

# THE RECORD



OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

2007

VOL. 62, NO. 1

## THE LAWYER'S ROLE IN CORPORATE GOVERNANCE

# THE RECORD

2007

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# Of Note

THE NEW YORK CITY BAR PRESENTED THE ASSOCIATION MEDAL TO Robert Fiske Jr., Davis Polk and Wardwell, and to Robert Morgenthau, District Attorney for New York County, in recognition of their exceptional leadership and service to the bar, on March 15, 2007, at the Association.

Barry Kamins, President of the Association made opening remarks, with Elkan Abramowitz presenting to Robert Fiske, and Hon. Pierre Leval, United States Court of Appeals, Second Circuit, presenting to Robert Morgenthau.

The Association Medal is sponsored by the Committee on Honors (Hon. Jed S. Rakoff, Chair).

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ON JANUARY 26, 2007, THE CITY BAR JUSTICE CENTER RECEIVED THE New York State Bar Association's 2006 Award of Merit in recognition of the Justice Center's Bankruptcy Pro Bono Panel. The Center established the Panel as part of a collaborative effort with the Bankruptcy Courts of the Southern and Eastern Districts of New York to meet the increasing need for the provision of pro bono counsel to assist indigent *pro se* debtors involved in litigation arising out of their bankruptcy cases.

The Panel is administered by John McManus, the Director of the Pro Bono Consumer Bankruptcy Project. Since its inception the Panel has recruited over 85 volunteer attorneys and Panel members have assisted more than 20 *pro se* litigants referred by the Bankruptcy Court.

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THE BROOKLYN LAW SCHOOL CAPTURED THE REGIONAL ROUNDS OF the 57th Annual National Moot Court Competition, held November 15-16, 2006, at the Association. Law students on the winning team included: Michael David Bell, Mark L. Legaspi, and Caren H. Rotblatt.

The New York University School of Law took second place honors. Members of the NYU team included: Brian Crow, Shaneeda Jaffer, and Kartik Venguswamy. Both teams advanced to the final rounds.

OF NOTE

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Best Brief honors went to Benjamin N. Cardozo School of Law, whose team members were Zev Singer and Mark Rosen. Best Runner-Up Brief went to the NYU School of Law.

Best Individual Oral Argument went to Kartik Venguswamy, NYU School of Law. Second Place Best Individual Oral Argument went to Caren H. Rotblatt, Brooklyn Law School.

The final round of the competition was judged by Hon. Andrew J. Peck, Hon. Sheila Abdus-Salaam, Hon. Cheryl Gonzales, Hon. Ralph A. Fabrizio, and Sheldon Elsen.

The American College of Trial Lawyers co-sponsored the regional rounds of the competition with the Association's Young Lawyers Committee.

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THE UNIVERSITY OF WASHINGTON SCHOOL OF LAW WON THE FINAL round of the 57th Annual National Moot Court Competition on February 1, 2007, at the Association. Law students on the winning team included: Candice Tewell, Aaron Thomson and Dustin Buehler.

The Texas Wesleyan School of Law took second-place honors. Team members included: Matthew Rhoads, Natalie Roetzel and Johannes Walker.

Best Brief honors went to the George Mason University School of Law team, whose members included Kimberly Bierenbaum, Rocklan King and Anthony Schiavetti. Best Runner-Up Brief went to Texas Wesleyan.

Best Speaker was Natalie Roetzel from Texas Wesleyan, with runner-up honors going to Dustin Buehler from the University of Washington.

Judges for the final round of the competition included: Hon. Shirley S. Abrahamson, Chief Justice, Supreme Court of Wisconsin; Hon. Robert S. Smith Judge, New York State Court of Appeals; Hon. Paul A. Crotty, Judge, United States District Court (SDNY); Hon. Steven W. Fisher, Justice, Appellate Division, Second Department; Hon. L. Priscilla Hall, Justice, New York State Supreme Court; David J. Beck, President, the American College of Trial Lawyers; and Barry Kamins, President, New York City Bar Association.

Twenty-eight winning and runner-up teams from 14 regions across the United States competed in the final rounds of the National Moot Court Competition. The American College of Trial Lawyers is a co-sponsor of the competition along with the Association's Young Lawyers Committee.

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THE 2007 BERNARD A. BOTEIN MEDAL, A RECOGNITION OF OUTSTANDING performance by the personnel attached to the courts of the First Judi-

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cial Department, were presented at the Association, on March 28, 2007. Hon. Peter Tom, Acting Presiding Justice, Appellate Division, First Department, presented the awards.

The Awards, dedicated to the memory of Bernard Botein, former President of the Association, and Presiding Justice of the First Department, have been presented annually since 1976 to pay tribute to court personnel in the First Department who have made outstanding contributions to the administration of the courts.

This year's recipients are: Lester E. Dickinson, Principal Appellate Court Clerk, Supreme Court, Appellate Division, First Department; Sheng Guo, Chief Technology Officer, Office of Court Administration; Nancy Hassell, Principal Court Clerk, Supreme Court, Appellate Term, First Department; John P. McConnell, Senior Court Clerk, Supreme Court, Bronx County; and Desmond O'Hanlon, Deputy Chief Clerk, Civil Court, Bronx County.

The medals are made possible by a grant from the Ruth and Seymour Klein Foundation, Inc.

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THE SECOND ANNUAL PRESENTATION OF THE THOMAS E. DEWEY MEDAL, given every year to an outstanding assistant district attorney in each of the city's District Attorney's offices, was held November 28, 2006, at the Association.

This year's medal winners this year are: Anne J. Swern, Kings County; Patrick J. Dugan, New York County; Anthony M. Communiello, Jr., Queens County; Yolanda L. Rudich, Richmond County; and Elisa F. Koenderman, Bronx County.

Albert M. Rosenblatt, then Associate Judge of the New York Court of Appeals, presented the awards. The award is sponsored by Dewey Ballantine LLP, and the winners were selected by the Dewey Medal Committee (Seth C. Farber, Chair).

# Recent Committee Reports

## **African Affairs/International Human Rights**

Letter to the president of Zimbabwe expressing concern that the Law Society of Zimbabwe (LSZ) is being subjected to government-sponsored attacks for its work to protect lawyer-client confidentiality, the independence of the legal profession, and the independence of the judiciary. The letter urges that President Mugabe publicly denounce the attacks on the LSZ and act to ensure the independence of the bar and the judiciary and the safety of the LSZ and its members.

## **Bankruptcy and Corporate Reorganization**

Detailed comments submitted to the United States Bankruptcy Court, Eastern District of New York, on the proposed revisions to the Eastern District of New York Local Bankruptcy Rules.

## **Capital Punishment**

Amicus Brief: *People of the State of New York v. Taylor*, filed in the New York State Court of Appeals, urges that New York's death penalty statute violates the due process provision of the New York Constitution, as well as the due process provision of the federal constitution. The brief focuses on the state due process clause and argues that the Court should apply strict scrutiny analysis to substantive due process claims such as this that involve the fundamental right to life. When applying that test, New York's death penalty statute violates the due process clause because the punishment does not achieve the asserted deterrence and retribution goals of the legislature and governor with the least restrictive means. Finally, the brief notes, accumulated experience from other countries, states and sources, supports the conclusion that the death penalty is not the least restrictive means to achieve the goals of punishment.

## **Civil Rights**

Amicus Brief: *ACLU v. Department of Defense* (U.S. Court of Appeals, Second Circuit). The brief argues that the government's invocation of Exemption 7(F) of the Freedom of Information Act (FOIA) as the basis for



refusing to disclose 21 images depicting mistreatment of people detained by the U.S. government in Iraq and Afghanistan (the “Detainee Abuse Images”) is not appropriate. The brief disputes the government’s contention that withholding of the Detainee Abuse Images is justified because their depictions of abuse and mistreatment of Iraqi prisoners reflect such egregious misconduct by government personnel that they would, if released, pose a grave risk of inciting violence and riots. The consequences of government misconduct, the brief argues, cannot be a basis for withholding evidence of the misconduct from the public.

Letter to Congress urging opposition to three bills that would substantially amend the Foreign Intelligence Surveillance Act by authorizing the president to conduct warrantless surveillance of U.S. citizens without any meaningful judicial oversight. The bills (S. 2453, S. 2455, and H.R. 5825) would result in the elimination of the role of Congress and the courts and fundamentally undermine the system of separation of powers and checks and balances.

Amicus Brief: *Center for Constitutional Rights v. Bush* (filed in the Southern District of New York and the Eastern District of Michigan) regarding the state secrets privilege. The brief argues that the government’s invocation of the state secrets privilege in response to this and numerous other lawsuits challenging illegal government activities threatens to undermine the rule of law and the role of the courts and legislature. The brief also argues that the invocation of the state secrets privilege in these circumstances is unwarranted because the administration’s public statements provide all the information needed to determine the illegality of the NSA Surveillance Program.

Amicus Brief: *ACLU v. Gonzalez*, filed in the U.S. District Court (SDNY), argues that the USA PATRIOT Improvement and Reauthorization Act of 2005 (“The Reauthorization Act”) impermissibly infringes on the role of the judiciary under the constitutional system of the separation of powers. In 2004 the court found the Reauthorization Act’s predecessor unconstitutional. Congress then amended the statute and passed the Reauthorization Act. The Reauthorization Act, however, fails to remedy the constitutional defects found in the earlier statute. The Reauthorization Act, the brief notes, interferes with the role assigned to the courts as the determiner of what law is constitutional. In particular, Section 115(2) of the Reauthorization Act effectively prohibits the judicial branch from review-

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ing the constitutionality of executive action, and therefore disregards the rule of law.

Amicus Brief: *Parents Involved in Community Schools v. Seattle School District No. 1*, filed in the U.S. Supreme Court. The brief argues that engaging in voluntary efforts to combat the adverse effects of *de facto* segregation in the public schools through an assignment plan that makes race one factor that is taken into account to avoid *de facto* segregation is constitutional. If local school districts, which are in the best position to judge local facts and local needs, are disabled from considering race as a factor in school assignment programs designed to remedy *de facto* segregation, notes the brief, more city schools, despite a diverse urban population, are likely to become overwhelmingly segregated by race.

Amicus Brief: *ACLU v. National Security Agency*, filed in the United States Court of Appeals for the Sixth Circuit, urging that the National Security Agency be permanently enjoined from directly or indirectly utilizing the Terrorist Surveillance Program in any way including conducting warrantless wiretaps of telephone and internet communications. The Surveillance Program should be enjoined, the brief argues, because it impermissibly impedes attorney-client communications, and fundamental rights, including the right to counsel, are being undermined. Justice, notes the brief, requires that persons accused by the government of wrongdoing have access to legal advice and that such legal advice can only be effective if lawyer-client communications are conducted in confidence uninhibited by fears that government agents are listening in.

Statement on Proposed New York City Parade Regulations. The statement expresses serious concerns with the proposed revisions to Chapter 19 of Title 38 of the Official Rules of the City of New York defining a “parade.” If adopted, the statement argues, these revisions would impose dramatic new restrictions on peaceful protests and other public gatherings in New York City. The New York City Council, argues the report, is the governing body that should define a parade and establish the criteria for issuing parade permits. Such a critical determination should not be relegated to rulemaking or to ad hoc decision making by the New York City Police Department.

**Civil Rights/Education and the Law**

Amicus Brief: *Campaign for Fiscal Equity, Inc. v. Pataki*, filed in the New



York State Court of Appeals, urges that the court issue a clear and precise order to ensure that the legislature and executive promptly remedy the constitutional deficiencies in funding for New York City's public schools. The court, the brief argues, should specify the dollar range of the operational funding needed to provide New York City schoolchildren with a sound basic education. The doctrine of separation of powers is not a bar, the brief argues, when, as in this case, the political branches ignore the court's directives to remedy constitutional violations and the vindication of fundamental constitutional rights is unreasonably delayed. The brief examined school funding cases in other states, and shows that decisive court action is necessary to achieve the remedy the courts prescribe.

**Civil Rights/Legal Issues Affecting People with Disabilities**

Report: "Ensuring Accessibility for People with Disabilities in the Wake of Katrina and of Other Natural and Man-Made Disasters," offers a discussion of the laws, regulations, and other resources that will be useful in advancing the understanding of, and compliance with, legal requirements for access to the built environment for people with disabilities as reconstruction takes place after natural and man-made disasters.

**Condemnation and Tax Certiorari**

Letter to the New York City Department of Finance expressing opposition to the proposed Amendments to Section 11-208.1 of the Administrative Code. The proposed changes, the letter notes, would require the electronic filing of the mandatory real property income and expense statement (RPIE) by most owners of income producing property located in the City of New York which would place an undue burden on many owners of real property in the City.

**Corporate Governance, Task Force on the Lawyer's Role in**

The report of the Task Force on the Lawyer's Role in Corporate Governance examines the role of counsel, both in-house and outside, with respect to counseling about corporate conduct and urges strengthening the role of corporate lawyers representing public companies. The report suggests a series of "best practice" recommendations for lawyers counseling public companies including that the general counsel i) have an express mandate from the board to promote a corporate culture of integrity, ii) have ready access to the board whenever needed, iii) have regular meetings with independent directors in the absence of management, and iv)

have ultimate authority over the hiring and supervision of both in-house and outside lawyers. The report also argues that New York should amend its ethical rules for lawyers to permit them to disclose to regulatory authorities criminal or fraudulent conduct by a client company's management utilizing the lawyer's services, as well as clearly illegal conduct. However, such a permissive right to disclose would be recognized only as a last resort, and the report opposes imposing a mandatory duty to report client wrongdoing.

### **Employee Benefits**

"Employer Stock Litigation: The Tension Between ERISA Fiduciary Obligations and Employee Stock Ownership," a report. The recent litigation involving employer stock held in Eligible Individual Account Plans (EIAP) raises numerous issues for courts, plan sponsors, plan fiduciaries and anyone with a personal or professional interest in U.S. employee benefits policy. These issues include: should the holding of employer stock in employee benefit plans be subject to the same fiduciary standards as other plan investments, to the standards set forth in the securities laws, or to some other standards? And does, or should, ERISA impose any special duty on a plan fiduciary who obtains non-public information about a company's prospects in his or her role as a corporate officer? The report examines these issues and others, and offers for consideration suggestions and recommendations that are based on experience in this field.

### **Energy**

Report: Electric Regulation in the State of New York, looks at a number of issues pertinent to the regulation of the electric industry in New York. The report concludes that the State's most significant energy issue is the encouragement of construction of new generating capacity in New York State where it is needed and that new generating capacity is needed to address reliability issues and the market conditions in southeast New York over the next few years. In addition the report recommends that the State reinstate some form of energy planning.

### **Environmental Law**

Letter to the New York Department of Environmental Conservation regarding proposed changes by the New York State Department of Environmental Conservation ("DEC") to its air permit regulations at 6 NYCRR Parts 200, 201 and 231. The letter expresses support for the DEC's decision

to move forward and adopt its own Prevention of Significant Deterioration (“PSD”) program instead of continuing under a delegation of the federal PSD program. Adoption of a state-approved PSD program, the letter argues, will simplify the permitting process for applicants because applicants will be subject to one set of permitting procedures. Further, it will enhance public participation because the communities near permitted facilities will only need to understand the state’s public participation procedures, and not both the state and federal procedures. The letter also offers comments regarding the implementation of New York’s PSD and NSR program.

Letter to the New York State Department of Environmental Conservation generally supporting the implementation of the Regional Greenhouse Gas Initiative (RGGI) in New York. The letter expresses some concerns that the initiative lacks sufficient detail regarding how the proceeds of the annual auction will be used.

**Estate and Gift Taxation**

Report commenting on certain provisions of the Pension Protection Act of 2006 that relate to the estate, gift and income tax charitable deductions for gifts of fractional interests in tangible personal property. The report argues that these provisions are inconsistent with Congress’s intent and that unless amended through technical corrections, they will effectively shut down an important avenue of charitable giving. The report sets forth proposed technical corrections as well as proposals for regulatory action.

Follow-up letter to the U.S. Senate Committee on Finance regarding the Committee’s December 2006 report which offered technical corrections to certain provisions of the Pension Protection Act of 2006 relating to charitable gifts of fractional interest in tangible personal property.

**Family Court and Family Law**

Letter to the New York City Administration for Children’s Services supporting the agency’s collaboration with the Nurse-Family Partnership to help fund a program for pregnant teenagers in the agency’s foster care population.

Letter to New York City Administration for Children’s Services (ACS) expressing support for the agency’s burgeoning collaboration with the Nurse-

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Family Partnership program. The letter specifically endorses ACS's initiative to allocate monies from its preventive services budget to underwrite the cost of program support from the Partnership for pregnant teens in the agency's foster care population, and expresses hope that a collaborative effort with ACS will enable the Nurse-Family Partnership to flourish and expand in the New York metropolitan area.

### **Financial Reporting**

Letter to the SEC providing comments on the proposal to develop additional guidance for management regarding its evaluation and assessment of internal control over financial reporting (ICFR). The letter supports the notion of additional guidance as it would be an important part of establishing an approach to the implementation of Section 404 of the Sarbanes-Oxley Act, and it would produce disclosure that is more useful to investors.

### **Futures and Derivatives Regulation**

Letter to the North American Securities Administrators Association (NASAA) commenting on the proposed revisions of the NASAA to the Guideline for Commodity Pool Programs. The letter offers specific suggestions on how to better clarify the proposals with regard to the definition of net worth in the guidelines and the portfolio diversification.

Letter to the Commodity Futures Trading Commission commenting on whether there are any conflicts between the criteria and relief in Advisory 18-96 and Commission Regulation 4.13 (a)(4). Electronic Filing of Part 4 Exemptions. Although most of the provisions of Advisory 18-96 have been superseded by regulation, the letter argues that there is still a benefit in retaining Advisory 18-96 in certain situations.

Letter to the Commodity Futures Trading Commission expressing support for the proposal to amend the rules governing advertising by commodity pool operators and commodity trading advisors, which would make explicit that the commission's advertising rules are equally applicable to electronic media presentations and to traditional media. Though the letter argues that this proposed change is consistent with other initiatives to modernize the commission's rules to reflect current technological changes that affect the futures industry, it outlines several clarifications that would make the rules more effective.

**Health Law**

Letter to the Commission on Health Care Facilities in the 21st Century, expressing concern that the Commission's forthcoming recommendations "which reportedly include possible closure, merger, consolidation and restructuring of hospitals" do not comply with Title VI of the federal civil rights law and would have dramatic and disproportionate effects on communities of color and poverty in New York City.

**International Commercial Disputes**

Report on the Hague Convention on Choice of Court Agreements. The report looks at how current U.S. and foreign law and practice would be affected by U.S. and foreign ratification of the Convention. The report identifies the respects in which the Convention would change or otherwise impact current U.S. law and practice with respect to choice-of-court agreements; assesses the pros and cons of such changes; and analyzes certain practical issues with respect to the implementation of the Convention.

**International Human Rights**

Letter to the Minister of Justice of Maldives expressing concern that the trial of Mohamed Nasheed, who was arrested and detained on charges of terrorism and acts against the state, has not comported with international standards as defined in the International Covenant on Civil and Political Rights.

"Antiterrorism and Security Laws in India." This comprehensive report examines India's recent antiterrorism and other security laws, situating those laws in historical and institutional context in order to (1) analyze the human rights concerns that arise from these laws and (2) understand the ways in which British colonial-era patterns and practices have evolved and been maintained after independence. The report is based to a considerable extent on information learned during a research visit to India by several members of the Committee on International Human Rights. In conclusion, the report recommends that the Indian government maintain and build upon its recent efforts to prevent acts of terrorism and hold perpetrators accountable. The report also urges the Indian government to take steps to cooperate more fully with international institutions responsible for monitoring and implementing compliance with human rights standards. Letter to President Bush expressing concern over the arrest and imprisonment of Mikhail Trepashkin, a Russian lawyer. The letter questions whether

Mr. Trepashkin was arrested and imprisoned in an effort to discourage his work for a client on whose behalf he had been scheduled to appear in court to discuss controversial evidence suggesting possible government involvement in two Moscow bombings. Since his arrest, Mr. Trepashkin has been held in a facility with substandard conditions and has not been given appropriate care for existing physical conditions. The letter urges President Bush to raise Mr. Trepashkin's case with President Putin.

**International Human Rights/Lesbian, Gay, Bisexual and Transgender Rights**

Amicus Brief: *Colombia Diversa v. State of Colombia* (filed in the Constitutional Court of Colombia). The brief, filed with the facilitation of the Vance Center for International Justice Initiatives, argues that the definition of a domestic partnership in la Ley 54 de 1990 as existing between a man and woman is contrary to fundamental rights guaranteed by the Colombian Constitution and that the Colombian Constitution's guarantee of equality before the law, as well as Colombia's commitments embodied in the ratification of international human rights treaties, prohibit the exclusion of otherwise eligible same-sex couples from attaining domestic partnership rights.

**International Security Affairs**

The Prevention and Prosecution of Terrorist Acts: A Survey of Multilateral Instruments. This report surveys the conventions on terrorism, the treaties that require prosecution or extradition of suspected terrorists and those that require other anti-terrorism measures relating to financing and securing nuclear facilities. The report also looks at the anti-terrorism efforts in the U.N. context, and the potential contribution of the International Criminal Court and other international tribunals to the prosecution of suspected terrorists. Finally, the report describes the array of international measures relevant to preventing terrorist acquisition of weapons of mass destruction.

**International Trade**

The Ramifications of the Port Security Legislation on Trade and National Security, examines the provisions that should be incorporated into any port security legislation and frames them in the context of the applicable World Trade Organization agreements. The report also identifies the potential consequences any such legislation might have on foreign direct investment and national security and urges Congress to consider these factors when enacting any port security legislation.



**Judicial Selection, Task Force on**

Recommendations on the Selection of Judges and the Improvement of the Judicial Selection System in New York State. The report reiterates the City Bar's long-standing position in favor of a commission-based appointive system and sets forth a proposed amendment to Article 6 of the New York State Constitution to implement such a system. However, the report recognizes that a change to an appointive system could be complex and lengthy. So in the alternative the report recommends statutory reform of the current judicial convention system to redress the constitutional infirmities identified in *Lopez Torres* until the State Constitution is amended in favor of a commission-based appointive system. The report opposes the default solution of primary elections for Supreme Court, and also offers suggested changes that can be made to promote a more diverse pool of judicial candidates.

**Labor and Employment Law**

"Employment Law Handbook for Non-Lawyers." The handbook is designed to assist individuals who have legal questions about their rights in the workplace. It provides a brief introduction and addresses a number of questions and issues for those who feel they have a workplace problem that they can not resolve and believe they require outside intervention to solve.

**Lawyers Assistance Program/Professional Discipline**

A Proposal for Adoption of a Diversion Rule for Lesser Misconduct Related to Alcohol/Substance Abuse or Mental Health Condition. The report recommends that the Appellate Division, First Department, establish a diversionary program for lawyers suffering from alcohol or substance abuse or a mental health condition, and proposes a draft rule along with commentary. Offering diversion, treatment and monitoring for lesser misconduct related to a mental health condition or alcohol or substance abuse, the report argues, is consistent with the best interests of the profession and the public and is already in place in other jurisdictions.

**Legal Issues Pertaining to Animals**

Memorandum supporting New York City Council Resolution 497 which calls upon the New York City Department of Education to help increase compliance with Section 809 of the New York State Education Law. Section 809 requires instruction in New York City and State schools on the humane treatment and protection of animals.

Testimony at the New York City Department of Health & Mental Hygiene

hearing on November 1, 2006, expressing support for the Parks Department's policy of permitting off-leash exercise and socialization for dogs in designated parks within the City during specified limited hours. The Committee also supported amendments to Health Code Section 161.05, concerning vaccination and licensing of dogs, which would further strengthen the off-leash policy.

Report expressing opposition to H.R. 4239, the Animal Enterprise Terrorism Act (AETA), which would give the Department of Justice the authority to apprehend, prosecute and convict individuals committing animal enterprise terror. The report raises a number of concerns with the legislation including that: (i) AETA is vague and overbroad, and would likely have a chilling effect on the lawful exercise of First Amendment rights; (ii) AETA would punish conduct that causes no economic damage or injury; (iii) AETA appears to lack a rational basis for the conduct it purports to criminalize and may violate equal protection rights; and (iv) AETA's penalty provisions appear disproportionately harsh.

**Lesbian, Gay, Bisexual and Transgender Rights**

Letter to the New York City Department of Health and Mental Hygiene with regard to birth certificate regulations for transgendered individuals. The letter expressed support for the Department's goal of updating and amending Article 207 of the City's Public Health Code by eliminating the requirement that applicants undergo "convertive surgery" before they may obtain a new birth certificate. The amendment, the letter notes, would also assist transgender individuals by ensuring that their new birth certificates designate them as male or female rather than effacing their sex designation altogether, as is the current practice.

Report supporting S.1571/A.3496, which would amend the New York Education Law to prohibit harassment and discrimination against students in school based on actual or perceived race, color, national origin, ethnic group, religious practice, disability, sexual orientation, gender (including gender identity and expression) and sex.

**Military Affairs and Justice**

Testimony before the U.S. Senate urging that it act quickly, in light of the recent decision in *Hamdan v. Rumsfeld*, to establish an expert panel with a mandate to advise Congress and its committees about the appropriate means to establish a military commission system. The testimony points

out that legislation authorizing the panel's creation and the method of selecting its members would be relatively simple to draft, and once authorized, such a panel could begin its work without delay to provide immediate useful advice and drafting assistance to Congress.

Letter to Congress urging opposition to the administration's proposed Military Commissions Act of 2006 (the "Act"). The Act, the letter argues, does not follow the Supreme Court's recent ruling in *Hamdan* or the United States' obligations under the Geneva Conventions. Rather the Act undercuts the United States' role as the chief proponent of human rights and the rule of law around the world.

Letter to the Department of Defense requesting that the Department provide for a period of public comment on the draft Manual for Military Commissions before its final publication. Given the importance and the public interest in this matter such an opportunity, the letter notes, would only serve to enhance the public confidence in any trials which might be conducted in accordance with the Manual.

Letters to Congress and to Secretary of Defense Robert Gates expressing concern that Executive Branch officials and military personnel have made the representation of Guantanamo detainees difficult by: discouraging detainees from seeking and utilizing legal assistance; intimidating lawyers providing pro bono representation; interfering with the attorney-client relationship; and encouraging clients of the law firms who represent detainees to pressure the firms to drop these cases. The letter focuses on statements made by (former) Deputy Assistant Secretary of Defense for Detainee Affairs Stimson. The United States Supreme Court, the letter states, has made clear that those detained at Guantanamo are entitled to counsel and that the above actions by officials indicate a bias inconsistent with their responsibilities.

#### **Non-Profit Organizations**

Letter to the Attorney General's Office endorsing the Attorney General's Legislative Program Bill #63-05, which would amend New York's Executive Law regarding the solicitation of charitable contributions, and enhance the available enforcement actions to prevent fraudulent charitable solicitations.

Letter to the New York State Bar Association offering comments on its Business Law Section's proposal to revise the New York Not-for-Profit Corpo-

ration Law. Though the committee agrees that the Not-for-Profit Corporation Law warrants substantial revision, it does not agree with many of the proposed changes and modifications in the Business Law Section's proposal.

**Professional and Judicial Ethics**

Formal Opinion 2006-3 concludes that a lawyer may ethically outsource legal support services overseas to a non-lawyer if the lawyer: (a) rigorously supervises the non-lawyer, so as to avoid aiding the non-lawyer in the unauthorized practice of law and to ensure that the non-lawyer's work contributes to the lawyer's competent representation of the client; (b) preserves the client's confidences and secrets when outsourcing; (c) under the circumstances described in this Opinion, avoids conflicts of interest when outsourcing; (d) bills for outsourcing appropriately; and (e) under the circumstances described in this Opinion, obtains the client's informed advance consent to outsourcing.

Formal Opinion 2007-01 considers whether under DR 7-104(A)(1) (the No Contact Rule) counsel representing another party in a matter may communicate directly with an organization's in-house counsel, without the consent, knowledge, or participation of the organization's outside counsel. The opinion finds that DR 7-104(A)(1) does not prohibit a lawyer from communicating with an in-house counsel of a party known to be represented in that matter, so long as the lawyer seeking to make that communication has a reasonable, good-faith belief based on objective indicia that such an individual is serving as a lawyer for the entity.

Formal Opinion 2007-02 considers under what circumstances a law firm may "second" a lawyer to a host organization without subjecting the law firm to the imputation of conflicts under DR 5-105(D). The opinion finds that a law firm may second a lawyer to a host organization without subjecting the law firm to the imputation of conflicts under DR 5-105(D) if, during the secondment, the lawyer does not remain "associated" with the firm.

**Professional Responsibility**

"Comments on Proposed Rule 3.8 (Special Responsibilities of a Prosecutor) of the New York Lawyers Code of Professional Responsibility." This report considers and responds to comments made by several prosecutors' organizations on the text of the State Bar's Committee on Standards of Attorney Conduct (COSAC) proposed Rule 3.8, which outlines the special responsibilities of a prosecutor.

