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LAWYERS AS DIRECTORS OF CLIENT CORPORATIONS

By M. Thomas Arnold

The lawyer as director of a client corporation is a multifaceted topic. While not exhaustive of all issues pertaining to outside counsel serving as director, my remarks—some of which may be more relevant in the public corporation context—will focus on two questions. First, what are the legal implications of board membership for a lawyer? Second, should lawyers serve on the boards of client corporations? With respect to the second question, I will attempt to avoid being overly dogmatic, hoping instead to impart some of the flavor of the controversy.

I. A LAWYER AS A DIRECTOR IS A DIRECTOR

While a logician might tell you that the above statement is tautological, there is, perhaps, a moral. A directorship cannot be treated as a purely honorary position.¹ The lawyer-director is subject to all the duties and obligations placed upon directors by state and federal law.

A. OBLIGATIONS OF A DIRECTOR UNDER STATE LAW

The import of director status under state law includes the imposition of fiduciary status. The Oklahoma Business Corporation Act expressly states that directors "stand in a fiduciary relation to the corporation."² The fiduciary duties of a lawyer-director would prohibit, among other things, the seizing of corporate opportunities, competing unfairly with the corporation, dealing with the corporation on unfair terms and accepting bribes for acting adversely to the corporation's interests.³ "[N]one of these prohibited activities

should trouble any honest director, whether he is a lawyer or non-lawyer."⁴

In addition, the Oklahoma Business Corporation Act provides that the affairs of the corporation "shall be managed and conducted by a board of directors."⁵ Thus, the director of a corporation is charged with the duty of managing the corporation, and he or she must do so with "that diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like position."⁶ This would presumably place an obligation on the director to keep informed as to corporate affairs, to attend board and committee meetings regularly, and to exercise reasonable business judgment.

The lawyer-director may be held, in some cases, to a higher standard of care than a layperson. The Oklahoma Business Corporation Act uses the phrase "under similar circumstances" in describing the director's duty of care,⁷ as does the Model Business Corporation Act.⁸ The drafter's comments to the Model Business Corporation Act state that this phrase "gives recognition to the fact that the special qualifications a particular director may possess . . . may place a measure of responsibility upon such director which may differ from that placed upon another director."⁹

The lawyer-director should bear in mind, however, that "[i]t is well settled that directors do not serve as insurers; they do not guarantee the company's success."¹⁰ If the rule were otherwise, capable individuals would be extremely reluctant to accept directorships. The director is given a great measure of protection by the business judgment rule¹¹ and by the requirement that, to be actionable, failure to exercise appropriate diligence

and skill in the management of a corporation must cause injury to the corporation.¹²

On the other hand, a lawyer-director would be remiss if overly complacent regarding his or her duty to exercise care in the management of the affairs of the client corporation. Despite the limited number of directors held liable in this context,¹³ one would not wish to be graced with the dubious distinction of being one of the few.

B. OBLIGATIONS OF A DIRECTOR UNDER THE FEDERAL SECURITIES LAWS

Very briefly, the lawyer as a director is subject to all the duties and liabilities imposed on directors by the Securities Act of 1933¹⁴ and the Securities Exchange Act of 1934.¹⁵ These would include, for example, the prohibition against trading on inside information,¹⁶ the obligation to give up "profits" made on short-swing transactions in equity securities registered under the 1934 Act,¹⁷ the prohibition against short sales of equity securities registered under the 1934 Act,¹⁸ and the liability for errors in registration statements utilized in public offerings under the 1933 Act.¹⁹

C. THE LIMITS OF PROFESSIONAL LIABILITY INSURANCE

The lawyer considering accepting a directorship should explore the matters of indemnification and directors and officers' (D & O) insurance. Since the lawyer as a director would be functioning in a business—as opposed to a professional or legal—capacity, it is doubtful that his or her professional liability coverage would extend to claims made against him or her *qua* director.

Oklahoma—and a number of other states—has a non-exclusive provision in its Business Corporation Act empowering corporations, subject to certain restrictions, to indemnify corporate directors for liabilities arising out of their service as directors and authorizing the purchase and maintenance by corporations of insurance covering claims against directors.²⁰ A lawyer joining the board of a corporation should inspect the applicable indemnification statute. In addition, "[w]ithout regard to whether the statute is exclusive, [he or she] should determine whether [the]

corporation has a charter or bylaw provision dealing with indemnity. It could be more restrictive than the statute."²¹ Finally, one commentator has suggested that "[a] lawyer going on a Board of Directors should inquire as to whether the corporation has D & O insurance and, if not, he should ask the board to obtain a quotation and consider such a purchase."²²

