlines for comments on draft reports; that K & L Gates dictated the scope of the transactions investigating, requiring status reports of P & W's findings; and that K & L Gates controlled P & W's use of outside resources. *Id.* at ¶ 167.

We conclude that the averments of the Amended Complaint establish that K & L Gates retained an extensive right to interfere with and control P & W's performance. *See Myszkowski,* 634 A.2d at 625. On this basis, we conclude that the Amended Complaint alleges a master-servant relationship sufficient to establish K & L Gates's vicarious liability for damages proximately caused by P & W's negligent performance.

[19] Trustee next claims that the trial court improperly dismissed his third-party beneficiary claim against P & W. Brief for Appellant at 55. According to Trustee, the trial court concluded that P & W's Retention Letter failed to establish that either P *762 & W or K & L Gates intended to give the benefit of P & W's performance to anyone other than the Special Committee and Minority Shareholders. *Id.* (citing Trial Court Opinion, 12/28/10, at 37). Based upon our review of the Amended Complaint and the P & W Retention Letter, we conclude that the trial court erred.

[20] "In order for a third party beneficiary to have standing to recover on a contract, both contracting parties must have expressed an intention that the third party be a beneficiary, and that intention must have affirmatively appeared in the contract itself." *Scarpitti v. Weborg,* 530 Pa. 366, 609 A.2d 147, 149 (1992). Furthermore,

> to be a third party beneficiary entitled to recover on a contract it is not enough that it be intended by *one* of the parties to the contract and the *third person* that the latter should be a beneficiary, but *both parties to the contract* must so intend and must indicate that intention in the contract; in other words, a promisor cannot be held liable to an alleged beneficiary of a contract unless the latter was within his contemplation at the time the contract was entered into and such liability was intentionally assumed by him in his undertaking.

Spires v. Hanover Fire Ins. Co., 364 Pa. 52, 70 A.2d 828, 830–31 (1950) (emphasis in original). While *Spires* was overruled by *Guy v. Liederbach,* 501 Pa. 47, 459 A.2d 744 (1983), it was only overruled "to the extent that it states the exclusive test for third party beneficiaries." *Id.* at 751; *accord Burks v. Fed. Ins. Co.,* 883 A.2d 1086, 1088 (Pa.Super.2005).

[21] In *Guy,* our Supreme Court established a "narrow class of third party beneficiaries." *Scarpitti,* 609 A.2d at 151. This narrow exception established a "restricted cause of action" for third party beneficiaries by adopting Section 302 of the Restatement (Second) of Contracts (1979). *Scarpitti,* 609 A.2d at 151. Section 302 involves a two-part test to determine whether one is a third party beneficiary to a contract, which requires that (1) the recognition of the beneficiary's right must be appropriate to effectuate the intention of the parties, and (2) the performance must satisfy an obligation of the promisee to pay money to the beneficiary or the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance. *Guy,* 459 A.2d at 751 (quotation marks omitted); *accord Burks v. Fed. Ins. Co.,* 883 A.2d 1086, 1088 (Pa.Super.2005). Thus,

even when the contract does not expressly state that the third party is intended to be a beneficiary, the party may still be a third party beneficiary under the foregoing test. *Burks,* 883 A.2d at 1088. "But *Guy* did not alter the requirement that in order for one to achieve third party beneficiary status, that party must show that both parties to the contract so intended, and that such intent was within the parties' contemplation at the time the contract was formed." *Id.*

Here, the recognition of Le–Nature's rights under P & W's Retention Letter and K & L Gates's Retention Letter are appropriate to effectuate the intention of the parties. Further, the circumstances indicate that K & L Gates and P & W intended to give Le–Nature's the benefit of the promised performance. P & W's Retention Letter expressly acknowledged P & W's understanding that it was retained to assist K & L Gates in investigating certain transactions involving Le–Nature's. P & W Retention Letter at 1. The P & W Retention letter stated that "P & W shall provide general consulting, financial accounting, and investigative or other advice as requested by K & L **to assist it in rendering legal advice to Le[-]Nature's. *763** " *Id.* (emphasis added). Thus, P & W confirmed its intention to assist in providing legal advice to Le–Nature's.

Further, through its own Retention Letter, K & L Gates expressed an intention to benefit Le–Nature's in performing its duties under that agreement. Through the K & L Gates Retention Letter, K & L Gates expressed an intention to provide legal advice and assistance to Le–Nature's, through its Special Committee. K & L Gates's Retention Letter confirmed that K & L Gates would provide legal assistance in investigating the allegations of fraud, and assist in preparing findings and recommendations that would be presented to Le–Nature's Board. Amended Complaint, Exhibit A (Retention Letter). Accordingly, the trial court improperly dismissed Trustee's third-party beneficiary claim against P & W. The Amended Complaint's averments are sufficient to establish Le–Nature's status an intended third-party beneficiary of that agreement.

[22] Finally, Trustee asks this Court to address whether, as a matter of law, the affirmative defense of *in pari delicto* bars his claims. The trial court did not address this issue. However, Trustee's claim involves a question of law in which our scope of review is plenary and our standard of review is *de novo.* In the interest of judicial economy, we will address his claim.

K & L Gates directs our attention to the Amended Complaint's allegation that "Le–Nature's top executive orchestrated a massive and intentional fraud." Brief for Appellees (K & L Gates & Ferguson) at 58–59. K & L Gates responds, stating that "[t]he law imputes those executives' acts to Le–Nature's and the doctrine of *in pari delicto* bars the Trustee's claims on behalf of the company for K & L's alleged failure to uncover the Company's fraud." *Id.* at 59; *see also* Brief for P & W at 36–38 (similarly asserting *in pari delicto*).

The doctrine of *in pari delicto* provides that a "plaintiff who has participated in wrongdoing may not recover damages from the wrongdoing." BLACK'S LAW DICTIONARY (7th ed.1999). *In pari delicto,* literally means "in equal fault," and is rooted in the common-law notion that a plaintiff's recovery may be barred by his own wrongful conduct. *Pinter v. Dahl,* 486 U.S. 622, 632, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988). "[I]n the *in pari delicto* arena, where corporate plaintiffs are involved, the subject of imputation is a key focus." *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP,* 605 Pa. 269, 989 A.2d 313, 330 n. 12 (2010) (*Allegheny II*).