RECENT COMMITTEE REPORTS

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“Comments on the Proposed Ethics Rules Governing Lawyer Advertising and Solicitation Issued by the Presiding Justices of New York State’s Appellate Division.” Though the report supports many of the proposed rules, it notes that the proposal suffers from two major flaws. First, the proposed rules contain content-based restrictions that would impinge on a lawyer’s First Amendment right to engage in commercial speech, and would prevent consumers from obtaining truthful, non-misleading information about the availability of legal services that would be relevant to the consumers’ selection of a lawyer. Second, certain elements of the proposed rules would be unworkable as a practical matter or would create a tremendous burden on lawyers without any evidence that they would further the overall objectives of the rules.

Comments on the New York State Bar Association’s Proposed Amendments to the New York Code of Professional Responsibility Rules 1.11, 1.12, 2.1, 2.3, 2.4, 4.2, 4.3, 4.4, and 6.1 - 6.5.

Amicus Brief: *Muriel Siebert & Co., Inc. v. Intuit Inc.* filed with the New York State Court of Appeals. This case, the brief notes, requires the Court to determine whether a corporate “party” within the context of DR 7-104 includes a former employee who had access to attorney-client information about the matter in dispute. In an earlier decision the Court determined that former employees do not fall within the definition of “party” and therefore may be contacted by the opposing counsel without notice to the corporate party’s attorney. The brief urges the Court to follow the same reasoning in this case and not alter the bright line rule that has been in place for over 15 years.

**State Courts of Superior Jurisdiction**

Proposed model confidentiality agreement form and commentary. The model confidentiality agreement is meant to reduce the substantial expenditure of time and resources of both the court and of attorneys with regard to negotiating and drafting confidentiality agreements and to promote efficiency in these cases.

*Copies of the above reports are available to members at the Association’s website, [www.nybar.org](http://www.nybar.org), by calling (212) 382-6624, or by e-mail, at [gbrown@nybar.org](mailto:gbrown@nybar.org).*

# The Prevention and Prosecution of Terrorist Acts: A Survey of Multilateral Instruments

*The Committee on  
International Security Affairs*

**T**he events of September 11, 2001 are etched in Americans' minds. The large-scale attacks occurring on U.S. territory brought home the imperative of preventing terrorism here and abroad, especially in light of the risk that future attacks might be perpetrated with nuclear or other weapons of catastrophic effect. In the years since then, casualties from international terrorism have remained high, largely due to attacks in South Asia and the Middle East.<sup>1</sup>

This report demonstrates that a framework of treaty-based regimes and other international initiatives and programs plays a valuable role in preventing terrorism, and should be strengthened and supported. It is an essential part of a broader campaign that includes intelligence coordination, border security, domestic law enforcement and emergency preparedness.

First, the framework articulates and solidifies the norm that terrorism is a wholly impermissible form of political conduct. The importance

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1. HUMAN SECURITY REPORT: WAR AND PEACE IN THE 21<sup>ST</sup> CENTURY, Human Security Centre, University of British Columbia, Canada 43-44 (2005).



of entrenching this norm was well stated by Undersecretary of Defense Douglas Feith:

Our ultimate goal is to change the international environment regarding terrorism—instead of tolerance, [to] an international norm of renunciation and repudiation of terrorism. As I said, we want the world to view terrorism as it views piracy, slave trading or genocide—activities universally repudiated by respectable people. This is not an abstract, philosophical, academic point, but a strategic purpose of great practical significance.<sup>2</sup>

Second, the framework provides tools to prevent terrorists from acquiring weapons of mass destruction (WMD). Among the tools are treaties<sup>3</sup> banning WMD, programs to secure materials and weapons in Russia and elsewhere, and an initiative to prevent and interdict shipment of WMD-related items. The 9/11 Commission placed great emphasis on the need to succeed in this effort, stating that “al Qaeda has tried to acquire or make weapons of mass destruction for at least ten years. There is no doubt the United States would be a prime target. Preventing the proliferation of these weapons warrants a maximum effort ....”<sup>4</sup>

Third, the framework provides mechanisms to bring terrorists to justice, including treaties requiring the prosecution or extradition of persons alleged to have committed terrorist acts, and international tribunals.

There are of course problems in working through international institutions, laws, and initiatives. For example, treaties banning WMD may give rise to unwarranted complacency that certain states are in fact complying with the bans. The United Nations—or more accurately, the states

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2. U.S. Department of State, *Feith Says Terrorism Makes Palestinian State Less Likely*, April 26, 2002, available at <http://usinfo.state.gov/regional/nea/summit/text/0426fth.htm>.

3. Treaties are agreements among states that are respected as binding agreements under international law. Such agreements may also take the form of “conventions” (a term generally used to describe agreements open to all states or a large number of states) or “protocols” (a term generally used to describe amendments or additional agreements to existing treaties). The three are generally of equal international legal significance and all are required to be ratified as set forth in Article II of the U.S. Constitution. For a discussion of the various terms used to designate an international agreement see United Nations Treaty Collection, *Treaty Reference Guide*, available at <http://untreaty.un.org/English/guide.asp>. To the extent that an arrangement between or among states is not intended to be binding under international law, this is indicated in the discussion of the arrangement. Examples include export control regimes and the Proliferation Security Initiative.

4. THE 9/11 COMMISSION REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON TERRORIST ATTACKS UPON THE UNITED STATES 381 (U.S. Government Printing Office, 2004).

working through the UN—has been notoriously slow in arriving at a definition of terrorism. This report fully addresses these and other problems, concerns, and criticisms, indicating when they are justified and what can be done about it.

Part I of the report surveys the conventions on terrorism, the treaties that require prosecution or extradition of suspected terrorists and those that require other anti-terrorism measures relating to finance and to security of nuclear facilities. Part II addresses anti-terrorism efforts in the UN context, including the negotiation of a comprehensive convention on terrorism and the adoption of a Security Council resolution requiring all states to take measures to suppress and prevent terrorism. Part III discusses the potential contribution of the International Criminal Court and other international tribunals to the prosecution of suspected terrorists. Part IV describes the array of international measures relevant to preventing terrorist acquisition of WMD, including WMD treaties, a Security Council resolution, export control arrangements, programs to secure materials and weapons, and the initiative to prevent shipment of WMD-related items.

## I. CONVENTIONS ON TERRORISM

### (A) Treaties in Force

Twelve multilateral treaties relating to terrorism have entered into force in the last forty years. The United States is a party to all of them.<sup>5</sup>

#### (1) 1963 Tokyo Convention on Offenses and Certain Other Acts Committed on Board Aircraft<sup>6</sup>

This treaty does not define specific offenses; it broadly covers “(a) offences against penal law” and “(b) acts which, whether or not they are offences, may or do jeopardize the safety of the aircraft or of persons or property therein or which jeopardize good order and discipline on board.” The state of registration of the aircraft is deemed to have jurisdiction over these acts and must enact legislation or other measures to ensure its ability to prosecute. The Tokyo Convention *inter alia* provides authority for the commander of the aircraft to take necessary measures to protect the

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5. A list of the states that have signed, ratified or acceded to each of these treaties, along with reservations attached thereto is available from the United Nations Treaty Collection, <http://untreaty.un.org/English/Terrorism.asp>.

6. Convention on Offenses and Certain Other Acts Committed on Board Aircraft (“Tokyo Convention”), Sept. 14, 1963, 20 U.S.T. 2941, 704 U.N.T.S. 219.

aircraft and requires states to permit the aircraft to land and to take custody of the perpetrator when necessary.

Many of the acts that fall within the scope of this treaty are also addressed in more detail in the aviation-related treaties described below.

**(2) 1970 Hague Convention for the Suppression of Unlawful Seizure of Aircraft<sup>7</sup>**

This treaty covers the prosecution of individuals accused of committing hijackings using force, threat of force, or any other form of intimidation. It also covers accomplices and attempted hijackings. State parties agree to adopt legislation making these acts punishable by “severe penalties.” States are required to take measures to establish jurisdiction over acts committed in their territory and in aircraft registered to them. States must also take measures to establish jurisdiction over alleged offenders located in their territory and either prosecute or extradite them.

The Hague Convention improves on the Tokyo Convention by detailing specific unlawful acts and requiring prosecution or extradition and the administration of “severe penalties.”

**(3) 1971 Montreal Convention for the Suppression of Unlawful Acts Against the Safety of Civil Aviation<sup>8</sup>**

This treaty covers violent acts against persons on board that are likely to endanger flight safety, destruction of the aircraft, damage to the aircraft that is likely to endanger flight safety, and destruction or damage of air navigation facilities. It also covers accomplices and attempted acts. Like the 1970 Hague Convention, the Montreal Convention requires states to adopt severe penalties against these offenses and to take measures to exercise jurisdiction over acts committed in their territory and in aircraft registered to them. States must also take measures to establish jurisdiction over alleged offenders located in their territory and either prosecute or extradite them.

The distinction between the Hague and Montreal Conventions is that the Hague Convention is aimed at acts of hijackings, whereas the Montreal Convention covers bombings and other violent acts that are likely to cause an aircraft to crash.

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7. Convention for the Suppression of Unlawful Seizure of Aircraft (“Hague Convention”), Dec. 16, 1970, 22 U.S.T. 1641, 860 U.N.T.S. 105.

8. Convention for the Suppression of Unlawful Acts Against the Safety of Civil Aviation (“Montreal Convention”), Sept. 23, 1971, 24 U.S.T. 564, 1975 U.N.T.S. 177.

**(4) 1973 Convention on the Prevention and Punishment of Crimes Against Internationally Protected Persons, Including Diplomatic Agents<sup>9</sup>**

This treaty covers violent acts (such as assassination or other attacks) against heads of state and representatives of government and international organizations that are protected under international law. Attempted acts and accomplices are also covered. States are required to make the crimes punishable by appropriate penalties in relation to the gravity of the crime. States must take measures to establish jurisdiction over acts committed in their territory, by their nationals and when the victim is a protected person acting on behalf of the state. States must also establish jurisdiction over suspected offenders located in their territory and prosecute or extradite them.

**(5) 1979 Convention Against the Taking of Hostages<sup>10</sup>**

This treaty defines the offense of hostage-taking as “seiz[ing] or detain[ing] and threaten[ing] to kill, to injure or to continue to detain another person . . . in order to compel a third party . . . to do or abstain from doing any act as an explicit or implicit condition for the release of the hostage.” Attempted acts and accomplices are also covered. It requires states to make the crimes punishable by appropriate penalties given the gravity of the crime and to take measures to establish jurisdiction over offenses committed in their territory, by their nationals and, where appropriate, when hostages are their nationals. States must also establish jurisdiction over suspected offenders located in their territory and prosecute or extradite them.

**(6) 1980 Convention on the Physical Protection of Nuclear Material<sup>11</sup>**

This convention sets standards for the protection of nuclear material being used for peaceful purposes. It applies mainly to material in international transport. States agree that they will only export or import nuclear material if they are assured of certain physical protections as laid out by the convention. States are required to criminalize acts including the theft of nuclear material, fraudulent acquisition of nuclear material, acts with-

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9. Convention on the Prevention and Punishment of Crimes Against Internationally Protected Persons, Including Diplomatic Agents, Dec. 14, 1973, 28 U.S.T. 1975, 1035 U.N.T.S. 167.

10. International Convention Against the Taking of Hostages, Dec. 17, 1979, T.I.A.S. No. 11081, 1316 U.N.T.S. 206.

11. Convention on the Physical Protection of Nuclear Material, Oct. 26, 1979, T.I.A.S. No. 11,080, 1456 U.N.T.S. 124.

out lawful authority that constitute “the receipt, possession, use, transfer, alteration, disposal or dispersal of nuclear material and which cause[ ] or [are] likely to cause death or serious injury to any person or substantial damage to property,” and threats to use nuclear material to cause injury to any person or substantial damage to property. States must take measures to establish jurisdiction for offenses that occur in their territory or by their nationals. States must also establish jurisdiction over suspected offenders located in their territory and prosecute or extradite them.

On July 8, 2005, delegates from 89 countries agreed to fundamental changes that will substantially strengthen the Convention on the Physical Protection of Nuclear Material (CPPNM).

IAEA Director-General Mohamed ElBaradei welcomed the agreement, stating that: “This new and stronger treaty is an important step towards greater nuclear security by combating, preventing, and ultimately punishing those who would engage in nuclear theft, sabotage or even terrorism. It demonstrates that there is indeed a global commitment to remedy weaknesses in our nuclear security regime.”<sup>12</sup> The amended CPPNM requires states parties to protect nuclear facilities and material in peaceful domestic use, storage and transport. It will also provide for expanded cooperation among states regarding rapid measures to locate and recover stolen or smuggled nuclear material, mitigate any radiological consequences of sabotage, and prevent and combat related offenses. The new rules will come into effect once they have been ratified by two-thirds of the 112 states parties of the Convention, expected to take several years.

**(7) 1988 Protocol for the Suppression of Unlawful Acts of Violence at Airports Serving International Civil Aviation<sup>13</sup>**

This protocol extends the provisions of the 1971 Montreal Convention to acts of violence at airports serving international civil aviation.

**(8) 1988 Rome Convention for the Suppression of Unlawful Acts Against the Safety of Maritime Navigation<sup>14</sup>**

This convention was drafted largely in response to the 1985 *Achille*

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12. IAEA Press Release, July 8, 2005, available at <http://www.iaea.org/NewsCenter/PressReleases/2005/prn200503.html>.

13. Protocol on the Suppression of Unlawful Acts of Violence at Airports Serving International Civil Aviation, supplementary to the Convention for the Suppression of Unlawful Acts Against the Safety of Civil Aviation, Feb. 24, 1988, S. TREATY DOC. NO. 100-19 (1988), 1589 U.N.T.S. 474.

14. Convention for the Suppression of Unlawful Acts Against the Safety of Maritime Navigation, Mar. 10, 1988, S. TREATY DOC. NO. 101-1 (1989), 1678 U.N.T.S. 222.

*Lauro* hijacking to address terrorist acts aboard ships. Offenses under the treaty include seizure of control of a ship by threat or use of force; violent acts against persons on board a ship (passengers or crew) that are likely to endanger the safety of its navigation, destruction of a ship or damage likely to endanger the safety of its navigation and damage to maritime navigation facilities. It covers attempted acts and accomplices. It does not apply to ships used for military purposes. It requires states to take measures to establish jurisdiction over offenses committed in their territory, on ships flying their flag and by their nationals. States must also establish jurisdiction over suspected offenders located in their territory and prosecute or extradite them.

**(9) 1988 Protocol for the Suppression of Unlawful Acts Against the Safety of Fixed Platforms Located on the Continental Shelf<sup>15</sup>**

This protocol, which supplements the 1988 Rome Convention, creates a legal regime similar to that which applies to international aviation. This protocol provides for the prosecution of violent acts committed against fixed platforms located on the continental shelf, which are defined as structures attached to the sea bed for “exploration or exploitation of resources or for other economic purposes.”

**(10) 1991 Convention on the Marking of Plastic Explosives for the Purpose of Detection<sup>16</sup>**

This convention was drafted largely in response to the 1988 explosion of a Pan Am flight over Lockerbie, Scotland. Recognizing the role that plastic explosives have played in terrorist bombings, this convention requires states to mark plastic explosives with a detection agent that will enhance their detectability. States are required to take measures (which may be penal, but are not required to be) to prohibit and prevent the manufacture of unmarked plastic explosives in their territory. To the extent that states’ police or military retain unmarked plastic explosives, they must be marked, consumed or destroyed within fifteen years.

**(11) 1997 Convention for the Suppression of Terrorist Bombings<sup>17</sup>**

This convention defines the offense of terrorist bombings as deliver-

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15. Protocol for the Suppression of Unlawful Acts Against the Safety of Fixed Platforms Located on the Continental Shelf, Mar. 10, 1988, S. TREATY DOC. 101-1 (1989), 1678 U.N.T.S. 304.

16. Convention on the Marking of Plastic Explosives for the Purpose of Identification, Mar. 1, 1991, 30 I.L.M. 726 (entered into force June 21, 1998).

17. International Convention for the Suppression of Terrorist Bombings, Jan. 12, 1998, S. TREATY DOC. 106-6 (1999), 37 I.L.M. 251 (entered into force May 23, 2001).



ing, placing, discharging or detonating an explosive or other lethal device in, into or against a place of public use, a state or government facility, a public transportation system or an infrastructure facility with the intent to cause death or serious bodily injury; or cause extensive destruction where the destruction results in or is likely to result in major economic loss. States must adopt necessary legislation to make these acts criminal. States are required to take measures to establish jurisdiction for offenses committed in their territory and by their nationals and may establish jurisdiction in other instances, including offenses committed against their nationals and their government facilities. States must also establish jurisdiction over suspected offenders located in their territory and prosecute or extradite them.

**(12) 1999 Convention for the Suppression  
of the Financing of Terrorism<sup>18</sup>**

Noting that the number and seriousness of terrorist attacks depend on obtaining funding, this treaty criminalizes the financing of terrorism. The offense of financing of terrorism is defined as providing or collecting funds intended to be used to carry out: (a) an act which constitutes an offense under specified terrorism-related treaties (the treaties listed above, with the exception of the 1963 Tokyo Convention and the 1991 Convention on Plastic Explosives) or (b) “any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a Government or an international organization to do or to abstain from doing any act.”

It is notable that clause (b) of the definition of financing terrorism comes closer to defining “terrorism” than any provision contained in the other 11 treaties. The treaty requires states to adopt penal legislation to prosecute individual offenders and also to hold legal entities liable for offenses committed on their behalf. States are required to take appropriate measures for the identification, detection, and freezing or seizure of any funds used or allocated for financing terrorism, or that are proceeds from terrorism. States must take measures to establish jurisdiction for offenses committed in their territory and by their nationals. There are other instances for which a state may establish jurisdiction, including when an offense is directed toward a state’s territory or nationals. States must also

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18. International Convention for the Suppression of the Financing of Terrorism, Jan. 10, 2000, 39 I.L.M. 270 (entered into force April 10, 2002).

establish jurisdiction over suspected offenders located in their territory and prosecute or extradite them.

**(B) 2005 International Convention for the Suppression of Acts of Nuclear Terrorism**

A recent development in the network of anti-terrorism treaties was the adoption of a convention addressing terrorist acts using, threatening to use, or aiming to use nuclear weapons or radiological bombs or involving damage to a nuclear reactor or facility. It also encourages States to cooperate in preventing terrorist attacks by sharing information and assisting each other in connection with criminal investigations and extradition proceedings. On April 13, 2005, the General Assembly adopted the treaty, and it opened for signature on September 14. It will enter into force when ratified by 22 states. Under its provisions, alleged offenders must be either extradited or prosecuted. It excludes activities of armed forces during an armed conflict, while also providing that it does not address the issue of the legality of the use or threat of use of nuclear weapons by states.

**(C) Assessing the Anti-Terrorism Treaty Regime**

The value that most of these treaties bring to the fight against terrorism is that they require states to take action against terrorist acts or actors within their territories and to ensure that their legal systems, particularly their criminal codes, are equipped to address these crimes. There have been some successes associated with these treaties. For example, in 1986, John F. Murphy, an expert on international terrorism, noted a general decline in aircraft hijacking “due in part to the preventive techniques mandated by [the International Civil Aviation] conventions and now employed both in airports and aboard aircraft.”<sup>19</sup> Although the author observed that hijackings were on the rise again because hijackers were learning to avoid the security devices, he found that “[t]here is also ample evidence that hijackers have been submitted for prosecution either in the states where they have been found or in states to which they have been extradited. The [International Civil Aviation] conventions appear to have played a useful role in support of these prosecutions.”<sup>20</sup>

The treaties on terrorism, however, are limited in what they are able

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19. John F. Murphy, *The Future of Multilateralism and Efforts to Combat International Terrorism*, 25 Colum. J. Transnat'l L. 35, 45 (1986).

20. *Id.*

to accomplish. They largely focus on prosecution, not prevention.<sup>21</sup> Due to their *ad hoc* nature, there are gaps in what they cover. For example, they do not extend to assassinations of non-official professionals such as businessmen and journalists and do not specifically criminalize attacks against water supplies, public buses or trains.<sup>22</sup> Most are far from universal, meaning that many states have not adopted them. They do not create any regulatory bodies to monitor implementation or ensure states' compliance. No sanctions exist for states parties that refuse to extradite or prosecute terrorists or that harbor terrorists. Several of the treaties are weakened by failure to reach acts that are committed solely within one state's territory and are inconsistent as to whether they permit refusal of extradition of suspects based on grounds of political acts.<sup>23</sup> The following discussion details some of the attempts being made to address gaps in this treaty system.

Since the September 11, 2001 terrorist attacks, progress has been made on the goal of universal ratification of the anti-terrorism treaties. In September 2001, the Security Council passed Resolution 1373, which requires states to take a series of actions to combat terrorism (discussed below).<sup>24</sup> It also calls upon states to become parties to the twelve international terrorism conventions and to increase cooperation in the fight against terrorism. The Counter-Terrorism Committee (CTC), the committee created to monitor implementation of Resolution 1373, is contributing to states' efforts to become parties to all twelve instruments. The CTC has been identifying those states that need assistance with the ratification process and working to ensure such states receive help from appropriate assistance providers. Prior to Resolution 1373, only a few states had ratified all 12 anti-terrorism conventions. After two years, over 40 states had done so.<sup>25</sup>

Efforts to improve the treaty regime continue within the United Na-

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21. Jennifer Trahan, *Terrorism Conventions: Existing Gaps and Different Approaches*, 8 *NEW ENG. INT'L & COMP. L. ANN.* 215, 222-25 (2002).

22. See Michael P. Scharf, *Defining Terrorism As the Peace Time Equivalent of War Crimes: A Case of Too Much Convergence Between International Humanitarian Law and International Criminal Law?*, 7 *ILSA J. INT'L & COMP. L.* 391, 393 (2001), *cited in* Trahan, *supra* note 21 at n. 19.

23. Trahan, *supra* note 21 at 225-26; 229-30.

24. S.C. Res. 1373, U.N. SCOR, 57<sup>th</sup> Sess. 4385<sup>th</sup> mtg., U.N. Doc. S/Res/1373 (2001).

25. *Fight against Terrorism Would be long with No Short Cuts, Counter-Terrorism Committee Chairman Tells Security Council*, UN Press Release, Security Council, 4792<sup>nd</sup> mtg., U.N. Doc SC/7823 (2003).

tions, with the General Assembly continuing to negotiate a comprehensive convention on terrorism—including a definition of terrorism—and the Security Council passing resolutions aimed at strengthening member states’ anti-terrorism laws. These are discussed below.

## II. UNITED NATIONS ACTIVITIES ON TERRORISM

### (A) The Efforts to Create a Comprehensive Terrorism Convention

As noted above, because most of the terrorism-related treaties were drafted in response to highly visible terrorist acts, they address only specific acts of terrorism and neglect others. A comprehensive terrorism convention would end this piecemeal response. In his survey of terrorism-related treaties, *International Terrorism: Multilateral Conventions and Documents*, international law scholar M. Cherif Bassiouni observed:

A comprehensive convention which combines all existing conventions pertaining to terrorism into a single updated text would significantly advance the overall objectives of these conventions. Such a comprehensive text would contribute to the elimination of overlaps, gaps and ambiguities which currently exist in the [existing] conventions. It would also eliminate the need to consult multiple legal sources in order to enforce State Party obligations. If this piecemeal subject-matter approach trend continues, there is no end to the number of conventions likely to be developed over the years to come, and there is no hope to make the legal mechanisms contained within each convention more effective.<sup>26</sup>

International terrorism scholar John F. Murphy also concluded that a global convention to “define international terrorism, make it an international crime, subject all state parties to the ‘extradite or prosecute’ formula and provide for other forms of cooperation” would be ideal.<sup>27</sup>

Since 1996, an *ad hoc* committee created by the United Nations General Assembly (“GA”) in 1996 and open to all UN members has been negotiating a draft comprehensive convention on terrorism. As elaborated by the *ad hoc* committee, the comprehensive convention would define terrorism and require states to criminalize terrorist acts and take measures to

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26. INTERNATIONAL TERRORISM: MULTILATERAL CONVENTIONS AND DOCUMENTS 7 (M. Cherif Bassiouni, ed., 2001).

27. Murphy, *supra* note 19 at 92.

establish jurisdiction over terrorist acts.<sup>28</sup> Two main issues have stalled completion of the draft: (1) whether acts committed by persons engaged in the struggle against “foreign occupation” (e.g., Palestinian attacks in Israel) should be considered acts of terrorism, and (2) whether the acts of states’ armed forces, which are already subject to the law of armed conflict during wartime, should be covered by this convention, i.e., whether acts committed by armed forces may be treated as terrorist acts under this convention.<sup>29</sup>

### (B) The Definition of Terrorism

The debate over the definition of terrorism, particularly whether the definition of terrorism should exclude resistance against foreign occupation, reflects the often-heard adage that one state’s terrorist is another state’s freedom fighter. It is a tension that has existed since the UN’s first attempts at addressing terrorism in the early 1970s.<sup>30</sup> At that time, there was a larger degree of tolerance for the position that politically motivated acts, particularly those committed in resistance to foreign occupation, did not constitute terrorism. As Professor Malvina Halberstam observes, this was demonstrated in a 1972 General Assembly (GA) resolution relating to terrorism that established an *Ad Hoc* Committee on Terrorism but at the same time “reaffirm[ed] the inalienable right to self-determination and independence of all peoples under colonial and racist regimes and other forms of alien domination and uph[eld] the legitimacy of their struggle, in particular the struggle of national liberation movements.”<sup>31</sup>

28. See *Report of the Ad Hoc Committee established by General Assembly Resolution 5/210 of 17 December 1996*, U.N. GAOR, 57<sup>th</sup> Sess., Supp. No. 37, Annexes I-III, U.N. Doc. A/57/37 (2002).

29. See *Measures to eliminate international terrorism: Report of the Working Group*, U.N. GAOR 6<sup>th</sup> Comm., 59<sup>th</sup> Sess., Annex, Agenda Item 148, p. 4, U.N. Doc. A/C.6/59/L.10 (2004). See also Jim Wurst, *U.N. Deadlock Continues on Two Terrorism Treaties*, U.N. WIRE, Dec. 10, 2003; Jim Wurst, *Negotiations on Anti-Terrorism Treaties Yield No Progress*, U.N. WIRE, February 4, 2002. Like the definition of terrorism, this issue of whether armed forces should be covered is closely related to the Israeli-Palestinian conflict. The Organization of the Islamic Conference has urged that any exclusion from the treaty’s provisions for the actions of armed forces should also cover situations of foreign occupation.

30. The goal of achieving a universal definition of terrorism dates back to the League of Nations. The Convention for the Prevention and Punishment of Terrorism included a definition of terrorism, but the treaty never entered into force. See Alex Schmidt, *War Crimes Research Symposium: “Terrorism on Trial”: Terrorism—The Definitional Problem*, 37 CASE W. RES. J. INT’L L. 375, 385 (2005). The UN resumed the attempt to reach a definition after the terrorist attacks at the 1972 Munich Olympics. *Id.* at 386.

31. See G.A. Res. 27/3034, U.N. GAOR, 27<sup>th</sup> Sess., Supp. No. 30, at 119, U.N. Doc. A/RES/

That resolution did not even condemn terrorism, and it was not until 1985 that the GA passed a resolution unequivocally condemning “as criminal, all acts, methods and practices of terrorism wherever and by whomever committed.”<sup>32</sup>

In 2005, efforts to reach a definition on terrorism were re-energized as part of the UN reform process leading to a 2005 summit of world leaders. The Secretary-General and a panel of high-level experts convened for the purpose of making recommendations on global security challenges both urged that a definition of terrorism be included in the Summit outcome.<sup>33</sup> Negotiations were not successful in reaching an agreement on a definition of terrorism. Instead, the 2005 Summit Outcome Document “condemned terrorism in all its forms” and stressed “the need to make every effort to reach an agreement on and conclude a comprehensive convention on international terrorism during the sixtieth session of the General Assembly.”<sup>34</sup>

The Security Council, especially since the September 11 attacks, has also condemned terrorism on numerous occasions and worked towards a definition as well. In 2004, Security Council Resolution 1566 stated that “criminal acts, including against civilians, committed with the intent to cause death or serious bodily injury, or taking hostages, with the purpose to provoke a state of terror in the general public or in a group of persons or particular persons, intimidate a population or compel a government or an international organization to do or to abstain from doing any act, which constitute offences within the scope of and as defined in the international conventions and protocols relating to terrorism, are under no circumstances justifiable by considerations of a political, philosophical, ideological, racial, ethnic, religious or other similar nature ....”<sup>35</sup>

While the General Assembly and the Security Council have condemned terrorism regardless of its motives, there are many member states that oppose

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27/3034 (1972), cited in Malvina Halberstam, *The Evolution of the United Nations Position on Terrorism: From Exempting National Liberation Movements to Criminalizing Terrorism Wherever and by Whomever Committed*, 41 COLUM. J. TRANSNAT'L L. 573, 574 (2003).