II. SHOULD LAWYERS BE PROHIBITED FROM SERVING ON THE BOARDS OF CLIENT CORPORATIONS?

Some law firms do prohibit lawyers affiliated with the firm from serving on the boards of client corporations.²³ In a Salt Lake City survey, sixteen percent of the lawyers who responded were with firms that had adopted such an approach.²⁴ One problem with a law firm policy prohibiting the acceptance of directorships with client corporations is that the unilateral adoption of standards of ethical behavior may have costs if others do not follow suit. One lawyer relates:

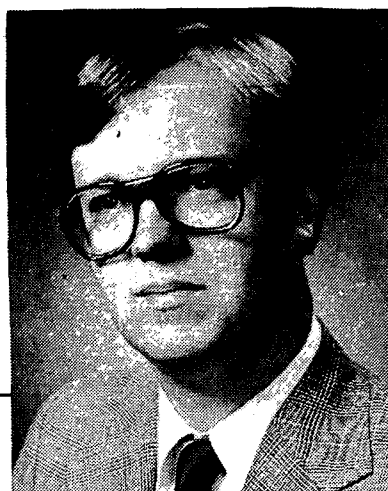
We have a strong policy in our firm against serving as a director where we represent the company more or less generally. And our experience in one or two instances has been that the company wanted somebody from the firm to serve as a director A prominent lawyer from another law firm was contacted who said, Yes, he would serve as a director, but only in the event the company shifted its business to his law firm.²⁵

Some lawyers purport to deplore the practice of accepting directorships with client corporations while continuing to do so.²⁶ One commentator, adopting a more cynical approach than my own, states:

When the company's chief executive asks [counsel] to go on the board, it is more than an invitation; it is a summons into the inner sanctum of management that from counsel's point of view cements the relationship of his firm to the client, or more precisely, of the firm to management. The invitation could be refused but there is concern not to affront the valued client, whose understanding of the ethical implications will presumably be less than his lawyer's Candor, then, requires the conclusion that the

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bar's occasional sensitivity to the issues of professionalism inherent in the subject has been dulled by the dollars involved.²⁷

The Code of Professional Responsibility for Lawyers as it is now constituted does not prohibit a lawyer from serving as a director of a client corporation. It has been suggested that the Code be amended to include just such a prohibition.²⁸ Comparisons have been made between the attorney and the accountant who is proscribed by the code of ethics of his or her profession from serving on the board of a client corporation.²⁹

It has been proffered that "[t]he lawyer is in no less need of complete independence in the expression of his legal opinion regarding his clients' programs and actions" than is the accountant.³⁰ One question here is whether the lawyer-director is able to "resist fully the temptation in close cases to trim his legal opinion to match his affirmative vote for management proposals."³¹

In addition to concern about the need for independence on the part of outside corporate counsel, questions have been raised regarding the effect of board membership on the lawyer's ability to be taken seriously in his role of counsellor. Professor Mundheim has asked:

If I am prepared to support a course of action as a director, how will that affect my lawyer's role in having the other members of the board take my descriptions of the [legal] risks seriously and weigh them independently when they know how I am going to vote as a director.³²

Even if the other members of the board are able to take the lawyer-director seriously in both

capacities, it is not clear that these dual roles are separable in the context of a board or committee meeting. One potential ramification of this is loss of the attorney-client privilege. For a communication at a board meeting to be privileged in Oklahoma courts, for example, it must be made for the "purpose of facilitating the rendition of legal services."³³ Thus, it seems the advice must be solicited from the lawyer-director in his or her capacity as a lawyer and not as a director.³⁴

Finally, it has been argued that the lawyer who serves as a director of a client corporation is in an inherent conflict of interest situation with regard to the selection, retention, and payment of his or her firm as outside counsel.³⁵

The question of whether the Code should prohibit lawyers from serving as a director of a client corporation is not, however, one-sided. Many feel that it would be unwise to amend the Code of Professional Responsibility to include such a proscription.

One argument advanced in favor of this position is simply that lawyers, by virtue of their training and experience, make good directors.³⁶ Apart from the merits of whether this is true, it is likely that a client corporation perceives this to be true. One lawyer has recounted that:

. . . . a client recently used the following argument to urge me to join a board. He said: 'I would like you on the board because I know if you are on the board you are going to worry I know you will try to do the right thing. So I want you there, worrying.'³⁷

In addition, it is argued that placing corporate counsel on the board gives him or her an opportunity to practice preventive law.³⁸ Many believe, as I do, that the lawyer is most successful when he or she prevents his or her client from getting entangled in the first place.