In *Allegheny II,* the defendant auditor grossly misstated the principal corporation's finances, despite knowing that certain of the corporation's agents, including its financial officer, had misstated those finances thereby hiding substantial operating losses. *Id.* at 315. The auditor gave a false impression to the board of directors that the company was in good financial condition. *Id.* The board had no knowledge of the operating losses and the company went bankrupt. *Id.*

During extensive federal litigation, the Third Circuit Court of Appeals found it necessary to petition for certification of the following question for resolution by the Pennsylvania Supreme Court: "What is the proper test under Pennsylvania law for determining whether an agent's fraud should be imputed to the principal when it is an allegedly non-innocent third-party that seeks to invoke the law of imputation in order to shield itself from liability?" *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP,* 607 F.3d 346, 351 (3d Cir.2010) (*Allegheny* ***764** *I*). Our Supreme Court answered the question as follows:

> The proper test to determine the availability of defensive imputation in scenarios involving non-innocents depends on whether or not the defendant dealt with the principal in good faith. While one of the primary justifications for

> imputation lies in the protection of innocents, in Pennsylvania ... it may extend to scenarios involving auditor negligence, subject to an adverse-interest exception, as well as other limits arising out of the underlying justifications supporting imputation. Imputation does not apply, however, where the defendant materially has not dealt in good faith with the principal.

Allegheny II, 989 A.2d at 339. As the Supreme Court noted, imputation "recognizes that principals generally are responsible for the acts of agents committed within the scope of their authority." *Id.* at 333.

> This is, in part, because it is the principal who has selected and delegated responsibility to those agents; accordingly, the doctrine creates incentives for the principal to do so carefully and responsibly. Imputation also serves to protect those who transact business with a corporation through its agents believing the agent's conduct is with the authority of his principal.
>
> The first exception ... is that involving adverse interest—where an agent acts in his own interest, and to the corporation's detriment, imputation generally will not apply. The primary controversy surrounding the appropriate application of the adverse-interest exception here concerns the degree of self-interest required, or, conversely, the quantum of benefit to the corporation necessary to avoid the exception's application (where self-interest is evident).

Id. at 333–34 (citations and footnotes omitted). "[I]mputation is not justified in scenarios involving secretive, collusive activity on the part of an auditor to misstate (and/or sanction management's misstatement of) corporate financial information." *Id.* at 337.

Our Supreme Court "dr[e]w a sharp distinction between those who deal in good faith with the principal-corporation in material matters and those who do not." *Id.* at 335. Regarding those who deal in good faith with the principal corporation, the Supreme Court generally would impute an agent's bad acts to the principal corporation *if they benefit the corporation,* although the Supreme Court did not specify the extent of benefit necessary. *Id.* at 333. The Supreme Court maintained the "traditional, liberal test for corporate benefit." *Id.* at 336. For those who do not deal in good faith with the principal corporation, a third party would not be able to impute an agent's bad acts to the principal corporation if those bad acts were only in the agent's self-interest and conferred benefits only to the agent, not the corporation. *Id.* at 333–34.

Applying the Supreme Court's statement of the law in *Allegheny II,* we conclude that the averments of Trustee's Amended Complaint negate the defense of imputation. Certainly, Le–Nature's allegations aver that Defendants did not act in good faith in conducting the investigation. *See, e.g.,* Amended Complaint ¶¶ 13–15, 34–35, 50–52; 53–73, 116. Further, we cannot conclude that a material misstatement of corporate financial information, so as to hide Podlucky's looting of the company, provided any benefit to Le–Nature's. Thus, the dismissal of Trustee's Amended Complaint is not appropriate under these circumstances.

For the reasons set forth above, we conclude that trial court erred in sustaining ***765** the preliminary objections of Defendants as to all causes of action asserted in the Amended Complaint. On this basis, we reverse the Order of the trial court and remand for further proceedings.

Application for Post–Submission Communication granted; Order reversed; case remanded for further proceedings; Superior Court jurisdiction relinquished.

Parallel Citations

2012 PA Super 102

Footnotes

1 A bankruptcy trustee is the representative of the bankrupt estate, and has the capacity to sue and be sued. 11 U.S.C.A. § 323. Among the trustee's duties is the obligation to "collect and reduce to money the property of the estate." *Id.* § 704(1). The "property of the estate" includes "all legal or equitable interests of the debtor in property as of the commencement of the case," *id.* § 541(a)(1), including the debtor's "causes of action." *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 205 n. 9, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983) (internal quotation marks and citation omitted). Contrary to the trial court's determination, Trustee does not represent the creditors of Le–Nature's.

2 (*George K. Baum Capital Partners, L.P. v. Le–Nature's Inc.,* Civil Action No. 2158–N) (Del.Ch.2006).

3 Contrary to the arguments of K & L Gates and Ferguson, no conflict of interest existed between Le–Nature's and the Special Committee as the Special Committee owed a fiduciary duty to act in the best interests of the company. *See Revlon,* 506 A.2d at

179.

4 Under federal bankruptcy law, a corporation is insolvent when the sum of the entity's debts is greater than all of the entity's property, at a fair valuation. 11 U.S.C.A. § 101(32)(A).

5 "Decisions of the federal district courts and courts of appeals, including those of the Third Circuit Court of Appeals, are not binding on Pennsylvania courts, even when a federal question is involved." *Chiropractic Nutritional Assocs. v. Empire Blue Cross & Blue Shield,* 447 Pa.Super. 436, 669 A.2d 975 (1995). However, Pennsylvania courts may look to the federal courts for guidance.

6 Despite the fact that other courts may have determined that similar complaints involving Le–Nature's have alleged deepening insolvency as damages, we conclude that the Complaint before this Court does not, under Pennsylvania law.

7 We acknowledge K & L Gates's arguments that corporate waste does not show harm to Le–Nature's, and that K & L Gates's investigation was too remote in time and fact from the alleged injuries. Such claims appear to raise issues of fact, which are better addressed in a motion for summary judgment or at trial.

End of Document

Attachment F

U.S. v. William Ruehle, 583 F.3d 600 (9th Cir. 2009).

583 F.3d 600
United States Court of Appeals,
Ninth Circuit.

UNITED STATES of America, Plaintiff–Appellant,
v.
William J. RUEHLE, Defendant–Appellee.

No. 09–50161. | Argued and Submitted Sept. 1, 2009. | Filed Sept. 30, 2009.

Synopsis
Background: The United States brought criminal action against chief financial officer (CFO) of corporation and other defendants for charges arising from the corporation's stock option granting practices. Following evidentiary hearing, the United States District Court for the Central District of California, Cormac J. Carney, J., 606 F.Supp.2d 1109, issued an order excluding all statements the CFO made to corporation's attorneys regarding stock option granting practices at corporation. Government filed interlocutory appeal.

Holdings: The Court of Appeals, Tallman, Circuit Judge, held that:

[1] district court committed legal error when it relied almost exclusively upon California law to define both the attorney-client relationship and the attorney-client privilege, and

[2] CFO's statements to corporation's attorneys were not made in confidence.

Reversed and remanded.

West Headnotes (11)

[1] **Privileged Communications and Confidentiality**
Attorney-Client Privilege

The attorney-client privilege is an evidentiary rule designed to prevent the forced disclosure in a judicial proceeding of certain confidential communications between a client and a lawyer.