32. G.A. Res. 40/61, U.N. GAOR, 40th Sess., 108th plen. mtg., para. 1, U.N. Doc A/RES/40/61 (1985), cited in Halberstam, *supra* note 31 at 575.

33. See, e.g., In Larger Freedom: Toward Development, Security and Human Rights for All, Report of the Secretary-General ¶ 91 (United Nations 2005); Stephen Stedman, A More Secure World: Our Shared Responsibility, Report of the High-Level Panel on Threats, Challenges and Change ¶ 163 (United Nations 2004).

34. World Summit Outcome, ¶¶ 81, 83.

35. S.C. Res. 1566, U.N. SCOR, 59th Sess., 5053<sup>rd</sup> mtg., U.N. Doc. S/Res/1566 (2005).

this construct of terrorism as unfairly imposed by powerful states and in ignorance of the types of “terrorism” that powerful states wage on repressed states. Libya raised this issue in the 2001 General Assembly debates, speaking on behalf of the Arab Group:

We cannot condemn terrorism and fight it when it hits one country and turn a blind eye when it hits other countries. It is unacceptable to label as terrorism the struggle of peoples to protect themselves or to attain their independence, while at the same time ignoring real terrorism and its many faces—such as occupation...<sup>36</sup>

It is this fundamental disagreement that poses a serious obstacle to achieving a definition.<sup>37</sup> Nevertheless, progress has been made since 9/11 to develop a system to improve states’ capacity to prevent and prosecute terrorist acts, particularly through rules imposed by the Security Council.

### **(C) Security Council Resolutions**

#### **(1) Pre-9/11**

The Security Council is uniquely qualified to respond to terrorism and to require states to take measures addressing terrorism. Under Chapter VII of the UN Charter, once the Security Council determines the existence of a threat to international peace and security—and the Council has determined that acts of international terrorism do constitute such a threat<sup>38</sup>—states are required to comply with the measures that the Security Council determines are appropriate to meet this threat. In addition to condemning certain specific acts of terrorism, the Security Council has passed a number of resolutions aimed at denying certain individuals and groups the means to carry out terrorist acts and requiring states to take action against such individuals and groups. For example, Resolution 1267 called for Afghanistan’s Taliban regime to stop providing sanctuary and training for international terrorists and to cooperate with efforts to bring in-

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36. Calls for Resolute Action Against Terrorism Tempered in Assembly by Appeals for Caution in Identifying ‘Enemy,’ U.N. GAOR, 56th Sess., 49th plen. mtg. U.N. Doc. GA/9962 (2001), cited in Aaron J. Noteboom, *Terrorism, I Know It When I See It*, 81 *OR. L. REV.* 553, 565 (2002).

37. Cf. Nicholas Rostow, *Before and After: The Changed UN Response to Terrorism Since September 11<sup>th</sup>*, 35 *CORNELL INT’L L.J.* 475, 489 (2002), arguing that it is unlikely consensus will be achieved until the conflicts in the Middle East and over Kashmir are resolved.

38. See, e.g., S.C. Res. 1373.

dicted terrorists to justice.<sup>39</sup> Resolution 1267 ordered the Taliban to turn over Osama bin Laden to authorities in a state where he had been indicted, such as the United States, or to another state where he would be arrested and prosecuted. It banned flights to Afghanistan, directed states to freeze funds that related to properties owned by the Taliban, and created a committee to oversee implementation of these sanctions. These measures were augmented by Resolution 1333 of December 2000, which included sanctions against the sale of military equipment to the Taliban.<sup>40</sup>

The sanctions regime created under Resolution 1267 has continued to function following the overthrow of the Taliban, by targeting specific individuals and entities for sanctions regardless of their physical whereabouts. All states are required to freeze the assets, prevent transit through their territory, and prevent the supply of arms and military equipment to individuals and entities designated by a Security Council committee established for this purpose (the “1267 Committee”).<sup>41</sup> The 1267 Committee, comprised of all Security Council members, maintains and updates the list of Taliban or Al Qaeda-related individuals and entities that are subject to sanctions, and monitors state compliance with these sanctions.

## **(2) Post-9/11**

The September 11, 2001 terrorist attacks brought a new level of urgency to the issue of terrorism in the United States and the United Nations. The UN Security Council responded to the September 11 attacks in Resolution 1368, passed the following day. The Security Council has the authority to take actions including authorizing use of military force to respond to threats to peace and security, and Resolution 1368 noted the Security Council’s “readiness to take all necessary steps” to respond to the attacks. The resolution also recognized “the inherent right of individual or collective self-defence in accordance with the [UN] Charter,” thus reaffirming the principle articulated in UN Charter Article 51 that “[n]othing in the...Charter shall impair the inherent right of individual or collective self-defence if an armed attack occurs against a Member of the United Nations, until the Security Council has taken measures necessary to maintain international peace and security.” When the United States invaded Afghanistan in its search for the perpetrators of the 9/11 attacks, it did not request authorization from the Security Council. This decision was gener-

39. S.C. Res. 1267, U.N. SCOR, 54<sup>th</sup> Sess., 4051<sup>st</sup> mtg., U.N. Doc. S/Res/1267 (1999).

40. S.C. Res. 1333, U.N. SCOR, 55<sup>th</sup> Sess., 4251<sup>st</sup> mtg., U.N. Doc. S/Res/1333 (2000).

41. S.C. Resolutions 1267 (1999), 1333 (2000), 1390 (2002), 1455 (2003).



ally accepted as consistent with this right to self-defense and the terms of Resolution 1368.

The most far-reaching Security Council response to the 9/11 terrorist attacks was adopted on September 28, 2001 at the behest of the United States. Resolution 1373 *requires* all states to take a series of actions: criminalize the act of providing or collecting funds to be used to carry out terrorist attacks; freeze all funds of individuals or entities with ties to terrorist activities; refrain from supporting entities or persons involved with terrorism, including the elimination of the supply of weapons to terrorists; and deny terrorists safe haven and ensure their prosecution. As described by John Negroponte, the U.S. Ambassador to the United Nations at the time the resolution passed, Resolution 1373 “generat[ed] a worldwide juridical transformation.”<sup>42</sup> Unlike the twelve terrorism conventions, which are only binding on states that ratify them, Resolution 1373, as a decision of the Security Council, binds all states.<sup>43</sup>

As a result, all states, regardless of whether they had consented to do so in any of the terrorism treaties, are by virtue of Resolution 1373 obligated “to prevent and suppress terrorist attacks and take action against perpetrators of such attacks” and to transform their national legislation to criminalize terrorist financing. The obligations set forth in Resolution 1373 are of unlimited duration and can only be terminated by a subsequent Security Council resolution.<sup>44</sup> As described by one international legal scholar, with Resolution 1373, “the United Nations Security Council broke new ground by using, for the first time, its Chapter VII powers under the Charter to order all states to take or to refrain from specified actions in a context not limited to disciplining a particular country.”<sup>45</sup>

Resolution 1373 ushered in a new era for the Security Council acting as global lawmaking body. In April 2004, the Security Council passed Resolution 1540, which requires states to adopt laws and other control measures to prevent the acquisition of weapons of mass destruction by non-state actors, discussed in Part V.<sup>46</sup> Like Resolution 1373, it establishes a sub-

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42. ‘We Must Not Fall Into Complacency’ in Fight Against Terrorism, Prime Minister of Spain Tells Council, United Nations Press Release, Security Council, 4752<sup>nd</sup> mtg., U.N. Doc. SC/7754 (2003).

43. UN Charter, Art. 25 requires all UN Members to “agree to accept and carry out the decision of the Security Council in accordance with the present Charter.”

44. Ilias Bantekas, *The International Law of Terrorist Financing*, 97 AM. J. INT’L L. 315, 326 (2003).

45. Paul Szasz, *The Security Council Starts Legislating*, 96 AM. J. INT’L L. 901, 901 (2002).

46. S.C. Res. 1540, U.N. SCOR, 58<sup>th</sup> Sess., 4956<sup>th</sup> mtg., U.N. Doc. S/Res/1540 (2004).

committee to monitor state implementation. Security Council Resolution 1566 sets forth a definition of terrorism (without labeling it as such) and called on all states to “ensure that such acts are punished by penalties consistent with their grave nature.”<sup>47</sup> Most recently, Resolution 1624, passed by a Security Council meeting of heads of state during the September 2005 Summit, creates a legal prohibition on incitement to commit terrorist acts.<sup>48</sup>

#### **(D) The Counter-Terrorism Committee**

##### **(1) Functions of the CTC**

Resolution 1373 called for the creation of the CTC, composed of all Security Council member states, to monitor the implementation of its measures and increase states’ capabilities to fight terrorism. States are required to report to the CTC on the measures they have taken to implement the Resolution. These reports form the basis of the CTC’s work; experts employed by the CTC review the reports and ask follow-up questions to be answered by states in additional reports.<sup>49</sup> The CTC received initial reports from all 191 countries.

The CTC’s assessment of states’ capabilities is separated into three stages. The first stage is to ensure that states have the necessary legislation in place to address all aspects of Resolution 1373, with a particular focus on combating the financing of terrorism.<sup>50</sup> The CTC recognized that legislation is a “key issue because without an effective legislative framework States cannot develop executive machinery to prevent and suppress terrorism, or bring terrorists and their supporters to justice.”<sup>51</sup> The second stage focuses on improving states’ executive machinery to best implement counter-terrorism legislation, for example, ensuring that states have in place effective intelligence and police to monitor and apprehend those

47. S.C. Res. 1566, U.N. SCOR, 59<sup>th</sup> Sess., 5053<sup>rd</sup> mtg., U.N. Doc. S/Res/1566 (2004).

48. S.C. Res. 1624, U.N. SCOR, 60<sup>th</sup> Sess., 5261<sup>st</sup> mtg., U.N. Doc. S/Res/1624 (2005).

49. For a discussion of the reporting process, see Rostow, *supra* note 37 at 483-484 (2002); see also the website of the CTC at <http://www.un.org/Docs/sc/committees/1373/work.html> at 335-336.

50. With respect to financing of terrorism, which is a principal target of Resolution 1373, this first stage goes beyond examining legislation and has already begun looking into states’ executive machinery to prevent and suppress financing of terrorism. See Rosand *infra* note 52 at 336.

51. See *About the CTC: Setting Priorities*, available at <http://www.un.org/Docs/sc/committees/1373/priorities.html>. The CTC maintains a website containing the status of states’ reports and other key documents. See <http://www.un.org/Docs/sc/committees/1373/>.

involved in terrorist activities. The third stage focuses on “the implementation of the above legislation and executive machinery to bring terrorists and their supporters to justice.”<sup>52</sup> Measures may include cooperation on the exchange of information and judicial cooperation to prosecute terrorists.

The CTC is not itself able to provide assistance to improve states’ anti-terrorism capabilities. It works as a switchboard to connect assistance providers with states seeking assistance. One tool offered by the CTC is its database, the CTC Directory of Counter-Terrorism Information and Sources of Assistance, which offers information on standards, best practices and sources of assistance in the area of counter-terrorism.<sup>53</sup> The CTC also maintains a “Matrix of Assistance Requests” that provides an overview of assistance needs, and information on assistance programs.<sup>54</sup>

## **(2) Revitalizing the CTC**

The early assessment of the CTC was that it was helping to build the political will to combat terrorism but that it lacked the infrastructure to sustain itself. On the positive side, as noted above, it significantly increased membership in the 12 anti-terrorism conventions. Reports to the CTC revealed that a large number of states did not have any legislation tailored to counter terrorism and are now revising their laws. However, the political will to implement this resolution has faded. Three years after the adoption of Resolution 1373, 78 states had failed to meet their latest reporting requirements.<sup>55</sup>

A January 2004 report of the Chair of the Counter-Terrorism Committee highlighted the problems in implementing Resolution 1373 and in particular the difficulties of the CTC’s role. The report determined, among other things, that the CTC needed to play a more proactive role in assessing states’ needs, needed to better monitor provision of assistance, including with field missions, and needed greater coordination and cooperation with regional, subregional and international organizations.<sup>56</sup> The

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52. Eric Rosand, *Security Council Resolution 1373, the Counter-Terrorism Committee and the Fight Against Terrorism*, 97 AM. J. INT. L. 333, 336 (2003).

53. See *Directory of Counter-Terrorism Information and Sources of Assistance*. Available at [http://www.un.org/Docs/sc/committees/1373/ctc\\_da/index.html](http://www.un.org/Docs/sc/committees/1373/ctc_da/index.html).

54. The Matrix of Assistance Requests is available at [http://www.un.org/Docs/sc/committees/1373/ctc\\_da/matrix.html](http://www.un.org/Docs/sc/committees/1373/ctc_da/matrix.html).

55. UN Press Release, SC/8221, October 19, 2004.

56. UN Doc. S/2004/70. Report by the Chair of the Counter Terrorism Committee on the problems encountered in the implementation of Security Council Resolution 1373 (2001).

Counter-Terrorism Committee then submitted a proposal for changes to the CTC's structure.<sup>57</sup>

In March 2004, the Security Council endorsed the CTC's reform proposals and unanimously adopted a "reform plan" in Resolution 1535.<sup>58</sup> It is described as "revitalizing" the CTC to strengthen its ability to help states implement their obligations under Resolution 1373.<sup>59</sup> The Committee was restructured to contain an Executive Directorate (hereinafter "CTED"), meaning that the Committee now has a full-time staff of professionals working on its agenda. It was declared operational in December 2005.<sup>60</sup> The CTED is committed to facilitating state assistance and developing a set of best practices for state implementation of counter-terrorism efforts. The CTC has also adopted guidelines and procedures for conducting visits to member states, so as to better monitor implementation of Resolution 1373 and to identify more effectively the technical assistance needs of states.<sup>61</sup> The absence of such procedures had been considered a major impediment to the effectiveness of the Committee.

### **(3) Assessing the CTC**

Even with its revitalization, there are limits as to what the CTC may accomplish. It is a reporting body, not a sanctions body. It is aimed at long-term and cooperative efforts, not challenging states' violations. It is therefore better suited to address states that are willing but unable to improve their national capabilities to fight terrorism than those states that are unwilling to fight terrorism. The CTC may report issues of non-compliance to the Security Council, which must then decide what tools it should bring to bear against states that fail to properly implement the terms of Resolution 1373.

The fact that Resolution 1373 does not include a definition of terrorism had left some ambiguities as to what acts states' legislation must cover. Resolution 1566 clarified this ambiguity with the inclusion of a definition of terrorist acts that states must take measures to prevent and prosecute.

The fundamental limitation of the CTC is that it depends on the

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57. UN Doc S/2004/124. Proposal for the Revitalization of the Counter-Terrorism Committee.

58. S.C. Res. 1535, U.N. SCOR, 58<sup>th</sup> Sess., 4936<sup>th</sup> mtg., U.N. Doc. S/Res/1535 (2004).

59. See UN Press Release SC/8041.

60. See UN Security Council Presidential Statement, U.N. Doc. S/PRST/2005/64 (2005).

61. See <http://www.un.org/Docs/sc/committees/1373/procedures.doc> and <http://www.un.org/Docs/sc/committees/1373/guidelines.doc>.

political will of its member states. States must be willing to maintain their commitments and use these tools to prevent terrorist acts and apprehend suspected terrorists. Despite its limitations, the CTC nevertheless has an important role to play in strengthening states' capacities to combat terrorism. The exchange of information between state governments and the CTC has generated an unprecedented amount of data on counter-terrorism capacities and practices. The Committee is best-positioned to coordinate the delivery of technical assistance by international and regional organizations and donor states to those requesting it. As the demand for assistance continues to increase, the CTC's function in this regard will become increasingly important.<sup>62</sup> The Committee is also best-positioned to improve coordination and cooperation among the many international and regional bodies concerned with counter-terrorism. Improving performance in these areas will allow the CTC to fulfill its mandate more effectively.<sup>63</sup>

Another important challenge for the United Nations is ensuring that states respect human rights in preventing and suppressing terrorism. The question of how to strike the right balance between protection of human rights and anti-terrorism efforts of terrorism is beyond the scope of this report. It is noteworthy, however, that the actions taken at the UN immediately after 9/11 did not affirm human rights norms in the context of combating terrorism while more recent UN initiatives to counter terrorism now incorporate human rights language.

Resolution 1373, for example, was criticized for failing to refer to states' duties to respect human rights in the fight against terrorism and the lack of a mandate for the CTC to consider human rights implications of counter-terror efforts.<sup>64</sup> The Security Council subsequently began to in-

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62. David Cortright et. al., *An Action Agenda for Enhancing the United Nations Program on Counter-Terrorism*, at 12 (2004), available at [http://www.ctproject.info/html/report\\_1.html](http://www.ctproject.info/html/report_1.html).

63. *Id.* at 14-21.

64. See written statement submitted by Amnesty International, Economic and Social Council, Commission on Human Rights, 59<sup>th</sup> Sess., Provisional Agenda Item 11, UN Doc. E/CN.4/2003/NGO/183 available at [http://www.unhcr.ch/Huridocda/Huridoca.nsf/e06a5300f90fa0238025668700518ca4/846e64533954171ec1256d03005ac56f/\\$FILE/G0311872.pdf](http://www.unhcr.ch/Huridocda/Huridoca.nsf/e06a5300f90fa0238025668700518ca4/846e64533954171ec1256d03005ac56f/$FILE/G0311872.pdf); See also Sergio Vieira de Mello, The High Commission for Human Rights, Address before the Counter-Terrorism Committee of the Security Council (Oct. 21, 2002) available at <http://www.un.org/Docs/sc/committees/1373/HC.htm>. For analysis of the controversial Security Council practice pursuant to Resolution 1267 and later resolutions of naming individual "terrorists" whose financial assets are frozen absent a quasi-judicial procedure for affected persons to challenge the action, see Jose E. Alvarez, *The Security Council's War on Terrorism: Problems and Policy Options*, in Erica De Wet and André Nollkaemper, eds., *Review of the Security Council by Member States 119-145* (2003).

corporate normative expressions that human rights be respected in the context of combating terrorism. Security Council Resolutions 1456, 1535 and 1624 require states to “ensure that any measures to combat terrorism comply with all their obligations under international law, and [to] adopt such measures in accordance with international law, in particular international human rights, refugee, and humanitarian law.” The World Summit Outcome included a similar statement.<sup>65</sup> The Counter-terrorism Executive Directorate also now includes a human rights expert.

### III. INTERNATIONAL TRIBUNALS TO PROSECUTE TERRORIST ACTS

Many of the terrorism-related treaties described above are aimed at strengthening states’ legal systems to improve their ability to bring terrorists to justice in a national legal system. But there may be incidents where a compelling interest exists for the prosecution of terrorists in an international forum, for example, when a large-scale terrorist attack directly affects a number of states or implicates citizens from a number of countries. For those crimes, there are several possible international tribunals where prosecutions could take place.

#### (A) The International Criminal Court

On July 1, 2002, the International Criminal Court (ICC) came into existence.<sup>66</sup> It was created by a treaty, the Rome Statute of the International Criminal Court, that has been ratified by over 100 states,<sup>67</sup> and is the world’s first permanent court empowered to prosecute individuals. The ICC is distinct from the International Court of Justice, the principal judicial organ of the UN, which handles disputes among *states*. The ICC has jurisdiction over crimes against humanity, war crimes and genocide, as well as aggression if and when agreement is reached upon its definition.<sup>68</sup> As a precondition for jurisdiction, crimes must be a) committed on the territory of a state party (or a state that has provided consent to the court’s jurisdiction); b) committed by a citizen of a state party (or a state

65. World Summit Outcome, *supra* note 34, at ¶ 85.

66. Rome Statute of the International Criminal Court, July 17, 1998, 37 I.L.M. 999 (entered into force July 1, 2002).

67. Ratification status as of December 2004. The ratification status may be found on the website of the Coalition for the International Criminal Court at <http://www.iccnw.org>.

68. The ICC will also have jurisdiction over the crime of aggression, once the state parties agree to a definition of the crime.

that has provided consent to the court's jurisdiction); or c) referred to the ICC by the UN Security Council. The ICC provides complementary jurisdiction to national courts. That is, the court will act only in cases where the relevant state is either unwilling or unable to exercise jurisdiction.

Acts of terrorism are not crimes *per se* under the ICC statute,<sup>69</sup> but large-scale terrorist attacks of the type and magnitude that occurred on September 11, 2001 would likely fall within the definition of crimes against humanity, which are covered under the ICC statute.<sup>70</sup> The possibility of the ICC trying terrorist acts has been confirmed by the ICC's chief prosecutor Luis Moreno Ocampo. Mr. Ocampo noted that the court's jurisdiction would cover acts on the scale of the 9/11 attacks, provided that the acts satisfy the preconditions for the ICC's jurisdiction (stated above).<sup>71</sup> The 9/11 attacks themselves may not be brought before the ICC because they took place before the ICC statute came into effect on July 2, 2002.

Currently, the United States is actively opposed to the ICC and does not endorse the use of the ICC to prosecute terrorists. The primary objection to the ICC is the fear that it will be used for politically-motivated prosecutions against American soldiers or politicians.<sup>72</sup> Proponents of the court deny that this is a credible risk, arguing that there are sufficient safeguards in place to prevent politically motivated prosecutions.<sup>73</sup>

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69. In the early stages of drafting the ICC statute, the drafters considered including the crime of terrorism. Its inclusion was ultimately rejected, due to political difficulties, including reaching an agreement on a definition. See, e.g., *Final Act of the United Nations Diplomatic Conference of Plenipotentiaries on the Establishment of an International Criminal Court Done at Rome on 17 July 1998*, U.N. Doc. A/CONF.183/10, Annex I, Resolution E; see David Scheffer, *Staying the Course with the International Criminal Court*, 35 *Cornell Int. L. J.* 47, n. 7 (2001-2002).

70. See Article 7 of the Rome Statute for the ICC's definition of crimes against humanity. For support of the argument that terrorist acts may constitute crimes against humanity, see Richard J. Goldstone & Janine Simpson, *Evaluating the Role of the International Criminal Court as a Legal Response to Terrorism*, 16 *Harv. Hum. Rts. J.* 13, 15 (2003); see also Scheffer, *supra* note 69.

71. James Podgers, *An Unused Weapon: International Criminal Court Could Play Role in War Against Terrorism Says New Chief Prosecutor*, ABA Journal eReport, September 19, 2003, available at <http://www.abajournal.com/ereport.html>.

72. See, e.g., Marc Grossman, U.S. State Department Under Secretary for Political Affairs, Remarks to Center for Strategic and International Studies (May 6, 2002), available at <http://www.amicc.org/docs/Grossman.pdf>.

73. See, e.g., Allison Marston Danner, *Navigating Law and Politics: The Prosecutor of the International Criminal Court and the Independent Counsel*, 55 *Stan. L. Rev.* 1633, 1646-47, 1655 (2003); Remigius Chibueze, *United States Objection to the International Criminal Court: A Paradox of "Operation Enduring Freedom,"* 9 *Ann. Surv. Int'l & Comp. L.* 19, 36-46 (2003).

President Clinton signed the Rome Statute, but simultaneously noted that he did not intend to seek its ratification.<sup>74</sup> In May 2002, the Bush administration revoked the U.S. signature of the Rome Statute.<sup>75</sup> Meanwhile, Congress passed legislation to block U.S. cooperation with and support for the Court, known as the American Servicemembers Protection Act (the ASPA).<sup>76</sup> The ASPA also blocks military funding—in the form of International Military Education Training funds and Foreign Military Financing funds—to states that are parties to the ICC unless those states enter into agreements where they undertake not to send U.S. citizens to the ICC or if the President waives this requirement based on national security.<sup>77</sup> In 2004, Congress added restrictions on economic assistance—in the form of Economic Support Funds—to the ASPA's restrictions on military funding in legislation known as the Nethercutt Amendment.<sup>78</sup>

Despite the U.S. government's general opposition to the ICC, Congress did recognize that the ICC could contribute to bringing terrorists and other international criminals to justice. Thus, the ASPA includes a clause (the Dodd Amendment) that states: "Nothing in this title shall prohibit the United States from rendering assistance to international efforts to bring to justice Saddam Hussein, Slobodan Milosovic, Osama bin Laden, other members of Al Qaeda, leaders of Islamic Jihad, and other foreign nationals accused of genocide, war crimes or crimes against humanity."<sup>79</sup> This amendment recognizes that the ICC may play a role in

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74. William J. Clinton, *Remarks on the Signature of the ICC Treaty* (December 21, 2000). For an analysis of U.S. concerns since the beginning of ICC negotiations, see Pam Spees, *The Rome Statute of the International Criminal Court*, in *RULE OF POWER OR RULE OF LAW: AN ASSESSMENT OF U.S. POLICES AND ACTIONS REGARDING SECURITY-RELATED TREATIES* (Nicole Deller et al. eds., 2002).

75. U.S. Department of State Press Statement, *International Criminal Court: Letter to UN Secretary General Kofi Annan* (May 6, 2002).

76. 2002 Supplemental Appropriations Act for Further Recovery from and Response to Terrorist Attacks on the United States, Pub. L. No. 107-206, §§ 2001-2015, 116 Stat. 820 (2002) [hereinafter "ASPA"].

77. ASPA § 2007. The ASPA also authorizes the president to use "all means necessary and appropriate" to bring about the release of U.S. and allied personnel from custody of the ICC. ASPA §§ 2008, 2013. Inferring that the language "all means necessary and appropriate" implies military operations, critics have dubbed the law "Hague Invasion Act" after the city in which defendants would be held for prosecution. Steven Mufson & Alan Sipress, *U.N. Funds in Crossfire Over Court; Exemption Sought for U.S. Troops*, WASH. POST, Aug. 16, 2001.

78. Appropriations for foreign operations, export financing and related programs for the fiscal year ending September 30, 2006 and for other purposes, Pub. L. No. 109-102 § 574; Stat. 2172 (2004).

79. ASPA § 2015.



prosecuting terrorists in the future, and the United States does not want to foreclose the possibility of involvement in such prosecutions. The sponsor of the amendment, Senator Chris Dodd, stated:

I cannot believe, I do not want to believe, that if we apprehend, through the international community, people I have just mentioned on [the amendment's] list, that under this bill we would be prohibited from assisting in the prosecution of Osama bin Laden, the Islamic Jihad, Saddam Hussein, and other members of the terrorist community in the world.<sup>80</sup>

David Scheffer, former U.S. Ambassador at Large for War Crimes Issues, observed that the possibility of using the ICC to prosecute terrorists is a powerful reason to consider supporting the court: "If only in its own self-interest, the United States will want to collaborate with its allies and friends around the world and explore the utility of the ICC as a potent judicial weapon in the war against terrorism."<sup>81</sup>

Notwithstanding its objections to the ICC, in March 2005 the U.S. abstained rather than vetoed a Security Council referral to the ICC Prosecutor to investigate atrocities in Darfur.<sup>82</sup> Adopted by a vote of 11 in favor, none against, with 4 abstentions (Algeria, Brazil, China, United States), the resolution accommodated the United States by deciding that officials or personnel from a contributing State outside the Sudan which was not a party to the Rome Statute would be subject to the exclusive jurisdiction of that contributing State. The United States refrained from vetoing the resolution based on the need for the international community to work together in order to end the climate of impunity in the Sudan, and because the resolution provided protection from investigation or prosecution for United States nationals.

#### **(B) *Ad Hoc* International Tribunals**

Another international legal option that may be available to the United States for the prosecution of terrorists is the creation of an *ad hoc* tribunal established by the UN Security Council.

There is precedent for the establishment of Security Council-based *ad hoc* tribunals to prosecute crimes against humanity in the International Criminal Tribunal for the Former Yugoslavia and the International Criminal

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80. 148 Cong. Rec. S 5132 (daily ed. June 6, 2002).

81. Scheffer, *supra* note 69, at 49-50.

82. S.C. Res 1593, U.N. SCOR, 59<sup>th</sup> Sess. U.N. Doc. S/Res/1593 (2005).

Tribunal for Rwanda.<sup>83</sup> Both tribunals were created by the Security Council acting under its Chapter VII authority<sup>84</sup> to prosecute persons responsible for serious violations of international humanitarian law in the two territories. The Security Council could create a similar tribunal to address serious terrorist acts.<sup>85</sup> Unlike the ICC, an *ad hoc* tribunal would have the ability to prosecute crimes that took place prior to July 1, 2002, the date that the jurisdiction of the ICC took effect. Also, it would likely have more political appeal to the United States than the ICC because such a court would have a limited mandate (tied to a certain act or series of acts) and would be overseen by the Security Council, a body in which the U.S. wields veto power. Such a court would therefore not risk the prosecution of US military personnel or government officials.

