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LAWYER-DIRECTORS: AN ENDANGERED SPECIES

Approximately 30% of the 250 largest industrial companies in the U.S. include on their boards of directors a lawyer, most of whom are partners in a law firm which represents the corporation. From the lawyer's standpoint, this practice helps strengthen the relationship between the client and the law firm, thus assuring continuation of lucrative fees. From the company's standpoint, this practice may enhance the credibility of the lawyer's advice and permits the lawyer to function better as an effective watchdog for potential legal problems.

When analyzed critically, however, service by lawyers on their clients' boards of directors creates a host of legal problems for both the lawyer and the corporation. As explained below, these problems far outweigh the self-serving and relatively minor benefits from such board service. The wisdom of this practice may be best summarized by the old maxim, "the lawyer who represents himself has a fool for a client."

I. HEIGHTENED LIABILITY EXPOSURE

Lawyers who serve as directors of their corporate clients expose themselves to increased liability risks in the following areas, among others.

A. Duty of Care. Directors are generally held to a standard of care commensurate with their special background, qualifications, knowledge, skills and training. The combination of the lawyer-director's specialized legal expertise and his intimate familiarity with many of the corporation's affairs will likely impose a higher standard of care and diligence than that placed upon other directors on the board.

B. Duty of Loyalty. Lawyer-directors are frequently faced with situations in which, in their capacity as directors, they participate in discussions or decisions affecting legal fees which may be paid to them or their law firms. Many decisions by a board will result in the need for substantial outside legal counsel services and thus substantial fees. In such circumstances, the lawyer-director who participates in those decisions may later be accused of self-dealing and violation of his duty to act only in the best interests of the corporation and its constituents. Conversely, if the lawyer-director abstains from those types of discussions and decisions, the corporation is deprived of the benefit of that board seat. The mere appearance of a conflict of interest by the lawyer-director may serve as a magnet for claims by private litigants or extra scrutiny by regulators.

C. Reliance Defense. An important defense available to directors under many types of claims is the good faith reliance upon outside experts, including legal counsel. A lawyer-director may not invoke this defense if he or his law firm provides the expert advice to the board. Similarly, the remaining board members may also be foreclosed from invoking this defense, if the lawyer-director provides the expert advice arguably in his capacity as a director, not as outside legal counsel.

D. Inside Director. Under numerous statutory theories of liability, an "inside" director faces greater liability exposure than a disinterested "outside" director. Lawyer-directors are generally considered "inside" directors because they are perceived to be beholden to management in order to maintain their lucrative, fee-generating relationship with the company. The lawyer-director's heightened liability exposure as an insider is most pronounced in the context of federal securities law claims, where outside directors enjoy more formidable liability defenses than inside directors.

E. Vicarious Liability of Law Firm. In addition to subjecting themselves to increased liability risks, lawyer-directors also may subject their law firms to those same risks. Law firms can be held liable for the conduct of their attorneys as directors under several legal theories. The law firm may be considered a "controlling person" of the lawyer-director for purposes of the federal securities laws and thus be jointly and severally liable for the actions of the lawyer-director. Similarly, the law firm may be vicariously liable under the common law doctrine of respondeat superior if the lawyer-director is deemed to be serving as an agent for the law firm. Also, consistent with a few court decisions, a law firm may be vicariously liable if it can be shown that the law firm "deputized" one of its attorneys to represent the law firm's interests on the corporation's board. This potential liability may be increased if the law firm selects the lawyer or consents to the lawyer's service on the board.

II. LOSS OF ATTORNEY-CLIENT PRIVILEGE

In addition to the lawyer-director incurring heightened liability exposure, the corporation and its other directors and officers may jeopardize their ability to protect from discovery communications between them and their lawyer-director. The attorney-client privilege generally protects confidential communications between a lawyer and client relating to the provision of legal services. This critically important privilege may not protect communications with the lawyer if the lawyer's communication is found to be in his capacity as a director. It is frequently difficult to distinguish between communications relating to legal advice and communications with a lawyer-director relating to business advice, particularly in the context of a board meeting.

Even if the communication is otherwise subject to the privilege, the outside counsel's service as a director may increase the risk of waiver of an otherwise applicable attorney-client privilege. Other directors or officers may mistakenly believe that communications by the lawyer-director were by the lawyer in his director capacity and therefore disclose those communications to third parties.

If the attorney-client privilege is inapplicable or waived, serious consequences may occur in the context of litigation. In a proper case, the files of not only the lawyer-director, but also his law firm, may be available for discovery by plaintiffs to the same extent as files and records of the corporation itself.

III. INEFFECTIVE DIRECTOR

A lawyer-director typically is not considered a disinterested, independent director due to his professional and self-serving relationship with company management. As a result, a lawyer-director's role on the board is quite limited. He should not serve on the nominating, audit or compensation committees, which should be composed of directors independent from management's influence. For similar reasons, he should not serve on various special committees of the board formed to review merger or buyout proposals, to evaluate demands in the derivative litigation context, or to validate an interested director transaction. Such special committees should consist of only disinterested directors in order to qualify for the protection afforded by the business judgment rule. For the same reasons, a lawyer-director may not be an objective and effective monitor of management conduct, which is fast becoming one of the primary responsibilities of directors.

Because of the dual capacity served by lawyer-directors, their participation in board meetings may mislead other directors. Opinions expressed by the lawyer-director may be mistakenly interpreted to constitute legal advice when in fact it was intended simply as business advice. Conversely, a lawyer-director may dilute the importance of his legal advice to the board if his conduct as director appears to ignore the legal concerns raised. In each of these situations, an increased risk exists that the other directors will give inappropriate significance or improperly discount the advice and opinions of the lawyer-director.

IV. DISQUALIFICATION OF LAW FIRM

The lawyer-director and his law firm may be disqualified from representing the corporation or the other directors and officers in litigation against the corporation or its D&Os. If the lawyer-director is a codefendant in that litigation, at least a potential for a conflict of interest between that lawyer-director and the co-defendants may disqualify the lawyer and his law firm from representing any of those co-defendants. For example, either the lawyer-director or the other co-defendants may wish to assert as a defense reliance upon the other. Even if no potential conflict of interest exists, it is doubtful the lawyer-director could exercise truly independent judgment for the benefit of the co-defendants when he is a codefendant personally. Ironically, such a disqualification would prohibit the lawyer-director from earning substantial fees, which ultimately is one of the primary reasons most lawyer-directors choose to serve in that dual capacity for clients.

V. INSURANCE

The lawyer-director will have potential insurance coverage under both his professional errors and omissions/legal malpractice insurance policy and the company's directors and officers liability insurance policy. However, both types of policies afford coverage only for wrongful acts

committed solely by the insured in his capacity as a lawyer or as a director and officer, as the case may be. Because of the difficulty in identifying in which capacity a particular wrongful act was committed and because many wrongful acts arguably are committed in both capacities, lawyer-directors have little certainty as to the existence and extent of insurance coverage for claims arising out of that dual capacity. At best, the insurers for the two types of policies will be arguing about their respective liabilities; at worst, both insurers will deny coverage.

VI. CONCLUSIONS

Recent activity by private litigants, the FDIC, the RTC and the SEC suggest that the problems identified above are not simply academic issues, but are arising with greater frequency. The risks to the lawyer-director, the other directors and officers and the corporation arising from a company's outside counsel serving as a director are sufficiently severe that companies should seriously consider adopting a general prohibition against such practice.

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