[2] **Criminal Law**
Review De Novo

The district court's conclusion that statements are protected by an individual attorney-client privilege is a mixed question of law and fact which the Court of Appeals reviews independently and without deference to the district court.

4 Cases that cite this headnote

[3] **Criminal Law**
Review De Novo

Whether a party has met the requirements to establish the existence of the attorney-client privilege is reviewed de novo.

5 Cases that cite this headnote

[4] **Criminal Law**
Review De Novo

The Court of Appeals reviews de novo the district court's rulings on the scope of the attorney-client privilege.

4 Cases that cite this headnote

[5] **Privileged Communications and Confidentiality**
Presumptions and burden of proof

A party asserting the attorney-client privilege has the burden of establishing the relationship and the privileged nature of the communication.

20 Cases that cite this headnote

[6] **Privileged Communications and Confidentiality**
Elements in general; definition
Privileged Communications and Confidentiality
Communications from client to attorney and from attorney to client

The attorney-client privilege protects confidential disclosures made by a client to an attorney in order to obtain legal advice, as well as an attorney's advice in response to such disclosures.

15 Cases that cite this headnote

[7] Privileged Communications and Confidentiality

Elements in general; definition

Typically, an eight-part test determines whether information is covered by the attorney-client privilege: (1) where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) unless the protection be waived.

17 Cases that cite this headnote

[8] Federal Courts

Evidence law

Issues concerning application of the attorney-client privilege in the adjudication of federal law are governed by federal common law.

6 Cases that cite this headnote

[9] Federal Courts

Evidence law

In federal criminal action against chief financial officer (CFO) of corporation arising from corporation's stock option granting practices, in determining whether CFO's statements to corporation's attorneys would be admissible, the district court committed legal error when it relied almost exclusively upon California law to define both the attorney-client relationship and the attorney-client privilege; under federal law, as the party asserting the privilege, the CFO was obliged to establish the privileged nature of the communications.

15 Cases that cite this headnote

[10] Privileged Communications and Confidentiality

Confidential character of communications or advice

Statements made by chief financial officer (CFO) of corporation to corporation's attorneys who were conducting internal investigation regarding propriety of corporation's stock option granting practices were not made in confidence, but were instead made for purpose of disclosure to outside auditors, and thus CFO's statements were not protected by attorney-client privilege; CFO admitted he understood the fruits of attorneys' inquiries would be disclosed to accounting firm in order to convince independent auditors of the integrity of corporation's financial statements or to take appropriate accounting measures to rectify any misleading reports and CFO was charged with primary responsibility for corporation's financial affairs.

5 Cases that cite this headnote

[11] Criminal Law

State or federal law

A state rule of professional conduct cannot provide an adequate basis for a federal court to suppress evidence that is otherwise admissible.

Attorneys and Law Firms

***601** Daniel B. Levin (argued), Gregory W. Staples, Andrew D. Stopler, United States Attorney's Office, Los Angeles, CA; Robb C. Adkins, United States Attorney's Office, Santa Ana, CA; Thomas P. O'Brien, United States Attorney, for plaintiff-appellant United States of America.

Matthew D. Umhofer (argued), Richard Marmaro, Matthew E. Sloan, Skadden, Arps, Slate, Meagher & Flom LLP, Los Angeles, CA, for defendant-appellee William J. Ruehle.

Appeal from the United States District Court for the Central District of California, Cormac J. Carney, District Judge, Presiding. D.C. No. 8:08–CR–00139–cjc–2.

Before: RAYMOND C. FISHER, RONALD M. GOULD, and RICHARD C. TALLMAN, Circuit Judges.

Opinion

TALLMAN, Circuit Judge:

We here explore the treacherous path which corporate counsel must tread under the attorney-client privilege when conducting an internal investigation to advise a ***602** publicly traded company on its financial disclosure obligations. Defendant–Appellee William J. Ruehle is the former Chief Financial Officer ("CFO") of Broadcom Corporation, a California-based, publicly traded semiconductor supplier that came under intense scrutiny for its suspected backdating of company stock options. Following a government investigation, Ruehle was criminally indicted for his involvement in an alleged backdating scheme that ultimately resulted in Broadcom's restatement of its earnings to account for approximately $2.2 billion in additional stock-based compensation expenses. The district court held an evidentiary hearing and, after evaluating the extensive briefing and evidence presented, issued an order suppressing all evidence reflecting Ruehle's statements to attorneys from Irell & Manella LLP ("Irell"), Broadcom's outside counsel, regarding the stock option granting practices at Broadcom. The court found that at the initial stages of the inquiry by Irell (called the "Equity Review") an attorney-client relationship also existed with the CFO individually, and not just with Broadcom, and that the lawyers breached their ethical duties to their client Ruehle in disclosing what he had told them in a preliminary interview.

The government filed an interlocutory appeal. We have jurisdiction pursuant to 18 U.S.C. § 3731, and we reverse and remand for further proceedings.

I

In March 2006, the *Wall Street Journal* published the first of a series of articles called "The Perfect Payday," which suggested that a number of public companies were backdating stock options granted to their employees. [1] Shortly thereafter, in mid-May 2006, an investor rights group publicly identified Broadcom as one of the corporations that appeared to have engaged in backdating. As a result of the media attention and in anticipation of an inquiry from the Securities and Exchange Commission ("SEC"), Broadcom's Board of Directors and company management decided to bring in outside counsel to commence an internal review of the company's current and past stock option granting practices. Ruehle, as Broadcom's CFO, was among those intimately involved in that decision from the outset. On May 18, ***603** 2006, Broadcom's Audit Committee engaged Irell, a private law firm with which it had longstanding ties, to conduct the Equity Review by investigating the propriety of the measurement dates utilized by Broadcom in its option granting process and identifying those grants which failed to meet the measurement date requirements of generally accepted accounting principles. [2] Irell immediately commenced its review, which entailed collecting corporate documents and records and conducting interviews with past and current Broadcom employees.

Broadcom representatives, including Ruehle, met with Irell lawyers on May 24 and 25, 2006, to discuss the scope of the Equity Review. It was agreed that Irell would report the results of its inquiries to the Audit Committee. It was also decided that the Board would not appoint a panel of independent, outside directors to oversee the Equity Review. On May 26, 2006, a formal meeting of the Audit Committee was convened. Ruehle and other senior Broadcom executives, several members of the Board, and Irell lawyers were among those present. During the hour-long meeting, Irell partner David Siegel explained the nature of typical "backdating" investigations and discussed the status of Irell's internal review, including the necessary involvement of Broadcom's outside independent auditors, Ernst & Young LLP, who would have to review and opine on the accuracy of the company's audited financial statements and regulatory filings. Siegel also cautioned "that Irell can handle issues related to the proper accounting for option grants but that if an issue of self-dealing or management or Board integrity arose, a special committee of independent directors would need to be appointed and special independent counsel engaged to conduct that inquiry." The Audit Committee and other representatives of Broadcom made clear that the intent was to turn over the information obtained through the Equity Review to the auditors, to fully cooperate with government regulators, and, if necessary, to self-report any problems with Broadcom's financial statements.