Some international law and human rights advocates have supported the use of international tribunals for the prosecution of suspected terrorists apprehended by the United States during the invasion of Afghanistan who are being held in Guantanamo Bay.<sup>86</sup> However, the use of international courts has been rejected by the Bush administration, which instead proceeded with trials in domestic courts and military commissions established by President Bush after 9/11 to try suspected terrorists.<sup>87</sup>

The post-9/11 policies of detaining and trying terrorists have been substantially eroded through challenges in the U.S. courts. The detention of suspected terrorists held in U.S. custody, whether or not for trial by military tribunals, was limited by a pair of decisions handed down by the Supreme Court in June 2004. The Court held that detainees could invoke the writ of habeas corpus to challenge their detentions, meaning that

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83. Statute for the International Tribunal for the Former Yugoslavia, S. C. Res. 827, U.N. SCOR, 48th Sess. 3217th mtg., U.N. Doc. 5/Res/827 (1993); Statute for the International Tribunal for Rwanda, S.C. Res. 955, U.N. SCOR, 49th Sess., 3453d mtg., U.N. Doc. 5/Res/955 (1994).

84. Chapter VII of the UN Charter confers on the Security Council the right to determine the existence of any threat to peace, breach of peace, or act of aggression and decide what measures shall be taken to maintain or restore international peace and security.

85. See Anne Marie Slaughter, *Use courts, not combat, to get the bad guys*, INT'L HERALD TRIB., Nov. 20, 2003; Goldstone & Simpson, *supra* note 70 at 20-21.

86. See, e.g., Anton L. Janik, Jr., *Prosecuting Al Qaeda: America's Human Rights Policy Interests Are Best Served By Trying Terrorists Under International Tribunals*, DENV. J. INT'L L. & POL'Y 498, 521-31 (2002).

87. See e.g. U.S. v. Massaoui, No. 01-455-A, (E.D.Va.) (federal criminal trial of suspected terrorist); see also *Detention, Treatment, and Trial of Certain Non-Citizens in the War Against Terrorism*, 66 Fed. Reg., (Dep't of Defense, November 13, 2001).

their detentions are open to review in U.S. courts.<sup>88</sup> The Court stopped short of declaring a right of all detainees to a full criminal trial, instead holding that they are entitled to “a meaningful opportunity to contest the factual basis for [their] detention before a neutral decisionmaker,” in accordance with due process of law.<sup>89</sup>

Subsequently, the use of the military commissions established by the Bush Administration to try suspected terrorists was rejected by the Supreme Court in *Hamdan v. Rumsfeld*<sup>90</sup> This case concerned a Guantanamo detainee, Salim Ahmed Hamdan, a Yemeni who was allegedly Osama bin Laden’s driver in Afghanistan. The Supreme Court ruled that the tribunals did not meet the requirements of the Geneva Conventions and the U.S. Uniform Code of Military Justice for failing to confer certain protections to the accused, including the right to be present, equivalent to those provided by courts martial for U.S. military personnel.<sup>91</sup> [After this report was written and in response to the Hamdan decision, In October 2006, Congress passed the Military Commission Act,<sup>92</sup> which was designed to meet the Supreme Court’s concerns and authorize the use of military commissions to try suspected terrorists, and for other purposes. The law is being challenged in the U.S. courts.]

The decision to use military tribunals had been harshly criticized by human rights activists and many international legal experts. The president of the American Society of International Law at the time of the announcement, Anne-Marie Slaughter, defended the use of international tribunals for these detainees: “The difference between military commissions and an international tribunal is the sanction and legitimacy of the global community. An international tribunal would demonstrate the depth of international solidarity against terrorism.”<sup>93</sup> On the other hand, Ruth Wedgwood, international law professor and advisor to the Department of Defense on military tribunals, observed that preference for military tribunals over international *ad hoc* tribunals is partly because the *ad hoc*

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88. *Rasol v. Bush*, 124 S.Ct. 2686 (2004).

89. *Hamdi v. Rumsfeld*, 124 S. Ct. 2633 (2004).

90. *Hamdan v. Rumsfeld*, 165 L.Ed.2d 723 (2006).

91. *Id.* Recent legislation stripped the judiciary of jurisdiction to hear cases regarding Guantanamo detainees except for specific limited appellate jurisdiction and jurisdiction, but the Hamdan case referenced above held that such legislation did not apply to cases pending at enactment. See Detainee Treatment Act of 2005, as included in the Department of Defense Appropriations Act, 2006, Public Law No: 109-148 (2005).

92. Public Law. No. 109-366 (2006).

93. Anne Marie Slaughter, *Al Qaeda Should Be Tried Before the World*, N.Y. Times, Nov. 17, 2001.

tribunals do not have the ability to handle a volume of cases and will not offer sufficient protection for sensitive intelligence information.<sup>94</sup> Others have suggested expanding the mandate of existing *ad hoc* tribunals to allow for the prosecution of terrorists.<sup>95</sup>

It is clear even in this brief review of US policy that the United States has not embraced the use of international tribunals to prosecute terrorists. Indeed, this is one of the most controversial uses of international legal mechanisms for American policy makers. Even with the rejection of the US military tribunals, the possibility of international tribunals does not appear to be an option in the near term. Nevertheless, employing international tribunals to dispense international justice is no longer only an ideal, and prosecution of past and future terrorist acts in a variety of international legal forums is a real option.

#### **IV. MULTILATERAL INSTRUMENTS ADDRESSING WEAPONS OF MASS DESTRUCTION**

The December 2002 United States *National Strategy to Combat Weapons of Mass Destruction* reflects how closely this administration links proliferation of WMD with the threat of terrorism: “[T]errorist groups are seeking to acquire WMD with the stated purpose of killing large numbers of our people and those of our friends and allies—without compunction and without warning.” The report goes on to name a number of international regimes that are intended to control access to and prevent use of WMD. The White House expressed the goals of strengthening and ensuring compliance with these instruments, creating new regimes to serve these goals and “cultivat[ing] an international environment that is more conducive to nonproliferation.”<sup>96</sup> Nonproliferation can be achieved by enhancing measures “that seek to dissuade or impede proliferant states and terrorist networks, as well as to slow and make more costly their access to sensitive technologies, material and expertise.”

Describing the successes of treaties and export control regimes, the Director of the State Department’s Office of Chemical, Biological, and Missile Nonproliferation said:

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94. Ruth Wedgwood, *Al Qaeda, Military Commissions and American Self-Defense*, 117 *Pol. Sci. Q.* 357, 369-73 (2002).

95. See Paul R. Williams & Michael P. Scharf, *Prosecute Terrorists on a World Stage*, *L.A. TIMES*, Nov. 18, 2001.

96. The White House, *NATIONAL STRATEGY TO COMBAT WEAPONS OF MASS DESTRUCTION* 4 (Dec. 2002).

These efforts have impeded progress in missile and [chemical and biological weapons] programs of concern—among other things causing delays, forcing the use of elaborate and time-consuming procurement networks, and compelling reliance on older and sometimes less effective technology. They have established a global political and legal barrier against the spread of WMD and led to unprecedented international inspections of nuclear and chemical weapons programs. Each has recorded a number of successes and each faces unique challenges.<sup>97</sup>

The relevant instruments described below range from multilateral treaties to less formal cooperative export control groups and codes of conduct.

**(A) WMD Treaties**

The primary purpose of these instruments is to address state actions. However, they also contain provisions that are useful in improving states' abilities to block terrorists' access to WMD and their precursors.

**(1) 1968 Nuclear Nonproliferation Treaty<sup>98</sup>**

Nuclear weapons and facilities pose several distinct risks in connection with terrorism. There is a risk that a state engaged in developing or acquiring nuclear weapons or materials will sell or transfer them to terrorists. There is a risk that terrorists will steal a nuclear weapon. Another risk is terrorist diversion of nuclear materials from a nuclear facility or during transit to manufacture a radiological weapon (a dirty bomb), which disperses radioactive material rather than creating a nuclear explosion. If sufficiently resourced and organized, there is a risk that terrorists will obtain fissile materials and then build a nuclear explosive device. There is also a risk that the nuclear facilities themselves will be attacked and disperse radioactive material.

The Nuclear Nonproliferation Treaty (NPT) and its monitoring agency, the International Atomic Energy Agency (IAEA), address these threats in a variety of ways. With respect to states transferring weapons to terrorists, the NPT prohibits nuclear weapon states (China, France, Russia, the United Kingdom and the United States) from transferring to any recipient what-

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97. *Strengthening Multilateral Nonproliferation Regimes: Hearing before the Subcomm. on International Security, Proliferation and Federal Services of the Senate Comm. on Government Affairs*, 107<sup>th</sup> Cong. (2002) (statement of Vann H. Van Diepen, Deputy Assistant Secretary of State).

98. Treaty on the Non-Proliferation of Nuclear Weapons, July 1, 1968, 21 UST 483, 729 UNTS 161.

soever nuclear weapons or nuclear explosive devices or control over such weapons. The non-nuclear weapon states agree not to develop nuclear weapons or accept their transfer. All states are entitled to use nuclear energy for peaceful purposes. All but four states take part in this regime.<sup>99</sup>

In order to ensure that NPT non-nuclear weapon states are not diverting nuclear energy programs for use in weapons, they are required to accept comprehensive safeguard agreements relating to their peaceful nuclear activities with oversight from the IAEA. Pursuant to these safeguards, the IAEA conducts inspections that, among other things, verify records and inventories.

**(a) IAEA Measures to Combat Terrorism**

After 9/11, the IAEA added initiatives and expanded existing programs to better guard against terrorism, many of which are set forth in its “Action Plan on Combating Nuclear Terrorism,” published in March 2002.<sup>100</sup> The focus areas of the action plan are prevention, detection and response.

The IAEA issues recommendations to help states improve the physical protection of their nuclear materials and facilities.<sup>101</sup> It also monitors and works to combat the illicit trafficking in nuclear material. It maintains a database on illicit trafficking and offers training to member states’ customs and police officials. Since 1993, the IAEA database has recorded “approximately 630 confirmed incidents of trafficking in nuclear or other radioactive material.”<sup>102</sup> Training is also offered to strengthen states’ systems for accountancy and control of nuclear materials. Finally, the IAEA also promotes the development of national legislation and adherence to related international agreements and guidelines.<sup>103</sup>

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99. India, Pakistan and Israel, never subscribed to this regime. A fourth state, North Korea, announced the withdrawal of its membership in January 2003.

100. The Action Plan is described in *Excerpts from the Introductory Statement by IAEA Director General Dr. Mohamed ElBaradei to the IAEA Board of Governors*, March 18, 2002, available at <http://www.iaea.org/worldatom/Press/Statements/2002/ebsp2002n001.shtml>.

101. See, e.g., *The Physical Protection of Nuclear Material and Nuclear Facilities*, IAEA Doc. INF/CIRC/225/Rev. 4 (Corrected) [undated], available at [http://www.iaea.org/worldatom/Programmes/Protection/inf225rev4/rev4\\_content.html](http://www.iaea.org/worldatom/Programmes/Protection/inf225rev4/rev4_content.html).

102. Statement by IAEA Director-General Dr. Mohamed ElBaradei, *Nuclear Proliferation and the Potential Threat of Nuclear Terrorism* (Nov. 8, 2004).

103. These initiatives are described in *Nuclear Security – Progress on Measures to Protect Against Nuclear Terror: Report by the Director-General*, IAEA Doc. GOV/INF/2002/11-GC/(46)/14, Attachment 1 at 2-3 (August 12, 2002), available at [http://www.iaea.org/worldatom/Press/News/PDF/action\\_plan.pdf](http://www.iaea.org/worldatom/Press/News/PDF/action_plan.pdf).

Although the IAEA continues to evolve in the face of heightened fears of nuclear terrorism, its mandate is limited. The recommendations regarding protection of nuclear materials and facilities are only recommendations; unlike the safeguard agreements, they are not binding obligations. Under the existing system, the ultimate responsibility for intra-state security of nuclear materials is not in the hands of the IAEA but with states themselves. As with the CTC, the success of these initiatives depends on the capabilities and the will of states.

**(b) Nuclear Fuel Cycle Technology**

Non-nuclear weapon states regard the acquisition of technology to produce plutonium and enriched uranium to power nuclear reactors as their right under the NPT, should they choose to exercise it. However, the same technology can also produce materials for weapons. In the wake of revelations about the Pakistan-based nuclear proliferation network led by nuclear metallurgist A.Q. Khan, the North Korean denial of IAEA monitoring of its fissile materials production capabilities, and concerns that Iran may be seeking a nuclear weapons capability, proposals have emerged to control the spread of uranium enrichment and plutonium reprocessing technology. One of the drivers for this trend is the desire to limit access of terrorists to the materials. About a dozen countries, including those possessing nuclear arms, now have such technology.

One proposed course of action is for exporting countries to deny the technology to additional states, as called for by President Bush. The G-8 responded to President Bush's call by declaring a moratorium on supply to non-possessing states, but the far larger Nuclear Suppliers Group has yet to take any action. A second course is indicated by IAEA Director-General Mohamed ElBaradei's call for "working towards multilateral control over the sensitive parts of the nuclear fuel cycle - enrichment, reprocessing, and the management and disposal of spent fuel."<sup>104</sup> While this proposed approach has received favorable comment from states and others, its implementation does not seem imminent.

**(c) The Role of Disarmament**

The NPT goes beyond establishing a monitored nonproliferation regime; it also includes a commitment to disarmament made by the nuclear weapon states. Article VI states: "Each of the Parties to the Treaty under-

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104. Mohamed ElBaradei, In Search of Security: Finding an Alternative to Nuclear Deterrence, Remarks at the Center for International Security and Cooperation, Stanford University (Nov. 4, 2004), available at <http://www.iaea.org/NewsCenter/Statements/2004/ebsp2004n012.html>.

takes to pursue negotiations in good faith on effective measures relating to cessation of the nuclear arms race at an early date and to nuclear disarmament, and on a treaty on general and complete disarmament under strict and effective international control.” Although that language intentionally left the nuclear weapon states’ commitment vague and indefinite, in recent years, states parties have clarified what the obligation entails, and the nuclear weapons states have agreed to arms control/disarmament measures.<sup>105</sup> Nuclear weapons states most recently made such commitments in the Final Declaration of the NPT 2000 Review Conference.<sup>106</sup> They include the entry into force of the Comprehensive Test Ban Treaty, negotiating a treaty to ban production of fissile material for nuclear weapons, and making the reduction and elimination of nuclear arsenals irreversible and verified.

If these steps are taken by all nuclear weapon states, they will also help to reduce and secure nuclear materials and explosives that would be available for acquisition or diversion by terrorists. In recent years, though, the nuclear weapons states, and particularly the United States, have backpedaled on the 2000 commitments. The May 2005 NPT Review Conference failed to reach any agreement, in large part due to deep division over the current status of the commitments.<sup>107</sup> The breakdown of the Review Conference was followed by the failure to agree on any measures or even language regarding non-proliferation and disarmament of nuclear and other weapons of mass destruction at the September 2005 World Summit.<sup>108</sup> One consequence has been an inability to advance action on widely agreed non-proliferation goals like enhancing the inspection powers of the IAEA, or to take on the difficult task of coming to agreement on proposals to control the spread of nuclear fuel cycle technology.

## **(2) 1972 The Biological Weapons Convention<sup>109</sup>**

Parties to this treaty (the “BWC”) are prohibited from developing,

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105. See John Burroughs & Elizabeth Shafer, *The Nuclear Nonproliferation Treaty*, in *RULE OF POWER OR RULE OF LAW?*, *supra* note 74 at 24-29.

106. 2000 Review Conference of the Parties to the Treaty on the Non-Proliferation of Nuclear Weapons, *Final Document*, May, 2000.

107. See David E. Sanger, *Month of Talks Fails to Bolster Nuclear Treaty*, *N. Y. Times*, May 28, 2005.

108. Jim Wurst, *Nonproliferation, Disarmament Matters Dropped from U.N. Summit Document*, *GLOBAL SECURITY NEWSWIRE*, September 14, 2005.

109. Convention on the Prohibition of the Development, Production and Stockpiling of Bacteriological (Biological) and Toxin Weapons and on Their Destruction, Apr. 10, 1972, Art. 13(2), 26 UST 583, 1015 UNTS 163.



acquiring or retaining microbial or other biological agents or toxins in quantities that have no justification for prophylactic, protective or other peaceful purposes or means of delivery of these agents or toxins. States are prohibited from transferring the prohibited items to any recipient whatsoever, directly or indirectly, and may not assist or encourage “any State, group of States or international organizations” to manufacture or acquire these items. States must also enact laws to prohibit the development or possession of bioweapons and equipment in their territory.

This treaty contains the basic framework to address biological weapons, but it lacks the necessary measures to restrain states from acquiring or using bioweapons and to ensure that states are protecting against terrorist bioweapons activity in their jurisdictions. The BWC contains no mechanisms to monitor compliance. It does not require states to prosecute people who are found to be violating the treaty’s prohibitions.

Between 1994 and 2001, BWC parties worked to fill in some of the gaps in the BWC with the negotiation of a protocol, a legally binding regime of declarations and inspections. It also would have required states to adopt criminal laws to prosecute individuals engaged in bioweapon activity. In July 2001, however, the United States put an end to the creation of this or any additional legally binding mechanism. The United States explained that it rejected the protocol because it would be ineffective (largely because of the difficulty in detecting small quantities of biological agents) and would compromise national security and commercial proprietary information.<sup>110</sup> As a substitute for the protocol, states parties, led by U.S. proposals, are considering ways to strengthen the convention through non-legally binding measures. Proposals include adopting legislation to criminalize offenses, devising a procedure to clarify and resolve compliance concerns on a voluntary basis, drafting a code of conduct for scientists, strengthening national security measures for handling toxins, and enhancing international response capabilities.<sup>111</sup>

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110. Donald Mahley, *Statement by the United States to the Ad Hoc Group of Biological Weapons Convention States Parties*, July 25, 2001, available at <http://usinfo.state.gov/topical/pol/arms/stories/01072501.htm>. But see Donald Mahley’s Testimony before a House Subcommittee less than a year prior, wherein he stated that achieving a successful BWC Protocol would be “extraordinarily difficult, but that makes it a worthy challenge.” *The Biological Weapons Convention: Status and Implications: Hearing before the Subcomm. on National Security, Veterans Affairs, and International Relations of the Comm. on Government Reform*, 106<sup>th</sup> Cong. 14 (2003).

111. The proposed measures are set forth in the Fifth Review Conference of the States Parties to the BWC, *Final Document*, 2002, available at [http://www.opbw.org/rev\\_cons/5rc/docs/final\\_dec/BWC-CONF.V-17-\(final\\_doc\).pdf](http://www.opbw.org/rev_cons/5rc/docs/final_dec/BWC-CONF.V-17-(final_doc).pdf). States parties had their most recent meeting to

There are no current plans to add to the BWC the type of monitoring regime that exists for chemical and nuclear weapons. Many arms control experts have pointed to the need to resume efforts toward a binding multilateral arrangement. Although such a protocol would not be able to detect all cheaters, supporters argue that it would offer benefits of increased transparency, deterrence and provide international standards and oversight.<sup>112</sup>

**(3) 1993 Chemical Weapons Convention<sup>113</sup>**

States parties to the Chemical Weapons Convention (the “CWC”) agree never to develop, acquire or use chemical weapons or transfer them to anyone, and those with stockpiles agree to destroy them. Each state party must declare the contents of its stockpiles and allow routine inspection of “dual-use” chemicals and facilities that could be used in a prohibited manner. The CWC prohibits the transfer of the most dangerous chemicals to non-member states.

The CWC creates a legal mechanism to help prevent chemical terrorism. The monitoring and accounting of chemicals and facilities help to deny terrorists’ access and deter potential diversions. States are required to ensure the physical security of their chemical facilities. Also, with the requirement that states enact criminal laws prohibiting individuals within their jurisdiction from producing, transferring and using chemical weapons, states are better able to investigate and prosecute chemical weapons-related terrorist activities. The regime includes a mechanism for challenge inspections in the event that one state suspects that another state is violating its provisions. This mechanism would be useful in the event a member country had permitted someone in its jurisdiction to acquire chemical weapons.<sup>114</sup>

Implementation of these provisions is conducted with assistance from the Organization for the Prohibition of Chemical Weapons (“OPCW”).

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advance these proposals in December, 2004, available at [http://www.opbw.org/new\\_process/msp2004\\_conf.htm](http://www.opbw.org/new_process/msp2004_conf.htm).

112. See, e.g., Barbara Hatch Rosenberg, *Allergic Reaction: Washington’s Response to the BWC Protocol*, *ARMS CONTROL TODAY*, July/August 2001.

113. Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and on their Destruction, Jan 13, 1993, S. Treaty Doc. No. 103-21, 1974 U.N.T.S. 3.

114. For more information on the CWC’s contributions to preventing terrorism, see Organization for the Prohibition of Chemical Weapons, *Possible Responses to Global Terrorist Threats [undated]*, available at <http://www.opcw.org/resp/>.

The OPCW's mission includes ensuring the destruction of member states' chemical weapons and the prevention of their re-emergence, providing protection and assistance against chemical weapons, encouraging international cooperation in the peaceful uses of chemistry and working for the universal ratification of the CWC.

In order to be most effective against terrorism, the CWC requires progress in a number of areas. It has not achieved universality, that is, many states are not yet members, and some states outside the CWC regime are suspected of developing weapons programs. There are concerns that some member states are attempting to develop chemical weapons. Challenge inspections have not yet been exercised. One reason, according to the United States, is that the OPCW is currently incapable of conducting the work required in a challenge inspection.<sup>115</sup> Expressing a commitment to strengthen the organization and improve its management, the United States led a successful movement to change OPCW's leadership in 2002.

#### **(4) Summary Regarding WMD Treaties**

The NPT, BWC and CWC are not directly targeted at terrorists, but rather aim to address state behavior. They can make a significant contribution in regard to terrorism because they prohibit transfer of materials to terrorists and criminalize possession of WMD materials. The ability of these treaties to succeed in curbing terrorists' acquisition of weapons of mass destruction depends to a large extent on the willingness of states to adhere to their treaty commitments. Universal adoption of the treaties is needed. At this time, there are a number of significant states outside of these regimes.<sup>116</sup>

The NPT and CWC, which include established declaration and inspection regimes, have the most potential for detecting illicit transfers to either terrorist groups or other states outside the treaty regime. The BWC, on the other hand, is in need of further strengthening to be an effective tool against transfers of bioweapons to terrorists.

#### **(B) Security Council Resolution on WMD and Non-State Actors**

In an address to the General Assembly in September 2003, President Bush stated:

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115. See, e.g., *Expounding Bush's Approach to U.S. Nuclear Security, An Interview with John R. Bolton*, ARMS CONTROL TODAY, March 2002.

116. As stated above, four states are outside the NPT regime: India, Israel, North Korea and Pakistan. The list of states parties and signatories to the BWC and the CWC may be found at <http://www.icrc.org/ihl>.

Today, I ask the U.N. Security Council to adopt a new anti-proliferation resolution. This resolution should call on all members of the U.N. to criminalize the proliferation of weapons—weapons of mass destruction, to enact strict export controls consistent with international standards, and to secure any and all sensitive materials within their own borders. The United States stands ready to help any nation draft these new laws, and to assist in their enforcement.<sup>117</sup>

Led by the United States, in April 2004, the Security Council adopted Resolution 1540, which seeks to prevent “non-state actor” acquisition of, or trafficking in, WMD weapons-related equipment, materials, and delivery systems.<sup>118</sup> The term “non-state actor” refers not only to terrorists, but also to unauthorized state officials and to businesses. The reasons for this scope are illustrated by the Pakistan-based nuclear proliferation network led by nuclear metallurgist A.Q. Khan. The Pakistani government maintains that it did not authorize Khan’s activities, and businesses from several countries around the world contributed to the Khan network. Acting under Chapter VII of the Charter, the Security Council *required* every state in the world to prohibit non-state actor acquisition of and trafficking in WMD weapons and related items. It also mandated the adoption of appropriate measures—national criminal laws, export controls, border controls, law enforcement efforts, physical security and materials accounting techniques—to prevent such acquisition and trafficking.

In some ways the resolution added new obligations for states, for example regarding export controls and border controls. Also, previously there had been no explicit requirement under the NPT and the Biological Weapons Convention that acquisition of and trafficking in nuclear and biological weapons be made criminal by national legislation. In other ways the resolution reinforced existing obligations and also applied them to the relatively few countries not party to the NPT and the biological and chemical weapons conventions. There is a parallel between Resolution 1540 and the Resolution 1373, described above, in that both are aimed at revising states’ legal systems to respond to terrorist activities, both impose mandatory requirements on all states, and both establish a

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117. George W. Bush, President of the United States, Address before the United States General Assembly (Sept. 23, 2003), *available at* <http://www.whitehouse.gov/news/releases/2003/09/20030923-4.html#>.

118. S.C. Res. 1540, *supra* note 46.

committee made up of all members of the Security Council to implement the resolution.<sup>119</sup>

### **(C) Export Controls**

Export control regimes are made up of groups of states that agree to “restrict the sale of goods to certain countries or to ensure that safeguards or end-use guarantees are applied to the export and sale of sensitive technologies and materials.”<sup>120</sup> The United States regards these regimes as crucial to the fight to keep dangerous materials out of the hands of so-called rogue states and terrorists.

Although these arrangements cover many of the same materials that are regulated under the treaties listed above, the goals of these regimes differ from those of treaties. A treaty regulating a potentially dangerous material generally establishes a comprehensive ban on the maintenance or use of that material for hostile purposes and establishes an accounting or inspection regime for the peaceful use of these materials. In contrast, export control regimes are not legally binding at the international level; they involve a grouping of countries that do not restrict their own use of the subject material but voluntarily agree to limit, through legislation and regulation, transfers to foreign nationals, entities and states not meeting certain criteria (for example, acceptance of IAEA safeguards) or otherwise deemed untrustworthy. Export controls are often able to control a broader scope of dual-use materials, including software, lab equipment and other technology that are not covered by the treaties.

The export control regimes described below have made efforts post-9-11 to strengthen their controls against terrorist acquisition of the subject materials.

#### **(1) Australia Group**

One export control group that is specifically mentioned in the U.S. *National Strategy to Combat Weapons of Mass Destruction* is the Australia Group. The Australia Group is an “informal network of countries that consult on and harmonise their national export licensing measures on [chemical and biological weapon] items.”<sup>121</sup> The group is made up of thirty-three partici-

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119. See Merav Datan, *Security Council Resolution 1540: WMD and Non-State Trafficking*, DISARMAMENT DIPLOMACY, April/May 2005.

120. Nuclear Threat Initiative, *Glossary of Terms*, available at [http://www.nti.org/b\\_aboutnti/b\\_index.html](http://www.nti.org/b_aboutnti/b_index.html).

121. *The Australia Group: New Measures to Fight the Spread of Chemical and Biological Weapons*, Australia Group Press Release AG/Jun02/Press/7, June 7, 2002. Available at <http://projects.sipri.se/cbw/research/AG-press-Jun02.html>.

pants from Europe, North America, and Asia that apply licensing measures to the export of specified chemicals, biological agents, and dual-use chemical and biological manufacturing facilities and equipment. These export controls are aimed at both curbing proliferation and also “allow[ing] legitimate trade to prosper in an unfettered manner and promot[ing] peaceful economic development everywhere.”<sup>122</sup> Since 9/11, the Australia Group has revised its export restrictions to include items that would be useful to terrorists rather than states.<sup>123</sup>

## (2) The Missile Technology Control Regime

Formed in 1987, the MTCR restricts the export of delivery systems (and related technology) capable of carrying a 500-kilogram payload for a distance of at least 300 kilometers and systems capable of delivering weapons of mass destruction. Its group of thirty-three participants largely overlaps with the countries that make up the Australia Group.<sup>124</sup> The members agree to a set of guidelines for the export of a list of materials. Some transfers are prohibited; others are subject to the satisfaction of specific conditions or the provision of certain assurances. The director of the State Department’s Office of Chemical, Biological and Missile Nonproliferation described the value of this regime: “MTCR Partners’ vigorous enforcement of export controls consistent with the MTCR Guidelines and Annex continues to make it more difficult for proliferators to get items for their missile programs, increasing the cost, time, and effort required.”<sup>125</sup>

The MTCR is now placing more emphasis on combating the risk of missile components and components falling into the hands of terrorists.

122. Australian Department of Foreign Affairs & Trade, International Security Affairs Division, *The Australia Group*, available at [http://www.dfat.gov.au/security/downloads/australian\\_group.pdf](http://www.dfat.gov.au/security/downloads/australian_group.pdf). Includes a list of participants.

123. See United States General Accounting Office, *Strategy Needed to Strengthen Multilateral Export Control Regimes*, Report to Congressional Committees, GAO-03-43, October 2002, available at <http://www.gao.gov/cgi-bin/getrpt?gao-03-43>.