One lawyer, speaking in favor of counsel serving as director, has stated: "2,000 corporations, 2,000 lawyers and 2,000 law firms can't be wrong."³⁹ My mother used to respond to my use of similar logic by asking whether I would put beans in my ears if everyone else did.⁴⁰ However, again, there may be a moral. Before the Code of Professional Responsibility is amended to prohibit an attorney from accepting a directorship of a client corporation perhaps we should attempt to answer two questions. First, what, if anything, does the corporate management expect to gain from having counsel as a director? Second, assuming we can ascertain the contemplated benefit, could it be obtained in a practical sense if outside counsel were prohibited from joining the board?⁴¹

CONCLUSION

The debate over whether the Code of Professional Responsibility for Lawyers should prohibit board membership by outside counsel has gone on for a number of years and can be expected to continue.⁴² There are certainly compelling arguments on both sides of the issue. Until such time as a prescription is promulgated, however, lawyers and firms will have to grapple with the matter at a more personal level. Those lawyers who decide to serve as directors for client corporations should be attentive to their duties, obligations and potential liabilities under state and federal law.

1. See, e.g., *Minton v. Caveaney*, 15 Cal. Rptr. 641, 364 P.2d 473, 475-6 (1961), where the court, in referring to a lawyer-director, stated:

It is immaterial whether or not he accepted the office of director as an 'accommodation' with the understanding that he would not exercise any of the duties of a director. A person may not in this manner divorce responsibilities of a director from the statutory duties and powers of that office.

Accord, *Kavanaugh v. Commonwealth Trust Co.*, 223 N.Y. 103, 119 N.E. 237, 238 (1918) ("No custom or practice can make a directorship a mere position of honor void of responsibility . . .").

2. O.S. tit. 18, §1.34(b) (1971). Absent such an express statement, the result would be the same under common law principles.

3. Ruder, "Lawyers as Directors: The Case Against the Lawyer-Director," 30 Bus. Law. 51, 52 (1975).

4. Harris, "Lawyers as Directors: The Case For the Lawyer-Director," 30 Bus. Law. 58, 59 (1975).

5. O.S. tit. 18, §1.34(a) (1971).

6. *Id.* §1.34(b).

7. *Id.*

8. Model Business Corporation Act §35.

9. "Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act," 30 Bus. Law. 501, 506 (1975). See also Coombe, "Lawyers as Directors: Application of Statutory Standard of Care," 30 Bus. Law. 39 (1975).

10. Soderquist, "Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors," 52 N.Y.U.L. Rev. 1341, 1344 (1977).

11. *Id.* at 1345-6.

12. *Barnes v. Andrews*, 298 F. 614 616 (S.D.N.Y. 1924) ("The plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided); *Litwin v. Allen*, 25 N.Y.S.2d 667, 701 (Sup. Ct. 1940) ("A director is not liable for loss or damage other than what was proximately caused by his own acts or omissions in breach of his duty.").

13. Professor Bishop has stated that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, "Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers," 77 Yale L.J. 1078, 1099 (1968).

14. 15 U.S.C.A. §§77a *et seq.* (1971).

15. 15 U.S.C.A. §§78a *et seq.* (1971).

16. This prohibition is imposed by Securities Exchange Act §10(b), 15 U.S.C.A. §78j (b) (1971) and Securities Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5 (1980), as interpreted by the Securities Exchange Commission and the federal courts. See *In The Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *S.E.C. v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968).

17. Securities Exchange Act §16(b), 15 U.S.C.A. §78p(b) (1971).

18. Securities Exchange Act §16(c), 15 U.S.C.A. §78p(c) (1971).

19. Securities Act §11, 15 U.S.C.A. §77k (1971). Recall, in this regard, the travails of defendants Birnbaum (house counsel) and Grant (outside counsel) in the celebrated case of *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

20. O.S. tit. 18, §1.43a (1971). This provision is like Delaware General Corporation Law §145 and Model Business Corporation Act §5.

21. Schauer, "Lawyers as Directors: Protections Afforded by Indemnification and Insurance," 30 Bus. Law. 47, 48 (1975).

22. *Id.* at 49. I have not dealt with the question of whether indemnification of liabilities under the federal securities laws is against public policy. On this issue, See Johnston, "Corporate Indemnification and Liability Insurance for Directors and Officers," 33 Bus. Law. 1993, 2007-2009 (1978). The Johnston article is excellent in its coverage of the topics of indemnification and D & O insurance in general.