As many within Broadcom had anticipated, civil lawsuits soon followed the media reports about the company's back-dating of stock options. On May 25, 2006, a shareholder derivative suit captioned *Murphy v. McGregor* was filed in California federal court. The following day, on May 26, the plaintiffs in the ongoing securities class action in California state superior court, *Jin v. Broadcom Corp.*, filed an amended complaint. Both the *Murphy* action and the *Jin* amended class action now alleged wrongdoing in relation to Broadcom's stock option granting practices; both suits named Broadcom and also personally named Ruehle, among other Broadcom officers and directors, as an individual defendant.

***604** On May 30, 2006, Broadcom's in-house General Counsel David Dull sent an e-mail to various Broadcom employees, including Ruehle, notifying them of the *Murphy* action and of the amended complaint filed in the *Jin* securities class action. Dull invited anyone with concerns to contact either him or Irell attorneys Siegel, Kenneth Heitz, or Dan Lefler. Shortly after receiving Dull's message, Ruehle received a separate e-mail from Heitz, one of the Irell partners with whom Ruehle had already conferred as part of the Equity Review. Heitz's e-mail updated Ruehle concerning the scheduling of interviews of three current or former Broadcom employees and, finally, inquired, "if you have open time on Thursday Dan Lefler and I would like to spend an hour or so with you...."

As arranged, Heitz and Lefler met with Ruehle in his office on Thursday, June 1, 2006, to discuss Broadcom's stock option granting practices and his role as the company's CFO. [3] Ruehle had subsequent, brief discussions with the Irell lawyers as the Equity Review continued and the lawyers reported back to the CFO their progress in unearthing the facts. At no point did the topic of the civil securities lawsuits arise as it might relate to Ruehle personally. Nor did Ruehle ever indicate to the lawyers that he was seeking legal advice in his individual capacity. It is the substance of these June 2006 interactions that lies at the center of the present dispute.

In late June 2006, Irell advised Ruehle to secure independent counsel with respect to the investigations and the pending civil suits. Ruehle retained the law firm Wilson Sonsini Goodrich & Rosati to represent him individually. Nevertheless, Ruehle remained heavily involved in the company's internal review and he was privy to Irell's reports to the Audit Committee of its findings and ultimately the disclosures of the information gathered by Irell to Ernst & Young.

In August 2006, at Broadcom's direction, Irell fully disclosed the information obtained from the Equity Review to the Ernst & Young auditors. Irell had a series of meetings with Ernst & Young in which the lawyers reported what they had found, which necessarily included the substance of Ruehle's June 1, 2006, interview with Heitz and Lefler. Ruehle was present for at least some of these meetings between Irell and the Ernst & Young auditors. There is no dispute that the Irell lawyers regularly updated Ruehle and others in senior management about the progress of the Equity Review and their meetings and contacts with the auditors.

The Equity Review revealed several accounting irregularities with respect to certain stock option grants. In January 2007, on the advice of its outside counsel and auditors, Broadcom restated its earnings as reported in its financial disclosure statements to include a total of $2.2 billion in ***605** previously undisclosed compensation expenses.

The SEC and the United States Attorney's Office commenced formal enforcement and grand jury investigations of several company executives in relation to Broadcom's stock option granting practices. In May and June 2007, with Broadcom's authorization, government investigators interviewed Irell attorneys Heitz and Lefler by telephone regarding their conversations with Ruehle in June 2006. The information they provided was summarized in FBI Form FD–302 reports of investigation, which are part of the sealed record. When he learned that the government intended to use this information against him in connection with possible criminal charges, Ruehle objected and claimed that any statements to the Irell attorneys were protected by his attorney-client privilege. Ruehle also insisted, after the fact, that whatever he said to Irell could not be disclosed without his prior written consent.

On June 4, 2008, a grand jury in the Central District of California indicted Ruehle and Henry T. Nicholas III —Broadcom's founder, and former President and Chief Executive Officer—on charges of conspiracy, securities and wire fraud, and various other violations of Title 15 of the United States Code. The indictment alleges that beginning in or around 1999 and continuing until at least in or around 2005, Nicholas and Ruehle, among others, engaged in a fraudulent scheme and conspiracy to disguise, conceal, understate, and mischaracterize compensation expenses Broadcom was required to recognize in connection with granting its stock options to various employees. Among the allegations of wrongdoing, the indictment claims that as part of the backdating scheme the defendants paid a former employee who threatened to expose the scheme, concealed the payoff from Broadcom's Board and its independent auditors, and took various steps to create plausible deniability as to Broadcom's option backdating practices.

On January 12, 2009, the government moved *ex parte* for a hearing to resolve whether the statements Ruehle made to Irell lawyers in June 2006 were privileged communications.

Ruehle argued that he had an individual attorney-client relationship with Irell arising from the securities lawsuits, in which he was a named defendant. Beginning on February 23, 2009, the district court held a three-day evidentiary hearing at which Ruehle and Irell attorneys Heitz and Lefler testified. At Ruehle's request, a substantial portion of the testimony and evidence was received *in camera* outside the presence of the federal prosecutors. Both Irell attorneys insisted that Irell's individual representation of Ruehle in relation to the civil securities lawsuits did not commence until after the June 1, 2006, interview. [4] Among other things, the attorneys testified that they began the June 2006 meeting with a so-called *Upjohn* or corporate *Miranda* warning, which included notice that the Irell attorneys were acting as representatives of Broadcom—specifically, the Audit Committee—and that the privilege therefore rested only with the company. Ruehle, however, denied any recollection of receiving such cautionary warnings at the June 1, 2006, interview. Ruehle testified that at the time he spoke with Heitz and Lefler he believed Irell represented everyone named in the civil suits, including ***606** him, and that Heitz and Lefler were acting at least in part as his personal attorneys during the interview.

At the conclusion of the hearing, the district court rendered its oral ruling which strongly condemned the Irell attorneys' behavior with respect to the firm's handling of the Equity Review. The court then found that Ruehle "had a reasonable belief that Irell and Manella were his lawyers prior to the June 1, 2006 interrogation by Irell, and that he never gave informed written consent, either to the dual representation by Irell or the disclosure of privileged information to third parties, including Ernst & Young and the government." Based on this reasoning, the court ordered suppression. The district court subsequently issued a written order, which included an additional finding that Ruehle intended his statements to Heitz and Lefler to be confidential. The order stated that "all evidence reflecting Mr. Ruehle's statements to Irell regarding the stock option granting practices at Broadcom is suppressed." [5] The court also referred Irell to the California State Bar for possible discipline in light of numerous perceived violations of state rules of professional conduct.