124. List of participants can be found at <http://www.state.gov/t/np/rls/prsr/2002/14497.htm>.

125. Van Diepen, *supra* note 97. The MTCR only addresses the supply side of missile technology. The United States has also lead the creation of a code of conduct aimed at the demand side, known as the International Code of Conduct against Ballistic Missile Proliferation (ICOC). It is a voluntary “political commitment” aimed at preventing states from developing and stockpiling missile technology. The text may be found at <http://projects.sipri.se/expcon/drafticoc.htm>. See also John Bolton, Remarks at the Launching Conference for the International Code of Conduct Against Ballistic Missile Proliferation, (Nov. 25, 2002), available at <http://www.state.gov/t/us/rm/15488.htm>. A critical review of the ICOC is found at [http://www.basicint.org/pubs/Notes/2002international\\_code.htm](http://www.basicint.org/pubs/Notes/2002international_code.htm).

At the 2002 plenary meeting of the MTCR, the partner states agreed to study possible changes to better address this risk, and in 2003, announced some revisions to the guidelines, including a national “catchall requirement” that would “provide a legal basis to control the export of items that are not on a control list, when such items are destined for missile programs.”<sup>126</sup>

### **(3) The Nuclear Suppliers Group**

The Nuclear Suppliers Group (NSG) is made up of forty states that have the ability to supply items designed for nuclear use, that adhere to non-proliferation arrangements (such as the NPT), and that have national policies to implement export controls. The aim of the group is “to contribute to prevention of the proliferation of nuclear weapons through export controls of nuclear-related material, equipment, software and technology, without hindering international cooperation on peaceful uses of nuclear energy.”<sup>127</sup> The NSG was formed in 1974 in response to India’s nuclear weapon test, which had demonstrated that nuclear materials transferred for peaceful purposes could be used for a nuclear weapons program.

The group follows two sets of voluntary guidelines. The first set governs exports of items designed for nuclear use (including source materials such as plutonium and uranium and nuclear reactors and equipment).<sup>128</sup> This set is known as the “Trigger List” because the export of items on this list triggers application of IAEA safeguards to the recipient facility. The second set governs exports of nuclear-related dual-use equipment and materials and related technology.<sup>129</sup>

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126. Plenary Meeting of the Missile Technology Control Regime, MTCR Press Release, September, 2003; MTCR Press Release, Plenary meeting of the Missile Technology Control Regime, MTCR Press Release, September 2002. Both documents are available at <http://www.mtc.info>.

127. Press Statement, Nuclear Suppliers Group Plenary Meeting, (May 16-17, 2002), available at <http://www.nsg-online.org/PRESS/2002-03-press-prague.pdf>.

128. See *Communication Received from Certain Member States Regarding Guidelines for the Export of Nuclear Material, Equipment and Technology*, IAEA Doc. INFCIRC/254/Rev.5/Part 1 (May 2003), available at <http://www.nuclearsuppliersgroup.org/PDF/infcirc254r6p1-030516.pdf>.

129. See *Communication Received from Certain Member States Regarding Guidelines for the Transfers of Nuclear-Related Dual-Use Equipment, Material, Software and Related Technology*, IAEA Doc. INFCIRC/254/Rev.5/Part 2 (May 2003), available at <http://www.nuclearsuppliersgroup.org/PDF/infcirc254r5p2-030516.pdf>.

Regarding prevention of terrorism, the NSG acknowledges the importance of information sharing, closer cooperation of member states' law enforcement agencies and support of the anti-terrorism work of the IAEA.<sup>130</sup> At the initiative of the United States, the NSG has revised its guidelines to better address the threat of nuclear terrorism.<sup>131</sup>

#### **(4) Wassenaar Arrangement**

The Wassenaar Arrangement was formed in 1996 by thirty-three states, most of which are party to the other export control regimes.<sup>132</sup> It is designed to prevent destabilizing accumulations of arms and dual-use technologies by promoting transparency, information sharing and greater responsibility in transfers. Member states apply restrictions to a list of items to "ensure that transfers of arms and dual-use goods and technologies do not contribute to the development or enhancement of military capabilities that undermine international and regional security and stability and are not diverted to support such capabilities."<sup>133</sup> The Wassenaar Arrangement is made up of states that are producers or exporters of arms or industrial equipment and that maintain non-proliferation policies and appropriate national laws.

With respect to terrorism, the Wassenaar Arrangement seeks to prevent the acquisition of conventional arms and dual-use goods and technologies for use by terrorists. To this end, it has developed new means for sharing information and for implementing concrete actions to strengthen export controls over these items. New initiatives to address terrorism include guidelines for the export small arms and light weapons, which the group believes are the preferred weapons of terrorists.<sup>134</sup>

#### **(5) The Zangger Committee**

Pursuant to NPT Article III.2, states parties must subject safeguards to transfers to any non-nuclear weapon state of (a) source or special fissionable material, or (b) equipment or material especially designed or pre-

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130. Press Statement, Nuclear Suppliers Group Plenary Meeting, (May 16-17, 2002).

131. See INFCIRC/254/Rev.5/Part 1, *supra* note 128 and INFCIRC/254/Rev.5/Part 2, *supra* note 129.

132. The list of participants may be found at <http://www.wassenaar.org/welcomepage.html>.

133. The Wassenaar Arrangement, *Initial Elements*, (July 11-12, 1996), available at <http://www.wassenaar.org/docs/IE96.html>.

134. The Wassenaar Arrangement, *Public Statement for 2002 Plenary*, (Dec. 12, 2002), available at <http://www.usun-vienna.usia.co.at/wassenaar/public02.html>.



pared for the processing, use or production of special fissionable material.” The 35-member Zangger Committee (ZC), also known as the Nuclear Non-Proliferation Treaty Exporters Committee, is responsible for “harmoniz[ing] implementation” of this provision of the NPT.”<sup>135</sup> The ZC maintains a “Trigger List” of (a) source or special fissionable materials, and (b) equipment or materials especially designed or prepared for the processing, use, or production of special fissionable materials. Export of items on this list trigger a requirement for the application of IAEA safeguards to recipient non-nuclear weapon states.<sup>136</sup> The Trigger List covers items that could contribute to a nuclear explosive program, including plutonium, highly-enriched uranium, reactors, reprocessing and enrichment plants, and equipment and components for such facilities. ZC member states agree that Trigger List items may only be exported if they are 1) not used for nuclear explosives, 2) subject to IAEA safeguards in the recipient non-nuclear weapon state, and 3) not re-exported unless they are subject to safeguards in the new recipient state.

The relative informality of the ZC has enabled it to take the lead on certain nonproliferation issues that would be more difficult to resolve in the Nuclear Suppliers Group (NSG).<sup>137</sup> For example, the Committee recently agreed to add plutonium separation technology to the Trigger List. However, the ZC is also less stringent than the NSG, which requires its members to agree to full scope safeguards.

#### **(6) Assessing the Export Control Regimes**

Export controls offer states the ability to proceed with commerce relating to sensitive materials while also protecting them from diversion or misuse. They target proliferation by limiting and regulating the supply of materials that would be available for terrorists or “rogue states.”

However, there are several limitations to these regimes as instruments of non-proliferation. They establish a two-tier system of countries that

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135. See U.S. Department of State, Bureau of Non-proliferation, Fact Sheet: Zangger Committee, (Sept. 10, 2003); includes a list of member states, available at <http://www.state.gov/t/np/rls/fs/3054.htm>.

136. The Trigger List was first published in September 1974 as IAEA document INFCIRC/209 and has been amended several times since then. The most current form is in *Communication of 15 November 1999 Received from Member States Regarding the Export of Nuclear Material and of Certain Categories of Equipment and Other Material*, IAEA Doc. INFCIRC 209/Rev. 2 (March 2000).

137. See U.S. Department of State, Bureau of Non-proliferation, Fact Sheet: Zangger Committee, (Sept. 10, 2003), available at <http://www.state.gov/t/np/rls/fs/3054.htm>.

may have and countries that are restricted from having; they only consist of voluntary, political commitments; and it is for each country through its own national legislation and regulations to interpret and implement the guidelines. Because of their voluntary nature, the regimes have no explicit mechanisms to enforce compliance with nonproliferation commitments. No inspection or monitoring systems are in place for member countries. Other concerns, as noted by a report by the United States General Accounting Office, include the rapid pace of technology that requires control lists to be constantly updated and also “secondary proliferation,” which is the growing capability of nonmember countries to develop their own sensitive materials, and then sell them outside the regime.<sup>138</sup> Modifying the control lists is a slow task because the regimes operate by consensus, allowing each country a veto.

Export control regimes are an important contribution but in themselves are not sufficient to end proliferation. Ending proliferation requires action on many fronts, including, as noted in *Arms Control Today*, “arms control agreements, multilateral sanctions and incentives, and counterproliferation, all of which are aimed at offering viable alternatives to merely coping with the effects of proliferation.”<sup>139</sup>

**(D) Other Multilateral Nonproliferation Initiatives**

**(1) Cooperative Nonproliferation Agreements  
between the United States and Former Soviet States**

The Cooperative Threat Reduction Program, also referred to as the “Nunn-Lugar Program” after the Senators who sponsored its founding legislation, was developed in the early 1990s to assist former Soviet states in safeguarding and destroying large stockpiles of weapons of mass destruction and related infrastructure. The logic behind the program is that these states do not have the money to properly dispose of these materials, or safeguard them from theft or diversion by other states or terrorists. The intelligence that contributed to the creation of these weapons is similarly in need of safeguarding.

Programs have included deactivating warheads, assisting countries with the removal of their nuclear weapons by providing funds and tech-

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138. See United States General Accounting Office, *Nonproliferation: Strategy Needed to Strengthen Multilateral Export Control Regimes*, (Oct. 2002), available at <http://www.gao.gov/new.items/d0343.pdf>.

139. Michael Beck & Seema Gahlaut, *Creating a New Multilateral Export Control Regime*, *ARMS CONTROL TODAY*, April 2003.

nical expertise, safeguarding chemical stockpiles and biological weapons laboratories and employing former scientists of the Soviet Union so they will not be tempted to sell sensitive information.<sup>140</sup> Total funding is about one billion dollars.<sup>141</sup>

In December 2003, President Bush signed the Nunn-Lugar Program Expansion Act, which allows \$50 million of Nunn-Lugar funding to be used for countries outside the former Soviet Union. Albania is the first country to receive a pledge of assistance under the expanded Nunn-Lugar Program, which will be used to destroy its chemical weapons stockpile.<sup>142</sup>

The 9/11 Commission has emphasized the importance of the program. Its report stated that “al Qaeda has tried to acquire or make weapons of mass destruction for at least ten years. There is no doubt the United States would be a prime target. Preventing the proliferation of these weapons warrants a maximum effort—by strengthening counterproliferation efforts, expanding the Proliferation Security Initiative, and supporting the Cooperative Threat Reduction program.”<sup>143</sup> In a November 2005 report on the status of its recommendations, the Commission assessed progress under the program, stating that it

has significant accomplishments over the past 14 years in dismantling former Soviet weaponry (40% of ICBMs, 51% of warheads, 64% of strategic bombers and 58% of missile silos), but much remains to be done to secure weapons-grade nuclear materials. The size of the problem still dwarfs the policy response. Approximately half of former Soviet nuclear materials still lack adequate security protection.<sup>144</sup>

The Commission added generally that “[p]reventing terrorists from gaining access to weapons of mass destruction must be elevated above all other problems of national security” and that the president “should de-

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140. Richard Lugar, *The Next Steps in U.S. Nonproliferation Policy*, Arms Control Today, December 2002.

141. Claire Applegarth, *Modest Hike in Threat Reduction Budget*, Arms Control Today, March 2005.

142. Michael Nguyen, *Albania to Receive Nunn-Lugar Assistance*, Arms Control Today, December 2004.

143. The 9/11 Commission Report: Final Report of the National Commission on Terrorist Attacks Upon the United States 381 (U.S. Government Printing Office, 2004).

144. 9/11 Public Discourse Project: Report on the Status of 9/11 Commission Recommendations, Part III: Foreign Policy, Public Diplomacy, and Nonproliferation 3 (2005).

velop a comprehensive plan to dramatically accelerate the timetable for securing all nuclear weapons material around the world ...."<sup>145</sup>

**(2) G-8 Initiatives**

In June 2002, the G-8 member states agreed to participate in a "Global Partnership Against the Spread of Weapons and Materials of Mass Destruction." Pursuant to this partnership, the United States agreed to spend \$10 billion toward dismantlement efforts over ten years, and the other G-8 nations agreed to collectively spend an additional \$10 billion. The Global Partnership is intended to enhance programs in Russia and other former Soviet states, including the following:

- Reducing strategic missiles, bombers, silos and submarines;
- Ending weapons-grade plutonium production;
- Reducing excess weapons-grade plutonium;
- Upgrading storage and transport security for nuclear warheads;
- Upgrading storage security for fissile material;
- Reducing nuclear weapons infrastructure;
- Destroying chemical weapons;
- Eliminating chemical weapons production capability;
- Securing biological pathogens;
- Providing peaceful employment for former weapons scientists;
- Enhancing export controls and border security; and
- Improving safety of civil nuclear reactors.<sup>146</sup>

At the 2004 G-8 Summit, members of the global partnership recommitted to raising \$20 billion by 2012 and welcomed the expansion of the Global Partnership to include other donor governments.<sup>147</sup> The most recent progress review at the 2005 G-8 Summit noted "visible progress" with projects to address the priority areas of destruction of chemical weapons, dismantling submarines, disposition of fissile materials and employment of former weapons scientists. The review warned, however, that "more needs to be done to increase the momentum so that the current

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145. *Id.*

146. The White House, Office of the Press Secretary, *Fact Sheet: G-8 Summit – Preventing the Proliferation of Weapons of Mass Destruction* (June 27, 2002), available at <http://www.whitehouse.gov/news/releases/2002/06/20020627-7.html>. See also James C. Kraska, *Averting Nuclear Terrorism: Building a Global Regime of Cooperative Threat Reduction*, 20 *Am. U. Int'l L. Rev.* 703, 744-56 (2005).

147. G8 Action Plan on Nonproliferation (June, 2004).

substantial pledges can be turned into completed projects by 2012, primarily in Russia.”<sup>148</sup>

### (3) Proliferation Security Initiative

According to the National Strategy to Combat Weapons of Mass Destruction, interdiction is a “critical part of the U.S. strategy to combat WMD and their delivery means.”<sup>149</sup> Consistent with this approach, in May 2003, President Bush unveiled a new initiative to develop “direct, practical measures to impede the trafficking in weapons of mass destruction, missiles and related items.”<sup>150</sup> This is known as the Proliferation Security Initiative (PSI). It is a global effort by states<sup>151</sup> “which, using their own laws and resources, will coordinate their actions to halt shipments of dangerous technologies to and from states and non-state actors of proliferation concern—at sea, in the air, and on land.”<sup>152</sup> The initiative does not specify any one state as its target, although it has generally been characterized as directed at North Korea and possibly Iran.<sup>153</sup> It is also intended to prevent the spread of WMD to terrorists.<sup>154</sup>

In its first stages, PSI participants agreed to share information on suspected proliferation and trafficking, and to conduct joint interdiction

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148. G8 Global Partnership Annual Report, G8 Senior Group (June 2005).

149. NATIONAL STRATEGY TO COMBAT WEAPONS OF MASS DESTRUCTION, *supra* note 96.

150. Paul O’Sullivan, *Chairman’s Statement: From the Proliferation Security Initiative (PSI) meeting in Brisbane* (July 9-10, 2003), available at [http://www.dfat.gov.au/globalissues/psi/chair\\_statement\\_0603.html](http://www.dfat.gov.au/globalissues/psi/chair_statement_0603.html).

151. The PSI began with eleven countries as members, which has subsequently increased to fifteen: Australia, Britain, Canada, France, Germany, Italy, Japan, the Netherlands, Norway, Poland, Portugal, Russia, Singapore, Spain, and the United States. In addition, Turkey and Denmark sent representatives to the PSI’s December 2003 operational experts meeting. See Michael Byers, *Policing the High Seas: The Proliferation Security Initiative*, 98 Am. J. Int’l L. 526, 528 (July 2004).

152. The White House, *‘Principles for the Proliferation Security Initiative’, Statement by the Press Secretary* (Sept. 4, 2003). “States or non-state actors of proliferation concern” is defined in the Statement of Interdiction Principles as “those countries or entities that the PSI participants involved establish should be subject to interdiction activities because they are engaged in proliferation...” Proliferation Security Initiative, *Statement of Interdiction Principles* (Sept. 4, 2003).

153. See, e.g., Barbara Slavin, *11 nations join plan to stop N. Korean ships; U.S. hopes to put squeeze on Kim*, USA TODAY, July 23, 2003; Wade Boese, *Countries Draft Guidelines for Intercepting Proliferation*, ARMS CONTROL TODAY, September 2003.

154. President George W. Bush, *Remarks by the President to the People of Poland* (May 31, 2003).

training exercises. At a PSI meeting on September 4, 2003, the participants agreed to a set of principles for taking actions in support of interdiction.<sup>155</sup> They are a set of political undertakings that the United States and other PSI participants will disseminate to governments with which they have diplomatic relations in hopes that they will gain widespread support.<sup>156</sup> Under the PSI principles, actions that a state agrees to take include the following: board and search ships flying their flag that are suspected of transporting the subject materials; “seriously consider” giving consent to other states boarding and searching ships flying their flag that are suspected of transporting the subject materials; stop and/or search vessels in their internal waters “that are reasonably suspected of carrying such cargoes to or from states or non-state actors of proliferation concern” and seize such cargoes; and require suspect aircraft that are transiting their airspace to land for inspections and to seize such cargoes.<sup>157</sup> Some sixty nations have agreed informally to cooperate with PSI members on an *ad hoc* basis to intercept “rogue” ships and aircraft in their territorial waters and airspace.<sup>158</sup>

The interdiction principles are limited to instances of interdiction by a state on a vessel flying its own flag, by a state with consent of the state whose flag it flies, or by a state in whose territory the suspect vessel is located.<sup>159</sup>

On June 1, 2005, Croatia became the fourth state—following Liberia, Panama, and the Marshall Islands—to sign a Proliferation Security Initiative Shipboarding Agreement with the United States. The shipboarding agreement signed by the United States and Croatia aims to facilitate cooperation between the two countries to prevent the maritime transfer of proliferation-related shipments by establishing points of contact and procedures to expedite requests to board and search suspect vessels in international waters. If a U.S. or Croatian-flagged vessel is suspected of carrying proliferation-related cargo, either Party to this agreement can request the other to confirm the nationality of the ship in question and, if needed, to authorize the boarding, search, and possible detention of the vessel and its cargo.

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155. *Statement of Interdiction Principles*, *supra* note 152.

156. *State Department Background Briefing: The Proliferation Security Initiative*, FEDERAL NEWS SERVICE (Sept. 9, 2003).

157. *Statement of Interdiction Principles*, *supra* note 152.

158. Byers, *supra* note 151, at 529.

159. Michael Evans, *US plans to seize suspects at will*, THE TIMES (LONDON), July 11, 2003.

In a September 2003 press briefing, the State Department explained that questions of permissibility would be answered on a case-by-case basis, and that “we do not intend to proceed with interdictions without a clear national or international authority,”<sup>160</sup> Yet the PSI raises a variety of legal issues relating to the law of the sea. It is a well-established principle of international law that states have jurisdiction over ships flying their flags. However, a state boarding a ship in its territorial waters that is flying another state’s flag (without consent of that state) raises issues relating to the right of innocent passage that is recognized as customary law and is codified in the United Nations Convention on the Law of the Sea (UNCLOS).<sup>161</sup> Innocent passage is defined as “not prejudicial to the peace, good order, or security of the coastal State.”<sup>162</sup> The list of acts that would be determined as prejudicial to peace, good order or security do not include transporting WMD materials. However, the list of acts prejudicial to the peace does include “any threat or use of force against the sovereignty, territorial integrity or political independence of the coastal State, or in any other manner in violation of the principles of international law embodied in the Charter of the United Nations.”<sup>163</sup> The authority to board ships suspected of transporting WMD materials when consent is not given would likely fall under this latter provision.

Interdiction on the high seas also implicates the right to freedom of navigation on the high seas which is recognized as a basic right of all states. A few exceptions to the freedom of navigation exist in UNCLOS, but the search for WMD material is not included. Under customary law as codified in UNCLOS the United States has the authority to board a ship on the high seas when the ship does not display a state’s flag (effectively making them pirate ships), or when the state under whose flag the ship sails gives permission to board the ship.<sup>164</sup> Since an important objective of the PSI is to halt WMD trafficking among “rogue” states (which would not give permission to board ships flying their flag), this may place the

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160. *State Department Background Briefing*, *supra* note 156.

161. United Nations Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 3 (entered into force Nov. 16, 1994) (The U.S. has signed but not ratified the treaty, and accepts its substantive provisions, other than those relating to deep sea bed mining, as binding statements of customary law; RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES, pt. V, introductory note, at 5 (1986)).

162. UNCLOS, *supra* note 161, Art. 19.

163. *Id.*

164. *See id.* Art. 20.

PSI's objectives in conflict with its members' legal obligations. Attempts have been made to justify the PSI's broader interdiction principles under a customary law rule of anticipatory self-defense; however, this route does not hold much promise as there is insufficient state practice to support the existence of such a rule. The United States may instead pursue the route of modifying current legal obligations by treaty. Treaty-based exceptions to the above rules on interdiction on the high seas have been created for cases of narcotics trafficking<sup>165</sup> and illegal fishing;<sup>166</sup> this may serve as a model for an additional exception based on trafficking of WMD material. Significantly, the United States concluded agreements in 2004 with Panama<sup>167</sup> and Liberia,<sup>168</sup> the two nations with the world's largest shipping registries. The agreements provide procedures for granting consent on short-notice to board ships registered under the signatory nations' flags; the agreement with Liberia allows consent to be presumed if a response to a request is not received within two hours.<sup>169</sup>

Shipping WMD material poses clear risks for proliferation by states and acquisition by non-state actors. The existing legal regime may not provide authority for states to respond to these concerns. Treaty-based modifications to this regime would be of limited effectiveness because they would apply only to signatory states. Another possibility is to

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165. See, e.g., United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Dec. 20, 1988), 28 ILM 493, U.N. Doc. E/CONF.82/15, available at [http://www.unodc.org/pdf/convention\\_1988\\_en.pdf](http://www.unodc.org/pdf/convention_1988_en.pdf). In addition, the United States has concluded twenty-three bilateral treaties with Caribbean and Central American states on this subject. For a table of these agreements, see <http://www.ciponline.org/facts/mar.htm>.

166. Agreement for the Implementation of the Provisions of the UN Convention on the Law of the Sea of 10 December 1982, Relating to the Conservation and Management of Straddling Fish Stocks and Highly Migratory Fish Stocks, Art. 21(1), UN Doc. A/CONF.164/37, 34 ILM 1542, at 1563 (1995), available at [http://www.un.org/Depts/los/convention\\_agreements/convention\\_overview\\_fish\\_stocks.htm](http://www.un.org/Depts/los/convention_agreements/convention_overview_fish_stocks.htm).

167. Amendment to the Supplementary Arrangement Between the Government of the United States of America and the Government of the Republic of Panama to the Arrangement Between the Government of the United States of America and the Government of Panama for Support and Assistance from the United States Coast Guard for the National Maritime Service of the Ministry of Government and Justice, May 12, 2004, available at <http://www.state.gov/t/np/trty/32858.htm>.

168. Agreement Between the Government of the United States of America and the Government of the Republic of Liberia Concerning Cooperation to Suppress the Proliferation of Weapons of Mass Destruction, Their Delivery Systems, and Related Materials by Sea (Feb. 11, 2004), available at <http://www.state.gov/t/np/trty/32403.htm>.

169. *Id.* Art. 4 § 3d.



pass a Security Council resolution directed against a suspect state, designating a right to board and seize, which would become immediate international law.

PSI has been praised by some as filling in the gaps of the non-proliferation regime (especially for states that are not monitored by the IAEA because they are outside of the NPT), and increasing deterrence and dissuasion. Although many PSI activities are kept secret, a prominent claimed success of the PSI was the September 2003 seizure of cargo in a German ship headed for Libya. The cargo included parts for centrifuges used to enrich uranium for nuclear weapons programs. The Bush administration credited the seizure as contributing to Libya's decision to give up its nuclear weapons program.<sup>170</sup> However, later reports indicated that the interception resulted from preexisting counterproliferation efforts.<sup>171</sup> Generally, beyond the legal concerns, the potential of the program has also met with some skepticism. For example, former Secretary of Defense William Perry observed, "The administration has suggested that it would interdict such transfers [of products from North Korea's nuclear program]. But a nuclear bomb can be made with a sphere of plutonium the size of a soccer ball. It is wishful thinking to believe we could prevent a package that size from being smuggled out of North Korea."<sup>172</sup>

#### **(E) Assessing the Regimes to Prevent Terrorists from Acquiring WMD**

The measures described above range from those that are more universal in character and binding under international law (conventions and Security Council resolutions) to those in which the United States and its allies control trade and shipping of WMD-related material and take initiatives to secure dangerous materials and weapons. There are advantages to the more universal approach. The WMD conventions offer global monitoring organizations and processes. As they apply equally among states, they offer incentives for each state to comply, as other states are doing the same. There are valid concerns that these regimes are not able to detect all instances of cheating and that they create a false confidence that by virtue of having signed on to a treaty, a state is cooperating. These

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170. Robin Wright, *Ship Incident May Have Swayed Libya; Centrifuges Intercepted in September*, THE WASHINGTON POST, January 1, 2004.

171. Wade Boese, *Key Interdiction Initiative Claim Misrepresented*, ARMS CONTROL TODAY, July/August 2005.

172. William Perry, *It's Either Nukes or Negotiation*, WASH. POST, July 23, 2003; see also *The Proliferation Security Initiative: An interdiction strategy*, STRATEGIC COMMENTS, August 2003, available at <http://www.iiss.org/stratcomfree.php?sclD=282>.

concerns do not require the abandonment or downgrading of the existing regimes; the United States may instead decide to improve monitoring and strengthen mechanisms to inspect and investigate allegations of non-compliance, as well as relying on its own means of monitoring and encouraging compliance. On the other hand, the non-universal nonproliferation regimes offer the United States the opportunity to more tightly control outcomes and flexibility in responding to emerging developments, without having to subject its own behavior to international regulation. However, they cause resentment among states which are the targets of, e.g., export controls, and tend to be stopgap in character, serving to slow rather than to stop proliferation. They may best be seen as needed complements to developing global regimes.

#### **V. CONCLUSION**

Since the end of World War II, international law has served the United States by internationalizing norms that are at the heart of its political and social structure. An international system has been installed for civil and political rights, women's and children's rights, freedom from torture and slavery, and the accountability of leaders who commit genocide, crimes against humanity, and war crimes. Much of this system has been implemented at the initiative of the United States. The norm that condemns terrorism is in need of similar institutionalization and internationalization.

In pursuit of a norm of repudiation of terrorism, and of capabilities to prevent terrorism, the legal instruments, institutions, initiatives, and arrangements surveyed in this paper—from the anti-terrorism conventions to Security Council resolutions to anti-WMD treaty regimes to the Proliferation Security Initiative—all need vigorous implementation underpinned by the understanding and support of the legal profession and the general public.

*June 2006*

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Herman Goldman Lecture

# Territorial vs. Worldwide International Tax Systems: Which Is Better for the U.S.?

*Paul R. McDaniel*<sup>1</sup>

*Paul R. McDaniel, James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida Levin College of Law, delivered the Herman Goldman Lecture, October 24, 2006, at the Association.*

**T**he Report of the President's Advisory Panel on Federal Tax Reform, entitled "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," was released in November 2005.<sup>2</sup> One of the issues addressed in the Panel Report was whether the U.S. should shift from its current international tax system (taxing the worldwide income of its nationals with a credit for foreign income taxes) to a territorial system (exemption of foreign branch business income and dividends from foreign subsidiaries out of such income). The Panel opted for the territorial system. The report

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1. I thank Karen Reschly and Andrew Sodl for research assistance.

2. Hereinafter "Panel Report." This paper generally will not consider the domestic aspects of the two major proposals in the Panel Report—the Simplified Income Tax Plan and the Growth and Investment Tax Plan. A helpful discussion by the Senior Counsel and the Senior Economist to the Panel can be found in Jonathan Z. Ackerman and Rosanne Altshuler, Constrained Tax Reform: How Political and Economic Constraints Affect the Formation of Tax Policy Proposals, LIX N.T.J. 165 (2006).

devoted only about twelve pages to the subject, but its recommendation has reignited interest in a subject which has recurred with some regularity over the past decade.<sup>3</sup>

In this paper, I explore whether the proposal of the Panel would represent a beneficial tax policy change for the U.S. In so doing, the territoriality recommendation and what I will term a “model” worldwide taxation of income coupled with a foreign tax credit (WWI/FTC) system will be examined from the perspectives of efficiency, equity, and simplicity.<sup>4</sup>

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3. See, e.g., Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 *SMU L. Rev.* 753 (2006); J. Clifton Fleming and Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 41 *Tax Notes Int'l* 217 (2006); Michael J. Graetz and Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 *Nat'l Tax J.* 771 (2001); Ernest R. Larkins, *Double Tax Relief for Foreign Income: A Comparative Study of Advanced Economies*, 21 *Va. Tax Rev.* 233 (2001); Ernest S. Christian, *The International Components of Tax Reform: Tax Policy that Serves the National Interest*, 14 *J. of Int'l Tax.* 48 (2003 [Part I]) and 15 *J. of Int'l Tax.* 36 (2004 [Part 2]); Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman and Martin van Kessel, *U. S. Territorial Tax Proposals and the International Experience*, 42 *Tax Notes Int'l* 895 (2006).