23. See, e.g., Cutler, "Ethical Responsibilities of Corporate Lawyers: The Role of the Private Law Firm," 33 Bus. Law. 1549, 1552 (1978) ("With a very few grandfathered exceptions, we forbid any lawyer to become a director of any corporation for which we act as principal outside counsel or as securities law counsel.").

24. Note, "Should Lawyers Serve as Directors of Corporations for Which They Act as Counsel?" 1978 Utah L. Rev. 711 at notes 38 & 47.

25. Panel Discussion, "Ethical Responsibilities of Corporate Lawyers: Should Code of Professional Responsibility Forbid Lawyers to Serve on Boards of Corporations For Which They Act as Counsel," 33 Bus. Law. 1511, 1517 (1978) (comments of Mr. Wheat).

26. Riger, "The Lawyer Director—A Vexing Problem," 33 Bus. Law. 2381, 2382 (1978).

27. *Id.* at 2383.

28. See, e.g., *id.* at 2387.

29. *Id.* at 2386.

30. *Id.*

31. *Id.*

32. Mundheim, "Ethical Responsibilities of Corporate Lawyers: Should Code of Professional Responsibility Forbid Lawyers to Serve on Boards of Corporations For Which They Act as Counsel," 33 Bus. Law. 1507, 1509 (1978).

33. O.S. tit. 12, §2502(B) (1980 supp.).

34. See Note, *supra* note 24 at 718-721 & 732-738, for more indepth discussion of this issue.

35. It has been suggested that "[i]n view of the fiduciary relationship owed by the lawyer-director, the fees charged by his firm should be carefully scrutinized for fairness." Ruder, *supra* note 3 at 54. I concur wholeheartedly with this suggestion if for no other reason than it makes good business sense. I question, however, the assertion that "[e]ven the selection of the lawyer-director's law firm to perform services for the corporation may be subject to challenge." *Id.* Statutory provisions such as O.S. tit. 18, §1.175(a) (1980 supp.) would seem to provide a means to avoid such a result.

36. Harris, *supra* note 4, at 58.

37. Panel Discussion, *supra* note 25, at 1513 (comments of Mr. Bialkin).

38. Note, *supra* note 24, at 723-725.

39. Harris, *supra* note 4, at 58-59, referring to statistics that indicated that approximately 2,000 publically held corporations had directors who were affiliated with law firms employed as outside counsel.

40. Of course, when I was eight years old, the answer was yes.

41. Mundheim, *supra* note 32, at 1510 states:

A final consideration which I think one ought to weigh is whether a rule prohibiting general counsel from serving on the boards of client companies will, as a practical matter, stop lawyers from serving on boards. I would not consider that a desirable result. Will an individual who is a lawyer but does not have a lawyer relationship with X company be willing to go on its board if he knows that doing so will bar him or his firm from doing substantial legal work for the company—or do so while he is on the board.

42. For example, the proposed ABA Model Rules of Professional Conduct provide:

(f) A lawyer may serve as general counsel to a corporation or other organization of which the lawyer is a director only if:

(1) there is adequate disclosure to and consent by all persons having an investment interest in the organization; or

(2) when doing so would not involve serious risk of conflict between the lawyer's responsibilities as general counsel and those as director.

DISCUSSION DRAFT OF ABA MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.9(f), reprinted in, 48 U.S.L.W. 1, at 8 (Feb. 19, 1980 special ed.).

The Comment to this Rule states that "it is often useful that a lawyer serve both as counsel to an organization and as one of its directors. When the risk of compromising the independence of counsel is remote, it is not improper that counsel be a member of the board." Comment to Rule 1.9, *id.* at 9. The proposed Rule seems destined to insure that discussion of this issue will not abate.

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4. The Maurice Merrill Essay Award in two categories, to-wit:
 - a. The high school student writing the best Law Day essay; said award to carry with it a \$100.00 cash prize.
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6. The Half Century Award to those members of the Oklahoma Bar Association who have served their profession 50 years.
7. The Outstanding Young Lawyer Award to members of the Oklahoma Bar Association under 36 years of age who have rendered meritorious service to their profession.
8. Earl Sneed Award (CLE contribution).
9. Inventor of year; said recipient to be chosen by the OBA Patent, Trademark and Copyright Law Section.
10. Outstanding lawyer practicing 50 years or longer.
11. Outstanding lawyer practicing less than 50 years.

Nominations should be mailed or delivered to OBA Awards Committee, Oklahoma Bar Association, 1901 North Lincoln Boulevard, P.O. Box 53036, Oklahoma City, Okla. 73152, on or before October 1, 1981.

Jack Mattingly
Chairman, Awards Committee
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