[1] The government interlocutorily appealed the district court's suppression order and we consider it on an expedited basis. [6]

II

[2] **[3]** **[4]** The district court's conclusion that statements are protected by an individual attorney-client privilege is "a mixed question of law and fact which this court reviews independently and without deference to the district court." *United States v. Bauer,* 132 F.3d 504, 507 (9th Cir.1997) (quoting *United States v. Gray,* 876 F.2d 1411, 1415 (9th Cir.1989)). That is, whether the party has met the requirements to establish the existence of the attorney-client privilege is reviewed de novo. *Id.* We also review de novo the district court's rulings on the scope of the attorney-client privilege. *Id.* Factual findings are reviewed for clear error. *See Al-Haramain Islamic Found. v. Bush,* 507 F.3d 1190, 1196 (9th Cir.2007). A district court's credibility determinations are given "special deference." *United States v. Craighead,* 539 F.3d 1073, 1082 (9th Cir.2008) ***607** (citing *United States v. Nelson,* 137 F.3d 1094, 1110 (9th Cir.1998)).

III

The government raises several arguments challenging the district court's order excluding Ruehle's statements to Irell attorneys. We begin with some basic premises. First, there is no dispute that Broadcom had an existing attorney-client relationship with Irell and, by electing to reveal the information gathered to Ernst & Young (and later to various agencies of the United States), deliberately waived any corporate attorney-client privilege it held with respect to all matters at issue. Second, the Equity Review and the civil securities suits, to which Ruehle was a party, both concerned the same general subject matter as of June 1, 2006—i.e., the stock option granting practices of Broadcom. Finally, the district court concluded as a fact that Ruehle reasonably believed that Irell represented him individually with respect to the ongoing civil lawsuits when the June 1, 2006, meeting took place. Because this factual finding is not clearly erroneous, we approach the parties' arguments from the perspective that Irell had attorney-client relationships with both Broadcom and Ruehle individually.

[5] We, however, must inquire further. After all, "[a] party asserting the attorney-client privilege has the burden of establishing the relationship *and* the privileged nature of the communication." *Bauer,* 132 F.3d at 507 (citing *Ralls v. United States,* 52 F.3d 223, 225 (9th Cir.1995)) (emphasis added); *accord In re Grand Jury Subpoenas,* 144 F.3d 653, 659 (10th Cir.1998) ("In certain circumstances, reasonable belief may be enough to create an attorney-client *relationship,* but it is not sufficient here to create a *personal* attorney-client *privilege.*"). We must determine whether Ruehle's communications to the Irell attorneys regarding Broadcom's stock option granting practices are protected by a personal attorney-client privilege belonging to Ruehle.

[6] **[7]** "The attorney-client privilege protects confidential disclosures made by a client to an attorney in order to obtain legal advice, ... as well as an attorney's advice in response to such disclosures." *Bauer,* 132 F.3d at 507 (quoting *United States v. Chen,* 99 F.3d 1495, 1501 (9th Cir.1996)) (emphasis omitted). "The fact that a person is a lawyer does not make all communications with that person privileged." *United States v. Martin,* 278 F.3d 988, 999 (9th Cir.2002) (citing *Chen,* 99 F.3d at 1501). "Because it impedes full and free discovery of the truth, the attorney-client privilege is strictly construed." *Id.* (quoting *Weil v. Inv./Indicators, Research & Mgmt., Inc.,* 647 F.2d 18, 24 (9th Cir.1981)); *accord United States v. Plache,* 913 F.2d 1375, 1379 (9th Cir.1990). "[T]he privilege stands in derogation of the public's 'right to every man's evidence' and as 'an obstacle to the investigation of the truth,' [and] thus, ... '[i]t ought to be strictly confined within the narrowest possible limits consistent with the logic of its principle.' " *In re Horowitz,* 482 F.2d 72, 81 (2d Cir.1973) (citations omitted). Typically, an eight-part test determines whether information is covered by the attorney-client privilege:

> (1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) unless the protection be waived.

In re Grand Jury Investigation, 974 F.2d 1068, 1071 n. 2 (9th Cir.1992) (quoting ***608** *United States v. Margolis (In re Fischel),* 557 F.2d 209, 211 (9th Cir.1977)).[7] The party asserting the privilege bears the burden of proving each essential element. *United States v. Munoz,* 233 F.3d 1117, 1128 (9th Cir.2000).

A

[8] **[9]** At the outset we note a fundamental flaw in the district court's analysis. "Issues concerning application of the attorney-client privilege in the adjudication of federal law are governed by federal common law." *Bauer,* 132 F.3d at 510 n. 4 (quoting *Clarke v. Am. Commerce Nat. Bank,* 974 F.2d 127, 129 (9th Cir.1992)); *see also United States v. Blackman,* 72 F.3d 1418, 1423 (9th Cir.1995) ("[S]ince the adoption of the Federal Rules of Evidence, courts have uniformly held that federal common law of privilege, not state law applies." (citations omitted)). The district court, however, applied a "reasonable belief" standard without ever referencing the well-established eight-part test. Rather, in reaching its holding, the court relied almost exclusively upon California state law to define both the attorney-client relationship and the attorney-client privilege. Most significantly, the court cited California Evidence Code section 917(a) for the proposition that all "communications made in the course of an attorney-client relationship are presumed confidential."[8]

This legal error is critical in this case. The district court applied a liberal view of the privilege that conflicts with the strict ***609** view applied under federal common law, which governs here. *See Martin,* 278 F.3d at 999. By approaching the exclusion question with a presumption that the privilege attached, the district court inverted the burden of proof, improperly placing the onus on the government to show what information was not privileged. *See Gordon v. Superior Court of L.A. County,* 55 Cal.App.4th 1546, 65 Cal.Rptr.2d 53, 59 (1997) ("[C]ommunications between a lawyer and his client are presumed confidential, with the burden on the party seeking disclosure to show otherwise." (citations omitted)).

As the party asserting the privilege, Ruehle was obliged by federal law to establish the privileged nature of the communications and, if necessary, to segregate the privileged information from the non-privileged information. *See Bauer,* 132 F.3d at 507; *see also* 3 Jack B. Weinstein & Margaret A. Berger, *Weinstein's Federal Evidence,* § 503.20[4][b] (Joseph M. McLaughlin, ed., Matthew Bender 2d ed.2009) (discussing rule that blanket claims of privilege are generally disfavored). With respect to the latter obligation, Ruehle has made no effort to identify with particularity which of his communications to the Irell attorneys are within his claim of privilege, in either his public or sealed filings before us. Under federal law, the attorney-client privilege is strictly construed.

Ruehle's failure to define the scope of his claim of privilege weighs in favor of disclosure; in any event, his claim cannot support the overly broad, blanket suppression order entered here.