4. The approach in this paper in general was taken by the American Bar Association Section of Taxation Task Force on International Tax Reform, *U.S. International Tax Reform: Objectives and Overview*, 59 *Tax Lawyer* 649 (2006) (hereafter “ABA Task Force”). The difference is that, because of disagreements among the Task Force members, neither system was endorsed over the other.

In adopting the approach described in the text, I reject competitiveness of U.S. companies as a tax policy criterion, although increased competitiveness by U.S. companies is often cited as a reason for adopting a territorial system. See, e.g., Panel Report, note 2, at 105; Staff of Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX-22-06 (June 21, 2006) pp. 55-56 (discussing the various meanings of the term “competitiveness”) (hereafter “JCT Staff Competitiveness Report”); Hearings on the Impact of International Tax Reform on U.S. Competitiveness, Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (2006) (Statement of R. Glenn Hubbard); David L. Brumbaugh, *Taxes and International Competitiveness*, CRS Report to Congress, RS 22445 (May 23, 2006).

I reject competitiveness as a criterion (1) because it has no substantive tax policy content (it seems largely to be a rhetorical slogan for U.S. multinationals that want tax cuts) and (2) I have found no empirical studies that show U.S. companies are at a competitive disadvantage vis-à-vis their foreign competitors. The World Economic Forum publishes an annual Global Competitiveness Report, the most recent being for 2006-2007. The report utilizes nine different factors to assess a country's (not a company's) competitiveness in global markets. Taxation—let alone a given international tax system—is not among the nine factors. The report can be found online at [www.weforum.org](http://www.weforum.org).

Mihir A. Desai and James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy*

Part I of the paper describes the Panel's proposal and the arguments it advanced in favor of the proposed change. Part II sets forth a model by which the Panel proposal will be evaluated. Part III compares the simplicity arguments for each of the two international tax regimes. In Part IV, the efficiency arguments advanced for each system are considered. Part V analyzes the equity issues under each system. Part VI sets forth my own conclusions on the issues.

I.

The Panel recommended that the current U.S. international tax regime be replaced with a two-part system:

1. Foreign active business income, as well as dividends from foreign subsidiaries out of such income, would be exempt from U.S. income tax.
2. Current U.S. income tax would be imposed on passive income and so-called mobile income (including, for example, financial services business income); a foreign tax credit would be allowed against the U.S. tax, with all such income being placed in a single basket.<sup>5</sup>

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in a Global Setting, 57 Nat'l Tax J. 937 (2004), advanced a new criterion, that of "ownership neutrality." That concept was sharply critiqued by Harry Grubert as lacking any "conceptual basis" and as of no use in addressing "any relevant policy issue." See comment of Harry Grubert, 58 Nat'l Tax J. 263 (2005). I find the Grubert analysis persuasive and will not employ the ownership neutrality concept in this paper. See also the critique of the concept by Fleming and Peroni, note 3, at 235-239.

Finally, I do not employ the criterion of "international norms," as was done, for example, by the Treasury Department in its study of subpart F. See United States Department of the Treasury Office of Tax Policy, the Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study (2000). The problem is that supposed "norms" change. For example, prior to the issuance of the first set of regulations under I.R.C. § 482 in 1968, there was no international consensus and hence no norm about the comparable uncontrolled price method to be used in the arm's length pricing methodology. Some 25 years later, when the Treasury issued proposed regulations, setting forth the largely formulary profit split and comparable profits methods, there was an outcry from many OECD countries that the international norm of arm's length transfer pricing was being violated by the new rules.

5. Panel Report at 240. The Panel Report closely parallels a report prepared by the Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05 (Jan. 27, 2005) at pp. 186-198 (hereinafter JCT Staff Report). This discussion will include references to that study and notes any differences between the Panel Report and

The Report provides a few of the technical details that would be required to implement the basic rules. Thus, allocation of expense rules between U.S. and foreign source income would be required. The Report asserts, without explanation, that these rules could be simpler than the current U.S. allocation rules.<sup>6</sup> The Panel goes on to recommend that interest expense allocation rules like those adopted in the 2004 Act be employed.<sup>7</sup> General and administrative expenses provided free of charge by one member of a (presumably controlled) group of corporations to another member would be required to be allocated first between U.S. and foreign income and then the expenses allocated to foreign income would have to be allocated between exempt and currently taxable income.<sup>8</sup> Research and experimentation expenditures, however, would be allocated only between U.S. and foreign mobile income.<sup>9</sup>

As to the exempt income group, the Report stated that gain on the sale of assets generating exempt foreign income likewise would be exempt from U.S. tax, but losses realized on such assets could not be deducted against U.S. income.<sup>10</sup> The Panel also noted that special rules would be needed for dividends from foreign corporations in which a U.S. company owned between 10 and 50 percent of the stock.<sup>11</sup> While dividends out of foreign active business income would be exempt, royalty and interest payments would be subject to U.S. tax if those payments were deductible in the source country.<sup>12</sup>

As to other issues, the Report noted that transfer pricing rules would become even more important under the proposed exemption system than under current law,<sup>13</sup> and recommended that increased resources be devoted to enforcing transfer pricing rules.<sup>14</sup>

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the JCS approach. The JCT Staff Report, at 189, adopts the same two-pronged approach. That Report, at 191-192, also observed that current subpart F and PFIC rules would have to be retained, including retaining the foreign tax credit for such income.

6. *Id.*

7. *Id.* The 2004 Act would change the current mandatory “water’s edge” interest allocation rule to provide certain corporations with an election to adopt a worldwide allocation method beginning in 2009. I.R.C. § 864(f).

8. *Id.* The JCT Staff Report, note 5, at 190, makes the same points with respect to expense allocation rules.

9. Panel Report at 240.

10. *Id.*

11. *Id.* Presumably, look-thru rules like those contained in § 904 would be required.

12. *Id.* at 134.

13. *Id.* at 134.

14. *Id.* at 240. The Panel also recommended that increased disclosure requirements be

The Report contains no recommendations with respect to transition rules that would be required if the Panel's recommendation were adopted.<sup>15</sup>

The Panel offered several reasons for its proposed changes. They will simply be listed here and discussed in succeeding parts of this paper. The reasons included:

1. The availability of deferral of U.S. tax on income earned by a foreign subsidiary creates an incentive to retain those earnings in the subsidiary for as long as possible and distorts other business and investment decisions.<sup>16</sup>
2. The current system distorts business decisions, treats different U.S. multinational corporations (MNCs) differently, and encourages wasteful tax planning.<sup>17</sup>
3. Changing to an exemption system would make U.S. businesses more competitive in their foreign operations.<sup>18</sup>

The benefits of changing to an exemption system, according to the Panel, include:

1. It would allow U.S. companies to compete abroad more effectively.

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adopted for foreign income. *Id.* The JCT Staff Report, at 192, observed that adoption of an exemption system by the U.S. would require it to renegotiate all of its income tax treaties.

15. Apparently, the Panel exemption system would apply to all post-enactment dividends, including those paid out of pre-enactment earnings on which U.S. tax had been deferred. The JCT Staff Report, at 191, proposed a transition rule under which the new exemption system would apply only to qualifying foreign income generated after the effective date of the enacting legislation. Present law would continue to apply to pre-effective date foreign earnings.

16. Panel Report at 103. The Panel also asserted that U.S. tax on repatriated dividends distorts the repatriation decision. *Id.* at 133. The JCT Staff Report, at 188, added that basing U.S. taxation on repatriation makes the U.S. tax on foreign source income substantially elective. It also noted that maintaining deferral indefinitely is the equivalent of exemption of the income so deferred.

17. Panel Report at 104. The Panel apparently had in mind tax planning that aims at averaging down overall foreign tax rates to avoid falling into an excess credit position for foreign tax credit purposes. JCT Staff Report, at 189, also asserts without any authority that U.S. corporations engage in a greater degree of tax-induced business planning than do corporations in exemption countries.

18. Panel Report at 104.



2. It would reduce the degree of tax-induced distortions on business decisions.

3. It would produce simplification gains.<sup>19</sup>

The Report also stated, without discussion, that there is no definitive evidence that investment location decisions would be significantly changed from the present situation.<sup>20</sup>

## II.

In this part, I will set forth the model I propose to use in assessing whether a worldwide taxation of income with a foreign tax credit system (WWI/FTC) or a territorial system is better for the U.S. And by “better,” I mean which maximizes the welfare of U.S. citizens and residents.

In so doing, I reject the approach of the Panel and the JCT staff in which they compared an ideal (or near ideal) territorial system with the current imperfect WWI/FTC system in effect in the U.S.<sup>21</sup> This approach, it seems to me, does a real disservice to policymakers (unless, of course, they have predetermined that they desire the adoption of a territorial system).

Instead, I believe the appropriate policy comparison is between a (near) ideal WWI/FTC system and a (near) ideal exemption system. Only then can policymakers assess each in terms of equity, efficiency, and simplicity. Accordingly, this part sets forth a model of a WWI/FTC system and a model of a territorial system.

### **WWI/FTC System**

In very brief form, the following basic elements constitute a (near) ideal WWI/FTC system.

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19. *Id.* at 134. The JCT Staff Report, at 195, however, notes that the need to retain subpart F rules, and transfer pricing rules, and to provide transition rules would create significant complexities.

20. Panel Report at 135. The JCT Staff Report, at 194, however, warned that there would need to be rules to prevent shifting of income to low-tax jurisdictions. It did observe, at 195, that disallowance of deductions attributable to exempt foreign income should serve as a brake on incentives to move more activity to low-tax jurisdictions.

21. See Panel Report, note 2, at 104-105. This same approach was taken in Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System* (American Enterprise Institute, 2001); Rosanne Altschuler and Harry Grubert, *Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 *Nat'l Tax J.* 787 (2001).

At various points in the following discussion, I do compare aspects of the proposed exemption system to current law.

1. All foreign income, whether from business operations or passive investments, would be taxed currently, on an accrual basis, by the U.S. No deferral of tax on foreign source income would be permitted.<sup>22</sup> As a result, U.S. income tax considerations would not affect the decision whether to operate in branch or subsidiary form, a situation that does not currently exist, e.g., the branch form is preferred if foreign losses are expected that can offset U.S. source income whereas if profits are expected, the use of a subsidiary provides the opportunity to defer U.S. on those profits.

2. An FTC would be allowed for all foreign income taxes paid by the U.S. taxpayer on its foreign source income.

a. The allowable credit would be limited to the U.S. tax on the foreign source income.

b. Two baskets—active business income and passive investment income—would be retained.

c. Because worldwide averaging of business income presents too much opportunity for eliminating U.S. tax on foreign source income, a per-country limitation (with two baskets in each country) should be employed.<sup>23</sup>

d. As discussed in further detail in following parts of this paper, a number of elements of the current U.S. FTC system would continue, e.g., look-through rules and allocation of deduction rules.

The implications of these basic elements and additional needed rules are detailed further in subsequent parts of this paper.

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22. For extensive discussions of a proposal to end deferral, see Robert J. Peroni, J. Clifton Fleming, Jr., and Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral*, 20 Tax Notes Int'l 547 (2000).

Senator John Kerry has introduced legislation to require current taxation of the income of controlled foreign corporations, coupled with a reduction in the corporate tax rates. S. 3777, *The Export Products, Not Jobs, Act*, 109<sup>th</sup> Cong., 2d Sess. (2006).

Note that this element of the model eliminates the concerns expressed in the Panel Report, note 2, at 133, that the current system discourages repatriation of dividends from foreign subsidiaries.

23. See ABA Task Force, note 4, at 672, for a discussion of a similar proposal.

### **Territorial System**

In very brief terms, the following sets forth the basic elements of a (near) ideal territorial system.

1. The residence country could include foreign source income in its tax base but exempt foreign source business income. Exempt income includes both branch income and dividends from foreign subsidiaries paid out of foreign business income.
2. Typically, countries adopting such a system do not extend the exemption to foreign investment income. As per the Panel Report, such income may be taxed currently, with a foreign tax credit allowed.
3. Foreign source losses are not permitted to offset domestic source income.

Implications of the foregoing and the rules necessary to implement a territorial system are discussed in subsequent parts of this paper.

### **III.**

Supporters of a territorial system frequently assert that such a system is more simple than a WWI/FTC system.<sup>24</sup> Typically, little analysis accompanies this assertion. And, indeed, there is no basis for such a statement. In fact, virtually all the elements that add up to complexity in a WWI/FTC system are, or should be, present in a territorial system. And, when additional elements of the Panel proposal are factored in, the U.S. international tax system would be made more rather than less complex.

The following discussion identifies the elements that can create complexity, or in any event are necessary, in a model WWI/FTC system. As each rule is identified, its role in a territorial system is considered, including an assessment whether there is greater or less pressure on the rule in one system versus the other.<sup>25</sup>

#### **Source of income rules**

Source of income rules play a critical role in the current U.S. interna-

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24. See, e.g., Panel Report at 174; Christian, note 3, at 40 (territoriality is simplest system "without question"); Larkins, note 3, at 250.

25. The best analysis of why an exemption system is not more simple than a WWI/FTC system is in Hugh J. Ault, U.S. Exemption/Territorial System vs. Credit-Based System, 32 Tax Notes Int'l 725 (2003).

tional tax system and would continue to do so in a model WWI/FTC system. Such rules are equally necessary in a territorial system. Since in that system complete exemption is provided for specified foreign source income, there would be greater pressure on the source of income rules than is the case even under present law. Under present law, deferral of tax but not complete exemption turns on classifying income as foreign source. A territorial system is no more simple (or complex) when compared to a model WWI/FTC system insofar as source of income rules are concerned.<sup>26</sup>

#### **Source (or allocation) of deduction rules**

Under current law, source of deduction rules play a crucial role in the operation of the FTC system. Deductions allocated to foreign source income reduce the allowable foreign tax credit (and for a taxpayer in an excess credit position, the allocation is equivalent to denying the deduction altogether). Such rules would continue to be necessary in a model WWI/FTC system. But it is also true that such rules play an equally important role in a territorial system. Failure to allocate appropriately deductions to foreign source income that is exempt from domestic tax means that the taxpayer would be able to deduct against domestic taxable income items that are costs of producing tax-exempt income (from the perspective of the residence country). This result, of course, would violate a long-accepted principle in U.S. tax policy. For these reasons, as compared to present law, pressure on the source of deduction rules would be at least as great in a territorial system. And, as with the source of income rules, in this respect, a territorial system is no more simple than a model WWI/FTC system or, indeed, even the present rules.<sup>27</sup>

#### **Outbound transfers of property**

Currently, I.R.C. § 367(a) may impose a toll charge on outbound transfers of property that has appreciated in value while subject to U.S. domestic taxation. Exceptions to this rule and exceptions to the exceptions are also to be found. In turn, I.R.C. § 367(b) and the regulations thereunder provide rules for the treatment of certain inbound and foreign-to-foreign transactions.

In a model WWI/FTC system, there would be no need for §367. Gain on appreciated property transferred to a CFC would be taxed currently by

26. In accord with the text discussion are Ault, note 25, at 727; Merrill et al., note 3, at 905; Graetz and Oosterhuis, note 3, at 782.

27. In accord with the text discussion are Ault, note 25, at 728; Panel Report, note 2, at 134; Merrill et al., note 3, at 905; Graetz and Oosterhuis, note 3, at 782.

the U.S. whenever realized. Similarly, the concerns of § 367(b) would appear to decline significantly.

Under a territorial system, however, § 367(a) would be of greater importance than under current law and would be necessary to protect the U.S. tax base.<sup>28</sup> Currently, the § 367(a) toll charge is the price paid to transfer property into a world of deferral. But under a territorial system the appreciation in value would be completely exempt from U.S. tax if the gain is not taxed at the time of transfer. It thus appears that some of the exceptions in § 367(a) that are tolerable in a world of deferral would not be acceptable in a world of exemption. The § 367(b) rules would need to be examined in a shift to a territorial system to see if it would still be necessary to deal with some of the inbound situations.<sup>29</sup>

In this set of rules, a territorial system produces more, not less, complexity than does a WWI/FTC system.

#### **Transfer pricing**

Transfer pricing rules play two important roles. First, they seek to assure that each entity in a controlled group is assigned the income that is appropriate to its role in cross-border transactions. Second, transfer pricing rules operate to allocate revenues between the governments of the countries that are involved in particular cross-border transactions.

As the Panel Report recognized, a territorial system would place greater pressure on transfer pricing rules than is true under present law.<sup>30</sup> Again, the reason is that profit that can be isolated in a low- or no-tax country is totally exempt from U.S. tax; in today's world, deferral of U.S. tax is at stake. The Panel also noted that in fact a territorial system would require a much higher degree of enforcement of transfer pricing than is currently the case.

By contrast, I argue that a WWI/FTC system could actually reduce the pressure on transfer pricing rules. In general, there would be no benefit from isolating profit in the Cayman Islands since the U.S. would tax that profit currently and would have to give little or no FTC. The argument needs to be modified if a per-country limitation is adopted. There

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28. In accord are Ault, note 25, at 728; ABA Task Force, note 4, at 665-666; Graetz and Oosterhuis, note 3, at 783.

29. Ault, note 25, at 728, observes that the issues to which the current regulations under I.R.C. § 367(b) are directed also would arise in an exemption system.

30. In accord are Ault, note 25, at 728; Panel Report, note 2, at 134, 240; JCT Staff Competitiveness Report, note 4, at 30; Merrill et al., note 3, at 905; Graetz and Oosterhuis, note 3, at 782.

would be an incentive, for example, to shift profits from a high-tax country in which the taxpayer is in an excess credit position to a low-tax country in which the taxpayer is in an excess limit position. This result could be most easily accomplished by making interest or royalty payments that are deductible in the payer's country. Of course, the high-tax country would have an interest in applying its own transfer pricing rules to such transactions. Effective exchange of information procedures would help protect the tax bases both of the U.S. and the high-tax country.

### **Tax havens**

The U.S. seeks to protect its tax base through the application of its transfer pricing rules and the rules of subpart F (requiring current taxation of specified base company income over passive investment income).

Countries with exemption systems have found that some rule is necessary to deal with efforts by their taxpayers to isolate income in low- or no-tax countries. Some countries require that the source country impose a specified minimum rate of tax, others that the income be subject to tax, and still others maintain lists of "good" countries, the income earned in which would qualify for exemption. The point is that shifting to an exemption system does not eliminate the need for subpart F-type rules.<sup>31</sup> As a result, no simplification gains from such a change should be expected as compared to the present U.S. approach.

On the other hand, such regimes are unnecessary in a WWI/FTC system. All foreign income would be taxed currently by the U.S. even if earned in a low- or no-tax country. Thus, purely on simplification grounds, in this area the model WWI/FTC system has the edge over a territorial system.<sup>32</sup>

### **Look-thru rules**

For purposes of applying the indirect FTC under I.R.C. §902, the U.S. uses look-thru rules to determine the proper basket into which to place dividends received either from a CFC or a so-called 10/50 corporation.<sup>33</sup>

Under the model WWI/FTC system, these look-thru rules would continue to be needed as it includes a two-basket (business income and passive investment income) system on a per-country basis.

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31. See Ault, note 25, at 727-728.

32. Astonishingly, the Panel Report contained no mention of the tax haven problem. Presumably, under the Panel approach even if foreign business income incurred no tax at source, the income would still be exempt from U.S. tax.

33. I.R.C. § 904(d)(3) and (4).

An exemption system in theory would not require baskets. However, in practice countries with territorial systems typically do not exempt foreign source passive investment income. Instead, they tax such income earned by their residents on a worldwide basis and provide a FTC for foreign taxes (typically withholding taxes) paid.

The Panel Report adopts this approach. It would tax so-called “mobile” income on a current basis and allow a FTC for foreign taxes incurred, if any. Two observations may be made. First, in effect a two-basket system is retained because it is necessary to distinguish business income from mobile income. Second, each basket of income is subject to a different international tax regime, i.e., an exemption system for business income and a worldwide system for mobile income. In contrast, under the model WWI/FTC system, while two baskets are employed, the same international tax system would apply to each basket. The Panel Report approach inevitably will be more, not less, complex than either the model WWI/FTC system or current law, as it requires the complete implementation of an exemption and an FTC system for each of the two different classes of income.

### **Foreign losses**

Under present U.S. law, a special set of rules applies to deal with foreign losses incurred by U.S. companies. The rules play two different roles. The first role is to account for the fact that, in the case of operation through a foreign branch, any losses incurred by the branch reduce U.S. taxable income. If the branch subsequently earns a profit, then special rules insure that the U.S. in effect recaptures those previously deducted losses into income.<sup>34</sup> The second set of rules operates within the FTC basket system and mandates how foreign losses in one basket of income are to offset income in other baskets of income.<sup>35</sup> Again, the objective is to ensure that foreign losses in one basket offset foreign income in other baskets before offsetting U.S. income for FTC purposes.

Similar foreign loss rules would be necessary in a model WWI/FTC system, although their FTC role would be significantly diminished in a two-basket system.

Foreign losses must also be dealt with in an exemption system. The basic rule needs to be that, since foreign source business income is exempt from domestic tax, foreign source losses cannot be taken against domestic

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34. I.R.C. §§ 367(a)(3)(C) and 904(f)(1) .

35. I.R.C. § 904(f)(5).

source income. That is the approach recommended by the Panel Report. It should be noted, however, that exemption systems are not impervious to deviations from the norm. In a number of exemption countries, foreign losses are allowed as a deduction against domestic source income. Such a rule constitutes a tax expenditure or tax subsidy in an exemption system.

### **Tax Treaties**

All current U.S. bilateral tax treaties guarantee U.S. taxpayers the availability of a foreign tax credit.<sup>36</sup> If the Panel proposal were adopted, all these treaties would have to be renegotiated, a prescription for complexity and uncertainty for the government and taxpayers alike.<sup>37</sup>

### **Transition rules**

Another element of complexity involved in a change to an exemption system would arise from transition rules from the current system to an exemption system. Remarkably, the Panel Report contains no such rules. Apparently, dividends repatriated out of pre-effective date tax-deferred business earnings would be wholly exempt from tax.

More realistically, as noted above, the JCT Staff Report did include transition rules to insure that distributions out of previously untaxed foreign earnings would be subject to tax. Presumably, some sort of ordering rule would be required to determine whether a post-effective date dividend was made out of pre-effective date or post-effective date earnings (or some combination thereof), the latter qualifying for exemption. As the JCT Staff Report recognizes, however, the necessity of such a transition rule introduces an additional layer of complexity.

If the U.S. were to adopt the model WWI/FTC system, transition rules would also seem to be required. That is, post-effective date income would be taxed currently, but tax on pre-effective date earnings would be imposed only when repatriated. Again, additional complexity is introduced by the necessity for transition rules.<sup>38</sup>

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36. See, e.g., Article 23 of the 2006 United States Model Income Tax Convention.

37. See JCT Staff Competitiveness Report, note 4, at 12-13; Merrill et al, note 3, at 905. It could be argued that a domestic law exemption system would apply to U.S. taxpayers without regard to the treaty in any event so no treaty change is required. However, some U.S. multinationals will pay a higher tax under an exemption system than they do under current law. Such taxpayers might assert that they are entitled to a treaty-based FTC.

38. See JCT Staff Report, note 4, at 10; Graetz and Oosterhuis, note 3, at 783-784.



### Conclusion

The assertion that an exemption system is less complex than a model WWI/FTC system simply will not stand up to analysis. Indeed, it does not even hold true as compared to the current U.S. rules. As noted above, in several important areas, the model WWI/FTC system actually achieves greater simplification than does an exemption system. Moreover, the Panel approach involving the use of an exemption system for business income and a WWI/FTC system for other income necessarily is inherently more complex than either current law or the model WWI/FTC system proposed here, as taxpayers have to comply with two different systems of taxing foreign income.

### IV.

The next issue to be addressed is whether efficiency gains would be realized by changing from the present system to a territorial system or, alternatively, by changing from the present system to a model WWI/FTC system. There may be a number of different ways in which the term efficiency is used. For definitional purposes in this paper, the term shall refer to a tax system that affects as little as possible the nature and location of business and investment activities.

There are a number of problems with the current U.S. international tax rules that violate this efficiency criterion. In no particular order, these include, but are not limited to, (1) use of the check-the-box rules for foreign subsidiaries;<sup>39</sup> (2) the ability of a parent company to borrow in the U.S. to fund foreign subsidiaries the tax on whose income is deferred but the interest on the loan is fully deductible against U.S. taxable income; (3) the deferral regime itself; (4) the ability to treat as foreign source 50% of export sales income even though that income is unlikely to be taxed in the importing country; (5) to this observer, at least, insufficient resources devoted to curbing aggressive transfer pricing structures; and (6) the ability to average down foreign taxes by cross-crediting low and high tax country taxes. The result has been very low effective rates of U.S. tax on the foreign income of U.S. companies.

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39. For a discussion of the impact of these rules in the international context, see Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 Fla. Tax Rev. 186 (2005). See also ABA Task Force, note 4, at 668. See also Lokken, note 3, at 759-764; Paul W. Oosterhuis, *The Evolution of U.S. International Tax Policy—What Would Larry Say?* 42 Tax Notes Int'l 1119, 1124 (2006), for a proposal similar to that advanced in the text.

Two competing notions of neutrality have been employed in assessing international tax systems: capital export neutrality (CEN) and capital import (or competitive) neutrality (CIN). The former is associated with a foreign tax credit mechanism and the latter with an exemption system. The issue is whether both of these asserted neutralities satisfy the efficiency criterion set forth above.

The Panel Report, following earlier studies, asserts that shifting from the present U.S. system to an exemption system would have little impact in terms of the decisions by U.S. companies to locate in low- or no-tax countries. Even if one accepts that view, it does not lead to the conclusion that adopting an exemption system is a desirable policy for the U.S. All these studies tell us is that the U.S. WWI/FTC system is deeply flawed.

One can gain perspective on the efficiency issue only if the comparison is made between an exemption system and the model WWI/FTC system outlined earlier in this paper. The model WWI/FTC system generally achieves CEN while the exemption system generally would achieve CIN. I have defined efficiency as including minimization of the tax impact on business location decisions. The model WWI/FTC system comes closer to achieving efficiency than the proposed exemption system. That is, the decision whether to carry on business or invest in the U.S. or another country generally would be unaffected by U.S. income tax rules in the model WWI/FTC system. There would be no incentive to invest or do business in a low- or no-tax country because, regardless of location, the U.S. tax would be imposed. This result would be reinforced by adopting a per country limitation for FTC purposes.

There is one deviation from a pure CEN approach that is accepted in the model WWI/FTC system proposed here. A completely implemented CEN policy would require that the U.S. refund all foreign taxes in excess of the U.S. tax on foreign source income. Such a rule, of course, would put U.S. revenues completely at the mercy of foreign countries' tax rates. Neither the U.S. nor any other FTC country will accept or has accepted this result. Accordingly, the model WWI/FTC system does accept that the U.S. will limit the allowable FTC to the U.S. tax on foreign source income, albeit imposed on a per country basis to prevent averaging between high- and low- or no-tax countries.

As compared to the CEN model, CIN does not satisfy the efficiency criterion as I have defined it. There is an inherent bias in favor of investing or carrying on business in countries with a tax rate lower than that of the residence country. In addition, it is unlikely that an exemption system can achieve its stated goal of insuring that a residence company can

do business in another country and face the same tax rate as its local or third country competitors operating in the source country. This failure is due to the fact that an exemption system will “work” only if all countries employ an exemption system and have identical tax rates, conditions obviously not now met or ever likely to be met.<sup>40</sup>

To a non-economist, it is puzzling why a territorial system would be seen as preferable to a model WWI/FTC system. It seems clear that whereas the model system would not favor locating business or investment abroad at the expense of U.S. workers, an exemption system would create just such an incentive in a world where there are a substantial number of low- and no-tax countries.<sup>41</sup> As a Treasury study concluded, CEN maximizes global (including the U.S.) welfare, whereas CIN does not.<sup>42</sup>

The Panel Report advances as a reason in support of its territorial recommendation its assertion that the sophisticated (wasteful) tax planning that is carried out under current U.S. rules would be greatly curtailed. The JCT staff went further and asserted that U.S. corporations engage in a greater degree of tax-induced planning than do corporations in exemption countries. These, I assume, are efficiency concerns. Unfortunately, neither report provides any basis for these assertions. And, indeed, there is no such basis.

