The Role of In-House Counsel

Recent corporate governance reforms have strengthened the notion that certain individuals are expected to act as gatekeepers, who will help to ensure that public companies fulfill their obligations. Regulators believe that in-house counsel are particularly suited to the gatekeeper role. They are often part of the inner circle of management at the company with access to important company information, but they are also subject to rules of professional conduct that require them to bring a high standard of integrity, objectivity and independence to their job.

Up-the-Ladder Reporting

Regulators have articulated the expanded responsibility of in-house counsel through “up-the-ladder” reporting requirements. In Ontario, these obligations arise from amendments made in 2004 to the Rules of Professional Conduct of the Law Society of Upper Canada.

The Law Society rules require that if a proposed corporate action would be illegal, the in-house counsel must inform the person from whom counsel is taking instructions of that fact. If the person refuses to abandon the course of conduct, the in-house counsel must advise the general counsel, or both the general counsel and the CEO, of the proposed conduct. If the proposed conduct is still not stopped, the in-house counsel must keep reporting it to the next highest person or group of persons within the company, including, ultimately, to the board of directors or the appropriate committee of the board. If the company still intends to go forward with the conduct, the lawyer must withdraw from the matter.

In the US, similar requirements have been enacted under the Sarbanes-Oxley Act of 2002 (except that no final rule has been issued yet on the requirement to withdraw from a matter where conduct is not stopped). Debate continues there on how public (“noisy”) such a withdrawal should be (in Canada, there is no requirement to make a public announcement of withdrawal). The US rule applies to attorneys “appearing and practising” before the SEC, which includes advising on materials filed with the SEC. Accordingly, the rule, as interpreted and applied by the SEC, may apply to Canadian in-house counsel involved in preparing documents that are filed with the SEC (including Canadian documents adapted for the purposes of an SEC filing).

In-House Counsel Face Personal Risks

Two recent SEC enforcement actions indicate the importance that regulators attach to the in-house counsel role and the enhanced risks that counsel face.

In the Isselmann case, the SEC brought charges against Isselmann, the general counsel of ESL, in connection with fraudulent financial statements that had been filed. The allegations were that the fraud was intentionally committed by the CFO (who ultimately became the CEO) who took steps to prevent Isselmann from raising with the audit committee the issues behind it (reversal of an employee benefit liability that turned a negative quarter into a positive one). The SEC did not allege that Isselmann was involved in the accounting that led to the fraudulent financial statements, but rather that Isselmann had failed to provide important information (that the reversal was not permitted under applicable foreign law) to the audit committee, board of directors and external auditors that could have prevented the fraudulent filing. Isselmann claimed that he did not appreciate that the facts he learned from foreign counsel had important financial statement implications. He had spent
little time on the issue. He described his job as "a mile wide and an inch deep". According to Isselmann, as soon as he realized what had happened, he reported his concerns to the audit committee. From the SEC's perspective, Isselmann had waited too long, and the delay had allowed ESI to file fraudulent financial statements. Isselmann ultimately settled with the SEC, paying a $50,000 civil penalty, consenting to an order prohibiting certain securities law violations and enduring considerable publicity.

In the Google case, the SEC brought an action against the general counsel of Google in respect of stock options issued by Google without proper SEC registration or an exemption from the registration requirements. The general counsel had obtained external counsel's advice about the availability of an exemption, but had failed to advise the board of directors that there was a risk that the exemption might not be available. In the cease and desist order that ensued, the SEC blamed Google's general counsel for Google's securities law violations and criticized him for not bringing the potential risk to the attention of the board of directors.

Google indicates that regulators are not limiting the responsibilities of in-house counsel to up-the-ladder reporting, but rather that they will also hold in-house counsel personally responsible for substantive legal violations by public companies. Google also indicates that, in addition to reporting to the board concerns about illegal conduct, in-house counsel must make sure that the board is aware of the broader set of risks associated with particular proposed courses of action.

What Should In-House Counsel Do?

These expanded responsibilities have the potential to put in-house counsel in difficult situations because they are employees of the company, concerned with job security and personal reputation and have a unique professional duty to act as whistleblowers. This is particularly true of the general counsel, who will typically be responsible for dealing with the company's senior officers when issues arise. To minimize personal risk, however, in-house counsel must identify and report concerns early on, even over any objections of senior officers.

The general counsel should develop and maintain an open line of communication with the board of directors (particularly the board chair, the lead director and/or the chair of the corporate governance committee). If the general counsel feels that the message to the board is not getting through because of interference from management, the general counsel should consider requesting a separate session with the board.

In-house counsel must also be sure to carefully describe to the board of directors all of the risks associated with a proposed course of action, even where it may have been determined that the risk can likely be avoided.

The requirement for in-house counsel to withdraw from a matter poses difficult practical and personal issues. However, since the requirement will only be triggered where the board of directors itself (or a board committee) has approved (or at least not prohibited) a proposed course of action, an appropriate way of withdrawing would be to state an intention to withdraw at the relevant board meeting and to request that the withdrawal be noted in the minutes. This will serve to put on the record counsel's decision to withdraw. It may also have the effect of causing the board to re-examine its decision.

The issues here are difficult and sensitive. In-house counsel and particularly general counsel, should be sure to develop a consultation network (whether with external counsel, board members or otherwise) with whom they can discuss these issues in real time, as they arise.

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