B

[10] With the burden properly on Ruehle, and after carefully reviewing and evaluating the record, we hold that Ruehle fails the fourth element of the traditional eight-part privilege test. Ruehle's statements to the Irell attorneys were not "made in confidence" but rather for the purpose of disclosure to the outside auditors. That he might regret those statements after later learning of the subsequent corporate disclosure to law enforcement officials is not material to the privilege determination as of June 2006.

The district court reached the contrary conclusion: "Mr. Ruehle intended his statements to be confidential, and he had no reason to suspect that his conversations with the Irell lawyers would be disclosed to third parties." We are unable to square this factual finding, which forms the linchpin of the suppression order, with the evidence presented at the evidentiary hearing. The notion that Ruehle spoke with Irell attorneys Heitz and Lefler with the reasonable belief that his statements were confidential is unsupported by the record. Of particular significance is what was said in the meetings he attended prior to June 1, 2006, with Irell attorneys, company management, and the Audit Committee, as acknowledged in Ruehle's own testimony. He frankly admitted that he understood the fruits of Irell's searching inquiries would be disclosed to Ernst & Young in order to convince the independent auditors of the integrity of Broadcom's financial statements to the public, or to take appropriate accounting measures to rectify any misleading reports. We reject the district court's contrary finding that an expectation of confidentiality was established because, upon review of the record, we are left with the "definite and firm conviction that a mistake has been committed" and thus we determine that this factual finding was clearly erroneous. *United States v. Overton,* 573 F.3d 679, 688 (9th Cir.2009) (quoting *Easley v. Cromartie,* 532 U.S. 234, 242, 121 S.Ct. 1452, 149 L.Ed.2d 430 (2001)).

***610** Ruehle was no ordinary Broadcom employee. He served as the public company's CFO—the senior corporate executive charged with primary responsibility for Broadcom's financial affairs. This was a sophisticated corporate enterprise with billions of dollars in sales worldwide, aided by accountants, lawyers, and advisors entrusted with meeting a multitude of regulatory obligations. The duties undertaken by Ruehle broadly encompassed not only accurately and completely reporting the company's historical and current stock option granting practices, but also Broadcom's strict compliance with reporting and record keeping requirements imposed through the Securities Exchange Act of 1934 and the Sarbanes–Oxley Act of 2002, among many other federal and state rules and regulations. *See, e.g.,* 15 U.S.C. §§ 7241, 7262(a). As the head of finance, Ruehle cannot now credibly claim ignorance of the general disclosure requirements imposed on a publicly traded company with respect to its outside auditors or the need to truthfully report corporate information to the SEC.

Ruehle was also intimately involved in all aspects of the Equity Review, including the planning, investigatory, and disclosure stages. Ruehle was a full participant in the initial May 2006 meetings with the Irell attorneys where the scope of representation and the details of the Equity Review were decided and agreed upon, even before convening the formal Audit Committee meeting. From the outset, it was settled and made widely known to senior management that Broadcom intended to fully cooperate with the SEC and the auditors. Ruehle, as the primary contact with Ernst & Young over the years, personally introduced the Irell attorneys to the team of outside auditors. Thereafter, he repeatedly met with the Audit Committee, senior management, the Irell attorneys, and the auditors, and remained fully apprised throughout the summer of 2006 of the status of Irell's investigation and the flow of information.

In his testimony at the evidentiary hearing, Ruehle acknowledged the broad nature of the planned third-party disclosure, noting that Irell was directed, to his knowledge, to freely share "all factual information" gleaned through the Equity Review—whether "good, bad, or ugly." As he explained, at the time of the June 1, 2006, interview, he understood that nothing would be withheld from Ernst & Young:

> Q: Did you think it was appropriate for Broadcom, represented by Irell ..., to withhold information from the auditors in connection with their work in early June of 2006?
>
> A: We were not withholding information from the auditors.

Q: They were not withholding information from the auditors; is that correct?

A: That's correct.

Q: And you understood that to be the case at the time; correct?

A: That's correct.

Indeed, Ruehle confirmed over and over again his awareness that the substance of his June 2006 interviews with the Irell lawyers was not to be held in confidence:

Q: You understood that Irell was going to be sharing the factual information they gathered to third parties?

A: That's correct.

Q: And fair to say you understood that Irell was there, among other things, to gather facts; correct?

A: Correct.

To dispel any doubt, Ruehle also confirmed that the information he provided to Heitz and Lefler was largely factual in nature—the type of information he understood would be disclosed to third parties.

***611** Q: To be clear, the information you provided to Irell was factual information; correct?

A: It was a combination of factual information and some assumptions and some recollections.

* * *

Q: And you understood that Ernst & Young was going to be looking to you, among other people, to help them understand what had happened as part of Broadcom's historical options review; correct?

A: That's correct.

As Ruehle anticipated when he met with the Irell attorneys in June 2006, the information obtained through the Equity Review, including his input, was passed on to Ernst & Young. He never raised any anxiety about the possible disclosure over what he now claims was intended to be confidential and thus privileged information. Ruehle had ample opportunity to raise any concern he might have harbored. Ruehle not only attended meetings where the Audit Committee directed Irell to disclose to Ernst & Young the fruits of the Equity Review, he was also present at meetings where disclosures to the auditors actually occurred. He did not object. Even after engaging independent counsel to apprise him of his legal rights, Ruehle never claimed that he thought his statements to Irell during the Equity Review, later shared with the auditors, were confidential—until the specter of criminal liability arose in 2008.

On appeal, Ruehle tries to minimize the damning evidence confirming his awareness that his interactions with Irell would not be held in confidence. He places much weight on the assertion that he only learned of the details of Irell's disclosures to Ernst & Young and the government in 2008 and that he was "shocked." Ruehle contends that, notwithstanding his obligation to fully cooperate in Broadcom's internal review, he would not have provided information as part of the Equity Review had he known it could be used in support of a criminal investigation or an SEC enforcement action. The district court seems to have agreed with Ruehle's analysis, noting:

> The Government argues that Mr. Ruehle knew that Irell would make some disclosure to Ernst & Young in connection with its investigation, and therefore Mr. Ruehle knew that his statements were not confidential. This argument is unpersuasive. Mr. Ruehle never understood that Irell might disclose statements adverse to Mr. Ruehle's interests to the Government for use in a criminal case against him.

This analysis misses the mark. The salient point from a privilege perspective is that Ruehle readily admits his understanding that all factual information would be communicated to third parties, which undermines his claim of confidentiality to support invoking the privilege. Ruehle's subjective shock and surprise about the subsequent usage of the information he knew would be disclosed to third-party auditors—e.g., information subsequently shared with securities regulators and the Justice Department now used to support a criminal investigation and his prosecution—is frankly of no consequence here.