The assertion that tax planning is less complex in an exemption country would be astonishing to a Dutch tax advisor, for example. Tax planning for Dutch multinational companies is at least as sophisticated as that carried on in the U.S. On the other hand, my own experience in dealing with tax advisors in Japan (an FTC country) is that less emphasis is placed on tax planning. Thus, the presence of complex tax planning has nothing to do with whether a country employs a WWI/FTC or a territorial regime.

I believe that the degree of sophisticated tax planning is affected far more by what I would term the “tax culture” of a country. In the U.S., that culture includes the general rule that lawyers are to advance the interests of their clients as vigorously as is permitted by law. In addition, in the tax context, this approach is reinforced by the view that no taxpayer is obligated to pay a dollar more in taxes than the law requires. These

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40. See Dan R. Mastromarco, U.S. International Tax Reform? Define “Reform” for Me, 43 *Tax Notes Int’l* 481, 487 (2006).

41. See ABA Task Force, note 4, at 665.

42. See United States Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study* by the Office of Tax Policy (Dec. 2000) at 23.

elements of the U.S. “tax culture” result in legal (and accounting) tax advisors aggressively advancing the tax interests of their clients to produce the lowest tax possible. Nothing in this tax culture would change just because the U.S. adopted a territorial system. Nor would it change if the U.S. adopted the model WWI/FTC system. Sophisticated and complex tax planning, and equally sophisticated legislative and regulatory responses thereto, are here to stay.

V.

Finally, I turn to the question whether an exemption system or the model WWI/FTC system is more equitable. Of course, the traditional notions of horizontal and vertical equity apply only to individuals. At the corporate level, as discussed in Part IV, the primary concern is efficiency, and that is the level at which most cross border investment and business is carried out. But this does not mean that there are no fairness issues raised by an international tax regime, particularly when coupled with a country’s corporate/shareholder tax regime.<sup>43</sup>

It is not always appreciated that there is an equity as well as neutrality principle embedded in a WWI/FTC system. The horizontal equity principle can be stated as requiring that a U.S. taxpayer pays the same amount of U.S. and foreign taxes as does a taxpayer realizing the same amount of income solely from a U.S. source. Likewise, vertical equity requires that a taxpayer with greater income from U.S. and foreign sources should pay relatively more tax than does a U.S. taxpayer with lower income, whether from U.S. or foreign sources.

The equity issue may be more readily seen if a model WWI/FTC system were employed by a country that had a fully integrated shareholder/corporate tax regime. By fully integrated, I mean that all income and tax attributes flow through the corporation and are taken into account only at the shareholder level. (A withholding obligation might be imposed on the corporation.) This would mean that in a model WWI/FTC system all foreign income taxes incurred by a corporation would flow through and be creditable by individual shareholders. In such a system, both horizontal and vertical equity would be satisfied.

The Panel Report did propose an integration system. Under its proposal all foreign income would be exempt at the corporate level but do-

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43. For an extensive analysis of fairness issues in the international context, see J. Clifton Fleming, Robert J. Peroi, and Stephen E. Shay, *Fairness in International Taxation: the Ability-to-Pay Case for Taxing Worldwide Income*, 3 Fla. Tax Rev. 299 (2001).

mestic income would be taxed. At the shareholder level, dividends paid out of domestic income would be exempt but dividends out of foreign (exempt) income would be fully taxable. This pair of proposals has several perverse effects. I shall describe three. First, depending on the tax rate in the foreign country, an individual U.S. shareholder could well experience a tax reduction on corporate-earned domestic income but a tax increase on dividends paid out of corporate-earned foreign income. Indeed, if there is any positive rate imposed on foreign source income, a dividend out of that income will bear a higher tax rate than a dividend paid out of domestic income.<sup>44</sup> Thus, the repatriation tax, much decried by exemption proponents, is retained; it is imposed at the shareholder level rather than at the corporate level. Perversely, only if the foreign income is not subject to any tax would dividends out of foreign and domestic source income bear the same tax. The inherent incentive in a territorial system to earn income in no-tax countries would thus be aggravated. Second, the Panel proposal replaces the asserted lock-in effect under current law for income earned abroad with a lock-in effect on distributing dividends out of foreign earnings. Thus, the only way to avoid the shareholder level repatriation tax is the same as that used to avoid the current corporate-level repatriation tax: do not distribute dividends to a U.S. parent corporation out of business income earned by a foreign subsidiary. Third, and following from the first two points, is that the sophisticated tax planning that currently takes place to avoid the corporate-level repatriation tax will shift to be carried out to avoid the shareholder-level repatriation tax.

It is thus clear that, under the Panel proposal, both horizontal and vertical equity principles would be violated. Shareholders with the same amount of dividend and other income generally would not pay the same

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44. Suppose that U.S. Corporation A has 100 of foreign source income on which it pays 30 of tax. U.S. Corporation B has 100 of domestic source income on which it pays 35 of tax. Corporation B distributes a 65 dividend which, under the Panel proposal, is exempt from tax at the shareholder level. Corporation A distributes a dividend of 70 and a tax of 24.50 (35 percent x 70) is imposed at the shareholder level because the dividend is not tax exempt. The shareholder of Corporation A has thus borne a total tax of 54.50, leaving only 45.50 in after-tax income, compared to the 65 that the shareholder of Corporation B realizes. This result will occur at any time the foreign source income is subject to a positive rate of tax. See also Merrill et al., note 3, at 907, for a further example of the phenomenon described here.

The Panel's integration proposal also raised complexity concerns as some type of ordering rules would be required for corporations that have both domestic and foreign income in order to determine the portion of a dividend that is subject to shareholder tax and the portion that is exempt. The Panel suggests a *pro rata* approach.

amount of tax. Nor would there be any guarantee that higher income shareholders would bear a relatively greater tax than lower income counterparts, at least not in the manner specified in I.R.C. §1.

**VI.**

The Panel Report missed an opportunity to assist U.S. tax policy makers and the American public by comparing its proposed exemption system only to the current flawed FTC system. In my view, it would have performed its stated mission far better if it had also compared its exemption proposal with a model WWI/FTC system so that taxpayers and tax policymakers could have formed a better judgment as to which direction the U.S. should move in reforming its international tax system. Of course, had the Panel done so, it might well have concluded, as did this examination of the issues, that a model WWI/FTC system is superior to a territorial system, on simplicity, efficiency, and equity grounds.

# Recommendations on the Selection of Judges and the Improvement of the Judicial Selection System in New York State

*The Judicial Selection Task Force*

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# Recommendations on the Selection of Judges and the Improvement of the Judicial Selection System in New York State

## *The Judicial Selection Task Force*

*This report of the Judicial Selection Task Force was issued in December 2006. In February 2007, the United States Supreme Court granted certiorari in Lopez Torres v. New York State Board of Elections, in which the lower courts held that New York's judicial convention method of nominating Supreme Court Judges is unconstitutional. The Supreme Court is expected to hear arguments in the case in the fall of 2007.*

### **INTRODUCTION**

The Judicial Selection Task Force (or “Task Force”) was convened by the Association of the Bar of the City of New York (the “Association”) in March 2006. Its mandate was to issue recommendations on improving the judicial selection system in New York State, particularly in light of the recent reform proposals by the “Commission to Promote Public Confidence in Judicial Elections” (the “Feerick Commission”) and Judge John Gleeson’s January 2006 decision in *Lopez Torres*.<sup>1</sup>

The question of how judges are generally to be selected has been the subject of debate throughout our nation’s history. *See infra* Section IA. In recent years this debate has been particularly prominent. In April 2003,

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1. *Lopez Torres v. N.Y. State Bd. of Elections*, 411 F. Supp. 2d 212, 246 (E.D.N.Y. 2006), *aff’d*, 462 F.3d 161 (2d Cir. 2006).

## JUDICIAL SELECTION TASK FORCE

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Chief Justice Judith Kaye appointed the 29-member Feerick Commission, headed by John Feerick, former Dean of Fordham Law School (and a former President of the Association), and charged it with the mandate “to provide New York’s courts with a blueprint for preserving the dignity of judicial elections and promoting meaningful voter participation, which will serve to reaffirm public trust in our judiciary.”<sup>2</sup> Abiding by its mandate, the Feerick Commission only examined the election system—and not other judicial selection mechanisms—and issued its recommendations on improvements that could be brought to that system.<sup>3</sup>

In January 2006, the landscape significantly changed with the issuance of Judge Gleeson’s decision in *Lopez Torres*, holding the current judicial convention process for selecting New York Supreme Court Justices unconstitutional and providing for primary elections in the absence of any action by the Legislature. The issue of judicial selection was thus transformed into a matter of immediate and significant consequence to the State. Now that Judge Gleeson’s decision has been affirmed by the Second Circuit, judicial selection must be a leading issue before the Legislature.

The Association, for more than a century, has played a very active role in the judicial selection debate and has long adhered to the position that the most appropriate method for selecting New York State’s judiciary is an appointive system. In October 2003, a task force appointed by the Association issued a report firmly supporting the Association’s long-standing position in favor of a commission-based appointive system and recommending that independent and diverse citizen screening commissions review candidates’ qualifications and forward the candidacy of only the most highly qualified applicants for appointment by an accountable elected official.<sup>4</sup>

In order to best fulfill its mandate of issuing recommendations improving New York’s judicial selection system, the present Task Force created three subcommittees: (i) the Impact on Minority Candidates Subcommittee, (ii) the *Lopez Torres* Subcommittee and (iii) the Improvement of the Elective System Subcommittee.

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2. Press Release, New York State Unified Court System, Commission to Foster Public Confidence in State’s Elected Judges and the Electoral Process (Apr. 16, 2003), available at [http://www.nycourts.gov/press/pr2003\\_08.shtml](http://www.nycourts.gov/press/pr2003_08.shtml).

3. See generally New York State Commission to Promote Public Confidence in Judicial Elections, *Final Report to the Chief Judge of New York State* (Feb. 6, 2006).

4. See generally Judicial Selection Task Force of the Association of the Bar of the City of New York, *Recommendations on the Selection of Judges and the Improvement of the Judicial System* (2003) (“Task Force 2003 Report”), available at <http://www.abcny.org/pdf/Judicial%20selection%20task%20force.pdf>.

*i. The Impact on Minority Candidates Subcommittee*, chaired by Judge Deborah Batts, reviewed a large variety of data, empirical studies and articles regarding minority representation on the bench. The subcommittee realized that—for a number of reasons—the data was inconclusive as to whether one of the two systems—appointive or elective—better promotes diversity. The subcommittee did, however, reach general conclusions as to improvements that *could and should* be made to both systems to promote a more diverse pool of candidates and, thus, a more diverse bench. *See infra* Section III.

*ii. The Lopez Torres Subcommittee*, chaired by Dean David Rudenstine, followed closely the evolution of *Lopez Torres* from the Eastern District of New York to the Second Circuit and oversaw the drafting of the Association’s *amicus brief* that was submitted in May 2006 before the Second Circuit in support of affirmance of Judge Gleeson’s decision.<sup>5</sup> As noted above, the decision was affirmed.<sup>6</sup>

*iii. The Improvement of the Elective System Subcommittee*, chaired by Lawrence Mandelker, studied and discussed improvements that can be brought to the current constitutionally mandated elective process until the State Constitution is amended in favor of a commission-based appointive system. The result of that work is incorporated herein. *See infra* Sections I and II.

In this Report on Recommendations on the Selection of Judges and the Improvement of the Judicial Selection System in New York State (the “Report”), the Task Force firmly reiterates the Association’s long-standing position in favor of a commission-based appointive system. It sets forth a proposed amendment to Article 6 of the New York State Constitution to implement such a system. *See generally* Section I.

The Task Force recognizes, however, that the current system of election has been long entrenched in New York and that a change to an appointive system could entail a process which could face considerable political opposition and which, in addition, could be complex and lengthy. Mindful of such a reality, the Task Force is also recommending a statutory

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5. The *amicus brief* was drafted by the law firm of Skadden, Arps, Slate, Meagher & Flom LLP. The Task Force is particularly grateful to Sheila L. Birnbaum and Preeta D. Bansal for their generous and skillful assistance. Judge Deborah Batts and Richard Rifkin recused themselves from any discussion or consideration of the *amicus brief* and of the *Lopez Torres* case more generally.

6. *Lopez Torres*, 463 F.3d 161.

reform of the current judicial convention and primary systems designed to redress—among other things—the constitutional infirmities identified in *Lopez Torres* until the State Constitution is amended in favor of a commission-based appointive system. The Task Force is adamantly opposed to the default solution of primary elections for Supreme Court without public financing and without a convention system. *See generally* Section II.

Finally, regardless of whether appointive or elective systems are in use for the selection of judges, changes must be made to promote a more diverse pool of candidates, and therefore a more diverse bench. These changes include public financing for all judicial candidates; the use of diverse screening and qualification commissions; encouraging appointing authorities to commit to the importance of diversity; public education about the importance of a diverse judiciary; and, if the convention system survives after *Lopez Torres*, reductions in the number of convention delegates. *See generally* Section III.

The Task Force believes that the recent developments relating to judicial selection issues, and in particular the Second Circuit’s decision in *Lopez Torres*, require a change to the current election process and provide the most promising opportunity in many decades for a thorough reassessment of the current judicial selection system. In this Report, we urge the adoption of reforms designed to provide our State with a judiciary of the highest quality and independence, and to restore the confidence of all New Yorkers in the judicial system.

#### **I. PROPOSED CONSTITUTIONAL AMENDMENT IN FAVOR OF A COMMISSION-BASED APPOINTIVE SYSTEM**

New Yorkers are faced with a historic opportunity for reforming the State’s disingenuous process for selecting many of New York’s trial court judges. In the wake of the seminal decision by the Second Circuit Court of Appeals in *Lopez Torres*, the Legislature must consider what changes should be made in the manner in which candidates are nominated for the position of Supreme Court Justice. For reasons set forth in this Report, the Legislature should seize this opportunity and enact, for consideration by the voters in a statewide referendum, an amendment to Article 6 of the New York State Constitution providing for commission-based appointment for all New York State trial court judges and for the presiding justice and justices of the Appellate Divisions of the State Supreme Court.

**A. Historical Background**

In *The Federalist* No. 78, Alexander Hamilton argued compellingly for the appointment of federal judges with permanent tenure during good behavior. Hamilton warned that if the periodic power to select judges were given “to the people, or to persons chosen by them for the special purpose, there would be too great a disposition to consult popularity, to justify a reliance that nothing would be consulted but the Constitution and the laws.”<sup>7</sup> The practice of appointing judges who would hold office during good behavior, he noted, “is conformable to the most approved of the State constitutions.”<sup>8</sup>

As Hamilton observed, at the birth of the nation, most states provided for the appointment of judges. In New York, the 1777 State Constitution provided for the selection of judges by means of appointments made by a Council of Appointment.<sup>9</sup> And although in a few states the legislature selected the judges during this time period, it was not until 1812 that any state elected judges by a vote of the people.<sup>10</sup>

In 1828, Andrew Jackson was elected President, and with his election the era of Jacksonian democracy became ascendant. Broadly speaking, Jackson’s supporters believed in expanding public participation in government; they were openly hostile to appointive judges<sup>11</sup> and rewrote

7. *The Federalist* No. 78 (Alexander Hamilton).

8. *Id.*

9. Under the 1777 Constitution, the Council of Appointment, comprised of the governor and four senators, had the power to make all appointments authorized by law. In *The Federalist* No. 69, Hamilton alluded to the Council and “the mode of appointment by the governor of New York, closeted in a secret apartment with at most four” persons. New York abolished the Council in 1821 and conferred the power to make judicial appointments on the Governor.

10. Georgia was the first state to elect judges by a vote of the people, a practice that applied only to the inferior courts of that state. See Learned Hand, *The Elective and Appointive Methods of Selection of Judges*, in *Proceedings of the Academy of Political Science in the City of New York*, Vol. 3, No. 2, 82 (Jan. 1913). State legislatures elected the judges in New Jersey, Virginia and South Carolina, and in Vermont and Tennessee when they became states in 1793 and 1796. *Id.*

11. “Delegates [to state constitutional conventions] branded the appointive system ‘a relic of monarchy’ and the ‘last vestige of aristocracy’; some delegates referred to ‘the immortal Jackson,’ and there was much talk of the need to make the judiciary ‘consonant with our theory of government.’” Caleb Nelson, *A Re-evaluation of Scholarly Explanations for the Rise of the Elective Judiciary in Antebellum America*, 37 *AM. J. LEGAL HIST.* 190, 191-92 (1993). Jackson himself proposed that the Electoral College be abolished and that senators and federal judges be elected directly by the people. *Id.* at 223.

many state constitutions to reflect that value. In 1832, in what Learned Hand called “a burst of democratic enthusiasm,”<sup>12</sup> Mississippi became the first state to establish an entirely elective judiciary. New York followed suit in 1846, and many states promptly followed soon thereafter. Every state that joined the Union between 1846 and 1958 adopted constitutions that provided for elective judiciaries. During the same period, Michigan (1850), Pennsylvania (1850), Virginia (1850) and Maryland (1851) all amended their constitutions to provide for the election of some or all of their judges.<sup>13</sup> By the time of the Civil War, 22 of 34 states elected their judges.<sup>14</sup>

For 160 years, justices of the State Supreme Court—New York’s trial court of general jurisdiction—have been elected by popular vote. That selection method has been dictated since 1846 by the State Constitution, which provides: “The justices of the supreme court shall be chosen by the electors of the judicial district in which they are to serve.” N.Y. Const. art.VI, § 6(c). Judges of other State courts of record are also chosen by election, including judges of the County, City, District and Surrogate’s Courts; New York City’s Civil Court; and (outside of New York City) the Family Court.

It was not long, however, before a backlash set in. Two factors motivated that change. First, political parties quickly attained effective control over the election of judicial candidates and the retention of judges in partisan elections. One historian observed that the history of early judicial elections “worked out as a de facto system of appointment.”<sup>15</sup> Indeed, in language penned in 1928—but which might, were it not for a reference to the City of Chicago, understandably be confused for a passage in *Lopez Torres*—a law professor at Northwestern University wrote:

It is one of our most absurd bits of political hypocrisy that we

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12. Learned Hand, *supra* note 10, at 88.

13. See Steven P. Croley, *The Majoritarian Difficulty: Elective Judiciaries and the Rule of Law*, 62 U. CHI. L. REV. 689, 716-17 (1995). After reviewing the debate at New York’s Constitutional Convention of 1846, Croley concludes: “An elective judiciary was defended by its supporters not so much on the grounds that it advanced fundamental principles of constitutional democracy, as on the grounds that giving judicial selection to the people directly would avoid certain ills that alternative selection systems had brought.” *Id.* at 721.

14. Jona Goldschmidt, *Merit Selection: Current Status, Procedures, and Issues*, 49 U. MIAMI L. REV. 1, 5 (1994).

15. James W. Hurst, *The Growth of American Law: the Law Makers* 133 (1950), *quoted in* Goldschmidt, *supra* note 14, at 6.

actually talk and act as if our judges were elected whenever the method of selection is, in form, by popular election. In a great metropolitan district like Chicago, where we have a typical long ballot and the party machines are well organized and powerful, our judges, while they go through the form of election, are not selected by the people at all. They are appointed. The appointing power is lodged with the leaders of the party machines. These men appoint the nominees.<sup>16</sup>

Second, compelling judges to become politicians in order to ascend to the bench eroded public confidence in the judiciary. In a notable speech before the American Bar Association in 1906, Roscoe Pound stated that “[p]utting courts into politics and compelling judges to become politicians, in many jurisdictions has almost destroyed the traditional respect for the bench.”<sup>17</sup> The Association, the American Bar Association, and other bar associations were founded in a concerted effort to restore public confidence in the courts that had been lost in part because of the political nature of judicial elections.

These concerns led to limited changes in the methods used to select New York judges. In 1921, the Legislature provided for the use of conventions for the nomination of candidates for Supreme Court Justice. In 1949, New Yorkers granted authority to the governor to appoint judges to the Court of Claims. And after an “acrimonious election” in 1973 for Chief Justice of the New York Court of Appeals, in which two candidates spent over \$1.2 million,<sup>18</sup> New Yorkers approved a state constitutional amendment in 1977 that provided for commission-based appointment of the judges on the New York Court of Appeals. Additionally, as a result of an executive order first issued in 1961 by New York City Mayor Robert Wagner, and later extended and reissued by subsequent mayors, the judges of the New York City Family and Criminal Courts are chosen by the Mayor on an appointive basis through the use of a nominating committee.<sup>19</sup>

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16. Albert M. Kales, *Methods of Selecting and Retiring Judges*, 11 J. AM. JUDICATURE SOC'Y 133, 134-35 (1928), quoted in Goldschmidt, *supra* note 14, at 6.

17. Roscoe Pound, *The Causes of Popular Dissatisfaction with the Administration of Justice*, 40 AM. L. REV. 729, 748 (1906), quoted in Goldschmidt, *supra* note 14, at 6.

18. Robert Lindsey, *California Leading in High-Cost Races for the Judiciary*, N.Y. TIMES, Oct. 19, 1985, § 1, at 6.

19. The Mayor derives this appointment power from Article 6, Section 15 of the New York State Constitution.

**B. The Case for Commission-Based Appointment:  
The Opportunity At Hand**

All judges of the New York State trial and appellate courts should meet the highest standards for intellectual rigor, integrity, independence, experience, fairness and temperament.<sup>20</sup> These qualities are critical not only for judges appointed to New York's highest court, but for all judges who dispense justice at the trial and appellate court levels. The vast majority of all legal disputes are not resolved in the Court of Appeals or indeed at any appellate level, but rather in New York's many trial courts. Most New Yorkers who interact with the judicial system appear before these trial judges and no others. These litigants are entitled to be heard by jurists who meet the highest standards of character and fitness.

In order to meet these high standards, judicial candidates for New York's courts of record should be chosen based primarily on merit, fundamentally in the same manner as are judges of New York's highest court, the Court of Appeals, although with differently constituted screening commissions. The most qualified candidates for each position should be identified and nominated by independent and diverse judicial screening commissions on the basis of intellectual capacity, integrity, fairness, independence, experience, temperament—in short, the qualities New Yorkers expect and have a right to see in their judges. The ultimate selection of candidates for each vacancy should be made from among those most qualified candidates by an appropriate appointing authority elected by the people.<sup>21</sup>

The current convention system is not an acceptable judicial selection system. In a powerfully rendered and compelling indictment of the current system for electing Supreme Court Justices, the Second Circuit held

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20. Town and Village Courts are being looked at by a newly formed task force of the Association. Articles about Justice Courts have recently appeared in the press. See, e.g., *Homespun Injustice*, N.Y. TIMES, Oct. 1, 2006, § 4, at 9.

21. In the next section of this Report, we recommend a system of judicial qualification commissions that would screen the qualifications of candidates for nomination for election to judicial office. We also recommend changes in the judicial convention system that we believe will remedy the constitutional infirmities elucidated in *Lopez Torres*. Although we believe these proposals would vastly improve the methods used to nominate and elect candidates for judicial office, and should render the improved methods constitutional, they would still allow unqualified or marginally qualified candidates to be nominated and elected; and they would still force incumbent judges back into the realm of elective politics and political fundraising. Accordingly, in this section of the Report we reiterate our strong preference to purge the present judicial convention system for selecting justices of its significant deficiencies, as outlined herein, once and for all.



in *Lopez Torres* that the current judicial nomination convention process has effectively “transformed a *de jure* election [of Supreme Court Justices] into a *de facto* appointment” by party leaders—a process the Second Circuit found to be unconstitutional.<sup>22</sup> Pursuant to the Second Circuit’s decision, nominations for Supreme Court Justice must henceforth be made by primary election until the Legislature takes corrective action.

Shortcomings in the system for electing Supreme Court Justices are inherent in the electoral process itself. For reasons described below as well as in the Task Force 2003 Report,<sup>23</sup> elections do not ensure the selection of judicial candidates who have the highest qualifications and the greatest integrity and independence—qualities so important to a well-functioning, fair and independent judiciary. Indeed, judicial elections do not even ensure what their proponents desire: judicial selection by means of a truly democratic electoral process.

First and foremost, election campaigns for judicial vacancies are, like many campaigns for major elective office, notoriously expensive. In high court races, the expenditure of millions of dollars in judicial races has been commonplace for years.<sup>24</sup> Where judicial races attract special-interest money on one or both sides, as they often do, costs escalate substantially.<sup>25</sup> Although races for New York’s trial courts are neither as expensive

22. *Lopez Torres*, 462 F.3d at 201.

23. See Task Force 2003 Report at 27-29.

24. In California in 1986, over \$11 million was spent on campaigns seeking to retain or unseat three incumbents; in Texas in 1988, more than \$10 million was spent by candidates in campaigns for six seats on the High Court. See Robb London, *For Want of Recognition, Chief Justice is Ousted*, N.Y. TIMES, Sept. 28, 1990, at B16. A campaign in 2000 for two seats on the Ohio Supreme Court cost \$9 million; in Michigan that same year, a race for three seats cost at least \$16 million. See William Glaberson, *States Taking Steps to Rein In Excesses of Judicial Politicking*, N.Y. TIMES, June 15, 2001, at A1. Anticipating another bruising campaign, one justice on the Ohio Supreme Court has already raised \$3 million since 2000. Adam Liptak and Janet Roberts, *Campaign Cash Mirrors a High Court’s Rulings*, N.Y. TIMES, Oct. 1, 2006, § 1, at 1.

25. In 2000, for example, the United States Chamber of Commerce earmarked between \$1 million and \$10 million for State Supreme Court races in as many as seven states where the Chamber saw “a danger that courts might block tort reform.” William Glaberson, *U.S. Chamber Will Promote Business Views In Court Races*, N.Y. TIMES, Oct. 22, 2000, § 1, at 24. Likewise, in 1999, the Michigan Manufacturers Association notified its members about the importance of the 2000 Michigan Supreme Court election and asserted that in the last election, contributions from the manufacturers’ political action committee “swayed the Supreme Court election to a conservative viewpoint, ensuring a pro-manufacturing agenda.” William Glaberson, *Fierce Campaigns Signal A New Era for State Courts*, N.Y. TIMES, June 5, 2000, at A1.

nor as high profile as some of these high court contests, they are nonetheless very costly. Evidence in the *Lopez Torres* case revealed that Civil Court candidates routinely spend \$100,000 or more in primary elections, even in small municipal court districts. In the last primary contest for New York County surrogate, the winner spent more than \$300,000, and her leading opponent spent nearly \$500,000.

Candidates backed by the major political parties may well be unfazed by these substantial costs. Local political parties have the muscle, mechanics and money to wage successful election campaigns for judicial nomination across judicial districts. But candidates backed by those local political parties are not necessarily the most qualified for judicial office. Many judicial candidates earn their party's backing after years of labor in the vineyards of the party or from other political considerations that have little or nothing to do with judicial qualifications.

A candidate who is without party support (an "insurgent" candidate), and who has deep pockets, can overcome a deficit in party support—but deep pockets offer no assurance of merit. Insurgent candidates without deep pockets are faced with an often insuperable task of raising vast sums of money, invariably from parties and lawyers who have appeared and will again appear before them. This unseemly practice is singularly responsible for undermining public confidence in an independent judiciary. The Feerick Commission found, for example, that "[e]ighty-three percent of registered voters in the state indicate that having to raise money for election campaigns has at least some influence on the decisions made by judges." New York State Commission to Promote Confidence in Judicial Elections, Final Report to the Chief Judge of the State of New York, at app. E (Public Opinion and Judicial Elections: A Survey of New York State Registered Voters (December 2003), at iv). Similar examples elsewhere in the United States are legion.<sup>26</sup>

Additionally, primary election voters are often poorly informed about

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26. In Texas, for example, a 1998 report by Texas for Public Justice found that the seven Texas Supreme Court justices elected since 1994 had raised \$9.2 million, 40 percent of which came from interests with cases before the Court. As reported in *The New York Times*, a survey taken for the Court itself "found that nearly half of the judges themselves thought that campaign contributions significantly affected their decisions." Ralph Blumenthal, *DeLay Case Turns Spotlight on Texas Judicial System*, N.Y. TIMES, Nov. 8, 2005, at A17. Likewise, according to a survey of 2,428 state court judges conducted in 2002 by the judicial reform organization Justice at Stake, "almost half said campaign contributions influenced decisions." Liptak and Roberts, *supra* note 24. And polls of voters "typically find many voters saying that campaign contributions influence judges' decisions." Glaberson, *States Taking Steps to Rein In Excesses of Judicial Politicking*, *supra* note 24.

the qualifications of judicial candidates for office and are not well suited to evaluate the significance of those qualifications (or the lack of them).<sup>27</sup> Although the Office of Court Administration has adopted regulations designed to inform voters whether an “Independent Judicial Election Qualification Commission” (“Qualification Commissions”) in each Judicial District has found a candidate “qualified for judicial office,”<sup>28</sup> these Qualification Commissions are wholly inadequate to educate voters about the “qualified” candidates. Nor may the Qualification Commissions indicate whether an applicant has been found unqualified for judicial office.<sup>29</sup> Nor is there any limitation on the number of candidates each Qualification Commission may report out as “qualified.” Voter guides offer a modest potential for improvement in this regard; but the reality remains that the vast majority of potential voters lacks the information, background and experience necessary to identify the most qualified candidates for office.