In support of his case for invocation of the privilege, Ruehle also repeatedly points to attorney Heitz's testimony that he could not "split his mind" so as to distinguish between facts relevant to the Equity Review and those relevant to the defense of Ruehle in the pending civil securities litigation, because they both had at their core Broadcom's stock option granting practices. But his efforts to make gold from lead are met with failure. The implicit concession on Ruehle's part — ***612** that the information underlying the Equity Review and the lawsuits was largely inseparable, if not one and the same—is detrimental, not helpful, to his case. His admitted awareness that anything relating to the former would not be held in confidence but rather shared with at least one third party destroys the confidentiality essential to establishing the privilege as to both.

Ruehle attempts to raise an exception to the full disclosure of all factual information, insisting that he anticipated the disclosure of only factual information "that was not otherwise privileged information." In other words, Ruehle now asserts an expectation of confidentiality only over statements that he claims were really given in confidence. He does not distinguish what those statements might be in his blanket invocation of the privilege. This circular reasoning is, analytically speaking, unpersuasive and cannot overcome the concrete evidence in the record before us. Even supposing he subjectively believed that *some* of the information he conveyed to the Irell lawyers was confidential, upon asserting the attorney-client privilege Ruehle was obliged to distinguish which particular statements should be afforded the privilege. He made no effort to do so before the district court and fares no better on appeal. His testimony at the evidentiary hearing, despite being held *in camera* at his request, due ostensibly to the sensitive subject matter to be discussed, did not delve into the details of his substantive contributions to the Equity Review and, frankly, entailed largely non-privileged matters. We are left guessing as to what particular facts Ruehle purportedly believed were disclosed in breach of confidence.

Ruehle's position is, at bottom, that some nebulous portion of his communications with Heitz and Lefler was intended to be confidential as to him personally and therefore everything said or not said to the attorneys should be protected by his individual attorney-client privilege. That is not the law nor, in our view, should it be. Having failed to better articulate his expectations regarding the scope of disclosure to Ernst & Young, he has failed to carry his burden with respect to any and all factual information arising from the Equity Review.

Moreover, Ruehle's argument runs squarely into the settled rule that *any* voluntary disclosure of information to a third party waives the attorney-client privilege, regardless of whether such disclosure later turns out to be harmful. *See* 3 Weinstein & Berger, *supra,* § 503.40. Ruehle freely and voluntarily disclosed the information in June 2006 and did not mention an individualized privilege until nearly two years later, after having sat in on the very meetings where his allegedly-privileged information was disclosed. Ruehle's assertion about his subjective intent in 2006 cannot sustain his privilege claim when he has freely admitted that the disclosure to Ernst & Young was planned. *See Weil,* 647 F.2d at 24 (holding subjective intent not dispositive and privilege waived).

In sum, the overwhelming evidence demonstrates that Ruehle's statements to Heitz and Lefler were not "made in confidence" but rather for the purpose of outside disclosure. Accordingly, we hold that Ruehle has failed to meet his burden of establishing the existence of an individual attorney-client privilege with respect to the information provided to the Irell attorneys in the June 2006 time frame.

IV

A considerable portion of the district court's suppression order was dedicated to recounting perceived violations of the California Rules of Professional Conduct committed ***613** by Irell attorneys. This portion of the order, which relates to possible disciplinary action by the state bar, is not before us on appeal. Ruehle, however, asserts that clear breaches of professional duties warrant suppression in a criminal prosecution. We disagree and reject this novel argument, which stands apart from the attorney-client privilege determination. [9]

[11] "[A] state rule of professional conduct cannot provide an adequate basis for a federal court to suppress evidence that is otherwise admissible." *United States v. Lowery,* 166 F.3d 1119, 1124 (11th Cir.1999); *accord United States v. Keen,* 508 F.2d 986, 989 (9th Cir.1974) ("[E]vidence obtained in violation of neither the Constitution nor federal law is admissible in federal courts, even though obtained in violation of state law." (citations omitted)). To be clear, in some cases, material protected by the attorney-client privilege may come to light as a result of counsel's breach of a duty of confidentiality. But it is the protected nature of the information that is material, not the ethical violation by counsel. *See Int'l Bhd. of Teamsters,* 119 F.3d at 217 (holding that an individual could not assert individual privilege even though the law firm failed to clarify that it represented only his employer, in violation of state rules of professional responsibility).

Contrary to Ruehle's contention, *United States v. Rogers,* 751 F.2d 1074 (9th Cir.1985), provides him no support. As the government correctly distinguishes it, *Rogers* involved government misconduct in acquiring evidence. *Id.* at 1079 (holding that a federal agent's "inducement of a violation of an ethical obligation of confidentiality ... does not warrant dismissal of an indictment" where suppression is a possible remedy with respect to the improperly obtained evidence). Read properly, that case supports the government's position that the suppression order was in error. *Id.* at 1077 ("The attorney-client privilege is an evidentiary rule designed to prevent the forced disclosure in a judicial proceeding of certain confidential communications between a client and a lawyer."). There has been no allegation that the government encouraged, was complicit in, or was even aware of, any breach of ethical obligations on Irell's part. It learned of the information only after Broadcom made an intentional disclosure to the government in response to regulatory inquiries as evidence of the company's good faith efforts to comply with its financial reporting obligations. Irell's allegedly unprofessional conduct in counseling Broadcom to disclose, without obtaining written consent from Ruehle, while troubling, provides no independent basis for suppression of statements he made in June 2006.

V

The district court erred in forbidding the United States from calling Irell attorneys to testify to the information they learned from Ruehle in June 2006. Consistent with his admitted understanding that Broadcom would fully disclose what Irell learned as part of the Equity Review to Ernst & Young, Ruehle lacks an expectation of confidentiality to support a blanket invocation of his individual attorney-client privilege over *all* factual information he provided. [10]

***614** The district court's order suppressing the Irell evidence is reversed and the matter is remanded for trial.

REVERSED and **REMANDED.**

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Footnotes

1 Stock options give individuals the right to buy shares of stock on a future date at a set price, commonly known as the "exercise" or "strike" price. Typically, as was the practice at Broadcom, stock options granted to employees could not be exercised until the end of a fixed vesting period. Once an option vested, the holder could exercise it and purchase stock from the company at the strike price. Thus, options that have a strike price below the current trading price in the stock market are commonly referred to as being "in the money," whereas options with a strike price above the current trading price are considered "underwater."

The strike price is typically equal to the market price on the date that the option is granted. "Backdating" refers to the practice of recording an option's grant date and strike price retrospectively. *See United States v. Reyes,* 577 F.3d 1069, 1073 (9th Cir.2009). The ability to manipulate the strike price maximizes the benefit to the option holders. Selection of an initial grant date when the share price, and thus the strike price, is at its lowest during a given period will increase the amount an option is "in the money" or, in some cases, may determine whether an option is "in the money" at all, rather than "underwater." In either case, the employee may immediately exercise the options to buy shares at the optimally low strike price, sell the stock at the current market price, and pocket any gain. "Backdating is not itself illegal, provided that the benefit to the employees is recorded on the corporate books as a non-cash compensation expense to the corporation, in accordance with an accounting convention promulgated in 1972 referred to as Accounting Principles Board Opinion No. 25." *Id.*

2 The relationship between Broadcom and Irell runs deep, as Ruehle contends, and dates back to before 1998 when Irell assisted Broadcom in its initial public offering of stock ("IPO"), which led to its becoming an investor-owned public company. Irell itself acquired stock during the IPO and its partners profited handsomely when the stock price rose. Since then, Irell has represented Broadcom in relation to numerous acquisitions and the firm has handled several litigation matters for Broadcom and its officers and directors. At the time it was engaged to conduct the Equity Review, the firm was counsel of record for Broadcom and its management employees named as individual defendants in a then-unrelated securities class action, *Jin v. Broadcom Corp.,* pending in California state superior court. Moreover, Irell had recently represented Broadcom, as well as several of its officers and directors, including

Ruehle, in an unrelated securities action referred to as the "warrants litigation." The warrants litigation settled several months prior, in December 2005.

3 At the evidentiary hearing the Irell attorneys testified that they provided Ruehle a so-called *Upjohn* or corporate *Miranda* warning. Such warnings make clear that the corporate lawyers do not represent the individual employee; that anything said by the employee to the lawyers will be protected by the company's attorney-client privilege subject to waiver of the privilege in the sole discretion of the company; and that the individual may wish to consult with his own attorney if he has any concerns about his own potential legal exposure. *See Upjohn Co. v. United States,* 449 U.S. 383, 393–96, 101 S.Ct. 677, 66 L.Ed.2d 584 (1981). Ruehle testified that he did not recall receiving any such warnings. As discussed *infra,* the district court seems to have disbelieved the Irell lawyers who took no notes nor memorialized their conversation on this issue in writing, and it apparently credited Ruehle's testimony that no such warnings were given. We cannot say that this finding is clearly erroneous on the record before us.

4 On June 8, 2006, Irell filed a Status Conference Report on behalf of all defendants in the *Jin* class action and shortly thereafter accepted service of the amended complaint in order to avoid the need for service of legal process on each person named therein, including Ruehle.

5 The order also directed the government to return all privileged documents within 14 days. That order is stayed pending the outcome of this appeal.

6 The district court and the parties label this a matter of "suppression." We will do so as well for the sake of consistency. However, analytically, the court's order is more accurately characterized as an order directing the exclusion of privileged evidence—akin to the grant of a motion *in limine.* Though courts in the past have used terms such as "suppress" and "exclude" interchangeably in similar contexts, *see, e.g., United States v. Plache,* 913 F.2d 1375, 1377, 1379–81 (9th Cir.1990), "suppress" is better confined to a narrower meaning that would not apply here. "The attorney-client privilege is an evidentiary rule designed to prevent the forced disclosure in a judicial proceeding of certain confidential communications between a client and a lawyer." *United States v. Rogers,* 751 F.2d 1074, 1077 (9th Cir.1985). In contrast, "suppression" is generally understood to concern invocation of the judicially created exclusionary rule, which is intended to operate as a deterrent to governmental misconduct and, as a necessary corollary, may be invoked to exclude other evidence discovered as the "fruit of the poisonous tree." *See Herring v. United States,* 555 U.S. 135, 129 S.Ct. 695, 700, 172 L.Ed.2d 496 (2009). There is no allegation of government misconduct in the instant case as the record reveals there was no governmental participation in the acts of Broadcom, the Audit Committee, or Irell's conduct of the Equity Review. Thus, the exclusionary rule does not apply here and "suppression" in that sense is not at issue.

7 The government urges that the special problems presented by joint representation of a corporation and its individual officers counsel adoption of particularized requirements before the individual officer could assert an attorney-client privilege. The Third Circuit in *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.,* 805 F.2d 120, 123–24 (3d Cir.1986), adopted a five-factor test intended to clarify that "any privilege that exists as to a corporate officer's role and functions within a corporation belongs to the corporation, not the officer." Several other circuits have adopted some form of tailored test for joint-representation scenarios. *See Ross v. City of Memphis,* 423 F.3d 596, 605 (6th Cir.2005); *In re Grand Jury Subpoena (Newparent),* 274 F.3d 563, 571–72 (1st Cir.2001); *In re Grand Jury Subpoenas,* 144 F.3d 653, 659 (10th Cir.1998); *United States v. Int'l Bhd. of Teamsters,* 119 F.3d 210, 215–16 (2d Cir.1997). We do not decide the propriety of adopting the specialized test of *Bevill* because, given Irell's longstanding representation of Ruehle as an individual before the instant case arose and in light of the planned disclosure of facts gained in the Equity Review investigation to the third-party independent auditor, this case can be resolved using our usual eight-part test. Accordingly, we leave for another day consideration of the extraordinary requirements of the *Bevill* five-prong test for establishing attorney-client privilege in a situation where both the executive and the corporation assert that they are dually represented. Similarly, we need not reach and decide in this case whether our circuit should adopt the rule of *Newparent:* that the corporation, without consent of an executive asserting privilege, can waive the attorney-client privilege in a dual-representation context where the subject matter of the waiver concerns matters of interest to the corporation. 274 F.3d at 572–74. We also need not reach *Newparent*'s further holding that the executive can control the assertion of attorney-client privilege only as to matters segregable from those of concern to the corporation. *Id.* at 573.

8 Ruehle insists that federal privilege law also creates a *prima facie* presumption of privilege, citing *Chen,* 99 F.3d 1495. He misreads that opinion. At issue in *Chen* was whether the defendants' attorneys were acting in the capacity of professional legal advisors—that is, whether the attorneys were providing legal advice, which is privileged, or non-legal business advice, which is not protected. *Id.* at 1500–01 (noting that "[i]f a person hires a lawyer for advice, there is a rebuttable presumption that the lawyer is hired 'as such' to give 'legal advice' "). Ruehle extrapolates from the unremarkable and narrow principle in *Chen* to argue that "[w]here an attorney-client relationship exists, communications made in the context of that relationship are *prima facie* subject to the privilege." This argument directly conflicts with our case law.

9 At the evidentiary hearing, Ruehle's counsel acknowledged that suppression was *not* a remedy for a breach of counsel's duty of loyalty. Ruehle reversed course and argued otherwise in his briefs on appeal. He appears to have abandoned the position at oral argument.

10 We stress that our holding today should not be interpreted as carte blanche approval of all foreseeable testimony by the Irell attorneys as we read the proffer summarized in the FBI Form FD–302 reports. The district court remains responsible for determining the admissibility of any testimony that may extend beyond factual information, and, to the extent consistent with our opinion, appropriate evidentiary objections, of course, remain viable.

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