In other settings, this Association<sup>30</sup> and other organizations<sup>31</sup> have set forth the position that independent screening commissions should determine whether candidates are “qualified,” should identify any candidates found unqualified and should impose strict limits (typically three for the first vacancy) on the number of candidates reported out as “qualified.” In Section II of this Report, we flesh out the details of this proposal and reiterate its importance as an adjunct to other changes necessary to comply with the mandate in *Lopez Torres*. However, even if these changes

27. See, e.g., London, *supra* note 24 (noting that the Chief Justice of Washington State, “a widely respected judge who has drawn little controversy in his six years in the post, was thrown off the bench last week by voters who chose instead a 39-year-old lawyer who has never been an elected judge and who did not campaign.”).

28. Each Qualification Commission is charged with evaluating whether candidates for election to the Supreme Court, County Court, Surrogate’s Court, Family Court, New York City Civil Court, District Courts and City Courts are “qualified for judicial office,” and with publishing an alphabetical list of the names of all candidates it has found “qualified.” N.Y. Comp. Codes R. & Regs. tit. 22, § 150.5 (2006). No candidate is required to submit credentials to the Qualification Commission, however.

29. Except as to any report whether a candidate is “qualified”, “all papers filed with or generated by the commission and all proceedings of the commission shall be confidential.” N.Y. Comp. Codes R. & Regs. tit. 22, § 150.8. Thus, the public could not ascertain whether a candidate applied for evaluation or whether, upon applying, the candidate was found unqualified.

30. See Task Force 2003 Report at 30-37.

31. See, e.g., The Fund for Modern Courts, 2003 Policy Statement, available at [http://www.moderncourts.org/Advocacy/judicial\\_selection/policy.html](http://www.moderncourts.org/Advocacy/judicial_selection/policy.html).

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were enacted, the proposal would still not ensure the election of only those candidates who are most qualified. So long as judges are chosen by election, political parties may nominate, support and work actively to elect candidates who are not rated most qualified—and who indeed may be found unqualified. A political party has no reason to forebear from pursuing its electoral interests merely because an independent screening commission has not found its candidate(s) “most qualified.” A party’s substantial monetary and organizational advantages over insurgent candidates—including any who may be rated “most qualified” by screening commissions—will continue to ensure the electoral success of lesser qualified candidates. The time has come to put principle above politics and end this practice.

In 1873, the Association correctly framed the issue in a way that is still applicable today:

Judges are not selected, like senators, assemblymen, and city officers, to represent the property, the opinions, or the interests of the people of a locality, but they are the mere selection of the fittest members of a single learned profession for the purpose of interpreting and applying the laws of the State in the same sense and the same spirit throughout its borders, irrespective of all parties, and all local interests, and all popular feelings. The fact that we vote for representatives is no reason why we should vote for judges, but quite the contrary. It is essential that a judge should be selected by a method which does not arouse personal prejudice or popular passion, which places him under no commitment to any locality, interest or political party, which shall give all the people who may be suitors or prisoners before him, the same power and participation in placing him upon the bench, and the same grounds of confidence in his impartiality.<sup>32</sup>

The Task Force firmly believes that the only effective means of ensuring the uniform selection of highly qualified candidates for judicial office is to provide that those candidates will be selected by an appointing authority from among a limited number of candidates rated as “most qualified” by truly independent judicial screening commissions. Only by doing so can all candidates compete on a level playing field, regardless of wealth or political connections. Only then can selections be reliably made

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32. Address of the Association of the Bar of the City of New York, *An Elective Judiciary* 6 (Oct. 24, 1873).

from the most qualified candidates. And only then can we take politics out of the selection of officials whose function in our democracy is to make decisions that are, as Alexander Hamilton put it, free of the “disposition to consult popularity” so that we may truly “justify a reliance that nothing would be consulted but the Constitution and the laws.” *The Federalist* No. 78 (Alexander Hamilton).

The Legislature should thus enact, for consideration by the voters in a statewide referendum, an amendment to Article 6 of the New York State Constitution providing for commission-based appointment of New York State judges.

### **C. Proposed Constitutional Amendment in Favor of a Commission-Based Appointive System**

Today, the State’s Constitution requires election of most judges.<sup>33</sup> The Task Force proposes the following amendments to Article VI, § 6 of the State Constitution:<sup>34</sup>

#### **1. Affected Courts**

The judges to be appointed in the method described below are:

- The presiding Justice and Justices of the Appellate Divisions of the Supreme Court
- Justices of the Supreme Court
- Judges of the Court of Claims
- Judges of the County Courts
- Judges of the Surrogate’s Courts
- Judges of the Family Courts
- Judges of the District Courts
- Judges of the Civil and Criminal Courts of New York City
- Judges of the City Courts outside of New York City

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33. See e.g., “The justices of the supreme court shall be chosen by the electors of the judicial district in which they are to serve.” N.Y. CONST. art. VI, § 6(c). Judges of other State courts of record are also chosen by election, including judges of the County (N.Y. CONST. art. VI, § 10(a)), District (N.Y. CONST. art. VI, § 16(h)), and Surrogate’s Courts (N.Y. CONST. art. VI, § 12(b)); New York City’s Civil Court (N.Y. CONST. Art. VI, § 15(a)); and (outside of New York City) the Family Court (N.Y. CONST. art. VI, § 13(a)).

34. The reforms suggested by the Task Force in this Report are only stated in terms of general principles and do not constitute textual proposals.

**2. Establishing Judicial Qualification Commissions (“JQC”)**

Independent and diverse JQCs shall be established in the manner outlined herein.

**(a) Jurisdiction**

- *Outside of New York City:* There shall be a JQC for each judicial district outside of NYC to evaluate candidates in that district for appointment to the Supreme Court, County Courts, Family Courts, Surrogate’s Courts and (where appropriate) District Courts.
- *Within New York City:* There shall be one city-wide JQC to evaluate candidates for the Supreme Court, Family Courts, Surrogate’s Courts, Civil Courts and Criminal Courts.
- *Statewide:* There shall be one statewide JQC to evaluate candidates for the Court of Claims and for the Appellate Divisions, and to provide the rules for the operations of all JQCs.

**(b) Membership<sup>35</sup>**

- Every member of each JQC shall have a three-year term with staggered appointments initially.
- Each JQC shall have at least 15 members, but no more than 21 members. The Chief Judge, the Governor, the presiding Justices of each Appellate Division in which the Region sits and

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35. As described herein, we recommend a system by which JQC members are appointed by Non-Governmental Appointing Authorities, which in turn are appointed by Governmental Appointing Authorities (including the Chief Judge, the Governor, the presiding Justices of the Appellate Division and others). Non-Governmental Appointing Authorities would rotate periodically. We make these recommendations to ensure that the judicial screening procedure is independent and free from undue political influence. Non-governmental authorities have been used as nominating authorities in whole or in part by the New York City Mayor’s Advisory Committee on the Judiciary, under the New York County Democratic Party’s rules since 1977 and are also used elsewhere in the country. *Cf.* American Judicature Society, *Judicial Merit Selection: Current Status*, <http://www.ajs.org/js/JudicialMeritCharts.pdf>. Under the procedure we recommend, JQC members would owe no allegiance to any political figure by reason of or in connection with their appointment to the JQC. This system would increase the likelihood that JQCs evaluate candidates for judicial office solely on the basis of merit and in a way that will hopefully minimize political considerations. Moreover, since the Non-Governmental Appointing Authorities appointed by the Governmental Appointing Authorities should include a wide range of civic or community organizations and bar associations, including minority organizations and associations where available, this system is expected to achieve greater diversity. Rules for the thresholds that would be required for organizations and associations to be qualified for serving as appointing authorities of the JQC members, such as size, 501(c)(3) status etc, would be set by the Legislature.

the highest ranking members of each party in the Senate and in the Assembly (collectively, the “Governmental Appointing Authorities”) shall appoint, from each Region, 15 to 21 (depending on the number of the members of the JQC to be formed) bar associations, law schools and/or not-for-profit civic or community organizations (collectively, the “Non-Governmental Appointing Authorities”), and each one of the Non-Governmental Appointing Authorities shall then in turn appoint one member of the JQC. The Governmental Appointing Authorities shall give consideration to achieving a broad representation of the communities within each Region when appointing the Non-Governmental Appointing Authorities, including race, ethnicity, gender, religion and sexual orientation as diversity factors. The Non-Governmental Appointing Authorities shall rotate every three years. No more than \_\_\_% of the members of each JQC shall be enrolled in the same political party.<sup>36</sup> When appointments of members of the JQC are being made by the Non-Governmental Appointing Authorities, an order shall be established in which they’ll make their appointments so that it can be determined when the \_\_\_% limit has been reached. Consideration should be given to rotation mechanisms in order to achieve appropriate representation of each county on the JQCs.

**(c) Operations**

- *Policies:* The statewide JQC shall also be the policy body for all commissions. Its functions shall include: promulgating and enforcing rules concerning qualifications of members of the JQCs and codes of conduct for JQC members (including confidentiality of proceedings, etc); the conduct of JQC proceedings; minimum outreach requirements (advertisements, notices, etc.) by each JQC; and the collection and reporting of information on the functioning of the process (including the numbers of those selected and the diversity of those recommended and those appointed).
- *Reporting of candidates:* For every single vacancy, there shall be three names of those found most qualified reported out for that

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36. Although the Task Force believes that ideally no more than 50% of members of each JQC should be enrolled in the same political party, it recognizes that, because of the imbalance of political parties in various judicial districts, the Legislature may have to utilize a higher limit such as 60%. Members of the JQC that are not enrolled in a political party would not count, of course, toward that limit. It is indeed assumed that a significant number of members would not be enrolled in any political party.

vacancy.<sup>37</sup> Where there is more than one vacancy in the same position in the same court, there shall be three names for the first vacancy and two names for each succeeding vacancy. In the case of an incumbent seeking re-election, if the JQC reported the incumbent as highly qualified, that person would be the only one recommended for the vacancy.<sup>38</sup>

- *Time limits:* Each JQC shall be required to act within 90 days of notice of a vacancy; and the appointing authority shall appoint within 60 days of receiving such recommendations. On the failure of the appointing authority to act, the Chief Judge shall make the appointments from the list.

**(d) Appointing Authorities**

- The Governor shall appoint from among those reported out by the statewide JQC for the Appellate Divisions and Court of Claims, as well as those reported out outside of the City of New York for the Supreme Court.
- The Mayor of the City of New York shall appoint from among those reported out by the New York City JQC for the Supreme Court, Family Courts, Surrogate's Courts, Civil Courts and Criminal Courts of New York City.<sup>39</sup>

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37. By recommending a limited number of candidates, the JQCs will report out the very best judicial candidates available. Screening commissions without such limited numbers report out all who have the bare qualifications. The difference is between finding the best and merely screening out the worst.

38. The Task Force is not in favor of retention elections mainly because of their potential adverse effect on judicial independence. See Task Force 2003 Report at 39.

39. We believe the Governor, as the State's Chief Executive, should have the major appointment power under this system. Indeed, the Governor has long had that authority for the Court of Claims and appellate division judgeships. The Governor is the most common appointing authority in other merit appointment systems across the country. In New York City, however, we believe there is also merit to giving the Mayor of New York City appointing authority for New York City judges. The Task Force believes the Mayor of the City of New York should be an appointing authority for New York City judges because of the *sui generis* and historical position of the City. Indeed, almost half of the population of the state lives in New York City, which is also the only city in the state comprising more than one county and more than one judicial district. For these and other reasons, New York City has historically been treated differently by the Legislature in several respects. Among them is having the Mayor appoint judges of the Family Court within New York City even though they are elected on a countywide basis outside the City. Moreover, utilizing both the Governor and the Mayor as appointing authorities results in more accountability for the appointments by both elected officials. Providing the Mayor with the appointment authority for the New York City judges is likely to achieve greater diversity, since there will be more accountability to the diverse population of



- All other judicial offices outside of the City of New York shall be appointed by the Governor from among those reported out by the JQC for the district.

**II. AN INTERIM PROPOSAL TO BE IN EFFECT UNTIL THE CONSTITUTIONAL AMENDMENT IS IMPLEMENTED: A REFORM OF THE CURRENT JUDICIAL CONVENTION SYSTEM**

**A. The Task Force’s Strong Opposition to Primary Elections**

If judges are to be elected, itself not an optimal means of selection, primaries are a constitutional, but not a wise means of selection. In *Lopez Torres* the Second Circuit held that New York’s judicial nomination convention process effectively “transformed a *de jure* election [of Supreme Court Justices] into a *de facto* appointment” by party leaders.<sup>40</sup> The Court affirmed, as an interim remedy, the District Court’s order that judicial nominations for justices of the Supreme Court shall proceed by primary election until the Legislature enacts corrective legislation.<sup>41</sup> However, it does not follow, nor did the Second Circuit hold, that the primary election is the only constitutionally permissible antidote to the ills that afflict the current election process. The Court noted that “a convention-based system is, in the abstract, a perfectly acceptable method of nomination.”<sup>42</sup> Moreover, this Task Force concludes that primary elections by themselves (*i.e.*, without a convention system and without public financing) are far from the best constitutional solution for the shortcomings of the current convention system. To the contrary, primary elections engender a host of problems that render such elections undesirable as a means of providing to the electorate a diverse slate of the highest caliber candidates to fill the positions of Supreme Court justices.

This Association has long adhered to the position that a commission-based appointive selection procedure is preferable to either primary elections or a judicial convention system. We remain unswervingly committed to that principle. However, in the absence of a commission-based appointive selection procedure, we conclude, as did the Feerick Commis-

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voters in the City. Also, if the Governor made all of the appointments, the numbers of such appointments would be substantially higher than if some of the appointments were made by the Mayor, and that higher number may not allow for the kind of attention that would be present for fewer appointments; fewer candidates also means more visibility for each appointment.

40. *Lopez Torres*, 463 F.3d at 200.

41. *Id.* at 204-207.

42. *Id.* at 189.

sion earlier this year,<sup>43</sup> that at least without public financing of judicial elections, a reformed judicial convention system would be preferable to primary elections for nominations for Supreme Court Justice.<sup>44</sup>

A substantial concern regarding the use of primary elections to select candidates for judicial office is the necessity for candidates without party backing to raise large sums of money to mount competitive campaigns. This problem is not unique to primaries; indeed, it plagues all elective systems including the current convention scheme. As the Second Circuit noted, the requirements of the current convention process—including recruiting large numbers of delegates and alternates, assembling delegate slates in each assembly district, recruiting petition circulators, collecting thousands of signatures, and conducting numerous localized voter education campaigns—“often shuts out candidates lacking either great wealth or the benefit of a political party’s county-wide apparatus.”<sup>45</sup> And yet the costs of mounting a successful district-wide primary election campaign are more daunting. Evidence in the *Lopez Torres* case revealed that Civil Court candidates routinely spend \$100,000 or more in primary elections, even in small municipal court districts.<sup>46</sup>

The need to raise large sums of money in order to compete independently and effectively for a nomination for Supreme Court Justice is profoundly disconcerting. Most candidates for Supreme Court are currently serving on the bench, many having been appointed by the Chief Administrative Judge for New York State to serve as Acting Supreme Court Justices. Compelling those sitting judges to embark on massive fund-raising campaigns during their tenure as sitting judges is deeply problematic. The primary targets of those fundraising efforts are the attorneys and law firms that appear or could appear before them. The specter of sitting judges or their representatives actively and aggressively soliciting large quantities

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43. New York State Commission to Promote Public Confidence in Judicial Elections, *Final Report to the Chief Judge of New York State* 3, 11 (Feb. 6, 2006) (“The Commission believes that, without public financing of judicial elections, the judicial nominating convention system should be retained rather than replaced by primary elections.”).

44. It should be noted, however, that our recommendations contained in this Section somewhat differ from those of the Feerick Commission in part because we are also trying to meet the constitutional requirements of the Second Circuit’s recent decision in *Lopez Torres*.

45. *Id.* at 174.

46. In addition, the high cost of campaigning would have a disproportionate effect on minority candidates who may not have the same level of access to resources as do non-minority candidates. New York State Commission to Promote Public Confidence in Judicial Elections, June 29, 2004 Report, at 24 (2004).

of money from those who will or may appear before them is an acid that corrodes public confidence in the independence and integrity of the State judiciary.<sup>47</sup> Nor is the practice any more seemly when candidates who are not currently sitting judges, but who aspire to be in the near future, raise large sums of money from those who intend to practice before them. And yet the alternative of relying on the backing of the political party machinery for that same critical financial support is equally unpalatable.<sup>48</sup>

It might be argued that an independent candidate for a Supreme Court nomination would face the same daunting fundraising challenges, no matter whether she is competing in a primary election or striving to assemble a slate of delegates to run on her behalf with an eye, as the Second Circuit put it, “toward placing those delegates at the judicial nominating convention so that they can cast their votes” in her favor.<sup>49</sup> But a reformed convention system offers greater opportunities to forge effective coalitions of delegates with other candidates, and thereby potentially reduce barriers and costs faced by an insurgent candidate. In *Lopez Torres*, the District Court found that opportunities for coalition-building of this kind in the existing convention process did no more than offer “a potential way to work *around* the onerous petitioning requirements . . . [And i]t could not alter the fact that the burdens on ballot access are severe.”<sup>50</sup> If, however, significant reforms are made independently to dismantle those severe burdens, as we recommend in this Report, then a reformed convention process could reduce the potential costs of an insurgent candidacy when compared to those of a primary election.

In addition to potential reductions in the costs of an insurgent candidacy, a reformed convention process is potentially more amenable than

47. The Code of Judicial Conduct prohibits candidates for judicial office from personally soliciting or accepting campaign contributions, and instead requires that such fundraising be performed by campaign committees. N.Y. Comp. Codes R. & Regs. tit. 22, § 100.5(A)(1)(5). Regardless of whether this prohibition successfully insulates all judicial candidates from identifying the campaign contributors, it does not successfully ameliorate the corrosive impact of aggressive fundraising by candidate committees on public confidence in an independent and qualified judiciary.

48. In other states, judicial elections (not necessarily at the trial level) have become heavily financed by “special interest money,” e.g., the plaintiffs’ trial bar and insurance companies have, in some elections, given large amounts to competing candidates. Although such practice does not seem to have become prevalent in New York, the Task Force does not want to risk New York State becoming one of those states where judicial campaigns attract large amounts of special interest money.

49. *Lopez Torres*, 462 F.3d at 172.

50. *Lopez Torres*, 411 F. Supp. 2d at 248 (emphasis in original).

are primary elections to the nomination of the most qualified candidates. This is not simply because a party organization could—as has the New York County Democratic Committee since 1977—adopt party rules requiring the county organization to support only those candidates rated most qualified by an independent screening commission.<sup>51</sup> Plainly, an enlightened party organization could adopt similar rules whether the candidates were vying for nomination at a convention or primary election. Rather, the convention system is more amenable to selecting qualified candidates because the size of the *audience* who must consider those qualifications is drastically smaller.

A candidate for nomination at a primary election who proudly bears a “most qualified” rating from an independent screening commission must still bear the cost of educating a vast number of potential voters about the significance and importance of such a rating. Even then the importance of that rating must stand out in a veritable stew of political considerations that often overwhelm the solitary voice of an independent screening commission. On the other hand, when the audience is comprised of a relatively small number of candidates for delegates, or delegates who have been elected, at a convention, a “most qualified” rating from an independent screening commission can be a much more significant, and indeed potentially decisive, factor.<sup>52</sup> For this reason, we are recommending conventions held in small districts from which delegates are elected, leading to many more conventions, with a maximum of 15 delegates at each convention. This will substantially increase the ability of qualified “outsider” candidates to have a realistic chance of nomination.

Finally, we believe that a reformed judicial convention system has the potential to promote greater diversity among candidates for Supreme Court nomination than does an open primary. As the District Court found, this is not an *inherent* advantage to the convention mechanism. We recognize that other means of promoting diversity on the Supreme Court bench are available, including the use of cumulative voting in primary elections and the creation of judicial districts involving geographically compact minority populations.<sup>53</sup> But for reasons discussed earlier, a re-

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51. Both the Task Force 2003 Report and this Report strongly recommend the establishment of screening commissions in the context of a reformed convention system. See Task Force 2003 Report at 32-35; *infra* Section IIB.

52. The Task Force recommends that a body governing and overseeing all qualification commissions set the standards of the evaluation of judicial candidates. See *infra* Section IIB. For the process by which the Association evaluates candidates for elective and appointive judgeships, see Task Force 2003 Report at 16-17.

53. *Lopez Torres*, 411 F. Supp. 2d at 252.

formed convention system—particularly one in which smaller judicial districts are used—offers certain potential advantages to promoting diversity when tightly coupled with independent and diverse screening commissions. Diverse screening commissions offer the potential to report out a field of most qualified candidates of diverse backgrounds. Those diverse candidates, in turn, can avail themselves of opportunities for coalition-building, and can trumpet the advantages of a “most qualified” rating more effectively in the convention setting than in an open primary. This is especially so in homogenous areas of the State where candidates representing diverse interests often have little realistic opportunity of electoral success in an open primary election.

For these reasons, and until the State Constitution is amended to adopt a commission-based appointive selection procedure, we concur with the Feerick Commission that a reformed convention system is preferable to primary elections for nominations for Supreme Court Justice.<sup>54</sup> However, even if the judicial convention system were to be reformed, absent adoption of the constitutional amendment suggested above, *see supra* Section IC, judges of the Surrogate’s County, Family (outside of New York City), City, District and New York City Civil Courts will continue to be nominated through primary elections.<sup>55</sup> We therefore recommend that the JQCs established in connection with our recommendation below for a reformed judicial convention system also review the qualifications of candidates for election to other elective judicial offices.<sup>56</sup>

A proposed statutory reform to the current convention and primary judicial selection systems follows. There should be a sunset provision causing the statutory solution proposed below to expire at the earlier of the effective date of the proposed constitutional amendment (*see supra* Section IC) or three years from the effective date of the statutory solution below, whichever comes first.

**B. Proposed Reform of the Convention and Primary Judicial Selection Systems**

1. In order to comply with the requirements of N.Y. Const. Art. VI, §6(c), nominees for the position of justice of the Supreme Court shall run

54. New York City Mayor Michael Bloomberg has also issued a proposal for a reformed convention system as a preferred alternative to primary elections.

55. Judges of the Family Court in the City of New York are appointed by the Mayor. N.Y. CONST. art. VI, § 13(a).

56. Justice Courts are unique—for example, town or village justices do not have to be lawyers—and present special problems. See *supra* note 20.

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for election from a judicial district (“the justices of the supreme court shall be chosen by the electors of the judicial district in which they are to serve”). However, solely for the purpose of nominating justices of the Supreme Court, each judicial district shall be subdivided into judicial convention districts consisting of either two or three assembly districts. Each position of justice of the Supreme Court presently filled by elections held within each judicial district shall be assigned to, and nominations shall be made from, one of the various judicial convention districts within each judicial district. Notwithstanding that a person may have been nominated from a particular judicial convention district, the person shall run at-large throughout the entire judicial district in which the judicial convention district is located. All registered voters residing in the judicial district shall be eligible to vote in the general election for justice of the Supreme Court.

2. The judicial convention districts shall be grouped into eight regional districts covering roughly the following geographical areas: (1) Long Island; (2) New York City; (3) Hudson Valley; (4) Capital Region; (5) Adirondacks; (6) Finger Lakes; (7) Southern Tier, and (8) Western New York (the “Regions”). Notwithstanding the foregoing, within a variance of one, each Region shall contain an equal number of judicial convention districts. An independent and diverse judicial qualification commission (“JQC”) shall be established within each Region.

3. JQCs should be established to review the qualification of candidates for all levels of judgeships, beginning with the Supreme, District and City Courts, the Civil Court of the City of New York, the Surrogate and County Courts and the Family Court outside the City of New York (collectively, the “Covered Judgeships”).

4. There shall be 21 members of each JQC. The Chief Judge, the Governor, the presiding Justices of each Appellate Division in which the Region sits and the highest ranking members of each party in the Senate and in the Assembly (collectively, the “Governmental Appointing Authorities”) shall appoint, from each Region, 15 to 21 (depending on the number of the members of the JQC to be formed) bar associations, law schools and/or not-for-profit civic or community organizations (collectively, the “Non-Governmental Appointing Authorities”), and each one of the Non-Governmental Appointing Authorities shall then in turn appoint one member of the JQC. The Governmental Appointing Authorities shall give consideration to achieving a broad representation of the communities within each Region when appointing the Non-Governmental Appointing Authorities, including race, ethnicity, gender, religion, and sexual ori-

entation as diversity factors. The Non-Governmental Appointing Authorities shall rotate every three years.<sup>57</sup>

5. In making appointments to the JQC, the Non-Governmental Appointing Authorities shall similarly give consideration to achieving a broad representation of the communities within each Region, including race, ethnicity, gender, religion and sexual orientation as diversity factors. Three members of each JQC shall be non-lawyers. No more than \_\_% of the members of each JQC shall be enrolled in the same political party.<sup>58</sup> When appointments of members of the JQC are being made by the Non-Governmental Appointing Authorities, an order shall be established in which they'll make their appointments so that it can be determined when the \_\_% limit has been reached. No individual may serve on a JQC for more than three consecutive years.

6. The Election Law should be amended to make clear that no person who has not completed the process of submitting his/her qualifications to the JQC shall have access to the ballot as a candidate for elective judicial office. Each JQC shall publish a list of all candidates who have submitted their qualifications to it, along with a list of the three most qualified candidates for the first vacancy for each court in a district and the two most qualified candidates for each additional vacancy in that court.<sup>59</sup> In the case of an incumbent seeking re-election, if the JQC reported the incumbent as highly qualified, that person would be the only one recommended for the vacancy.<sup>60</sup> The JQC shall also report those whom it has found to be unqualified. The JQCs in each Region shall report to the State Board of Elections the names of all persons who have completed the process of submitting their qualifications to the JQC for an election.

7. The conventions in each judicial convention district shall be held following the September primary of each year. The delegates to the convention shall be elected from within the judicial convention district at the September primary. Candidates for justice of the Supreme Court would be required to file a declaration with the appropriate board of elections at least 60 days prior to the date of the primary election. This would give the JQCs sufficient time to review their qualifications before the primary or judicial convention. Since candidates seeking a designation or

57. See *supra* note 35.

58. See *supra* note 36.

59. See *supra* note 37.

60. As mentioned earlier, the Task Force is not in favor of retention elections mainly because of their potential adverse effect on judicial independence. See Task Force 2003 Report at 39.

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nomination to other elective judicial office, or nomination by an independent body for justice of the Supreme Court are required to file designating or nominating petitions, the JQC would receive ample notice of their candidacies.

8. There shall be no more than 15 delegates for each judicial convention. Each party's delegates shall be elected at large at a primary election from within the judicial convention district. Candidates for the party position of delegate shall qualify for the ballot by filing a designating petition bearing the signatures of at least 5% of the enrolled voters of the party residing in the judicial convention district or 200 such signatures, whichever is less. The State Board of Elections is to promulgate regulations pursuant to which candidates for delegate can, if they choose, either run as part of a slate with other candidates for delegate or identify the candidate(s) for nomination for election to justice of the Supreme Court for whom they are pledged to vote on the first ballot, or both.

9. There shall be a governing body, overseeing all JQCs, which shall promulgate rules and regulations governing the operation and composition of the JQCs. The Chief Judge, the Governor, the presiding Justices of the Appellate Division in which the district sits and the highest ranking members of each party in the Senate and in the Assembly shall each appoint an independent bar association or a law school or a not-for-profit civic or community organization that will in turn appoint the members of the governing body, and these appointing authorities shall rotate every three years. No individual may serve on the governing body for more than three consecutive years.

10. The governing body shall adopt rules applicable to all JQCs. In addition to the rules governing proceedings before the JQCs, these rules shall include, but not be limited to: qualification for selection of an organization as a non-governmental appointing authority; conflicts of interest applicable to members and staff; disclosure and recusal standards applicable to judges before whom a JQC member might appear; disclosure and recusal standards applicable to JQC members before whom a candidate for evaluation might appear; compliance with the composition requirements for each JQC; the standards by which the JQC will determine whether a candidate is "most qualified," "highly qualified" (in the case of an incumbent) or "unqualified."

11. The governing body shall publish a judicial voters' guide for each primary, general and special election involving candidates for a Covered Judgeship. It shall contain a biographical entry for each candidate who has submitted his/her qualifications to a JQC for review and who has



been designated for nomination or nominated, as the case may be. The biographical entry shall also reflect whether the candidate was reported out as “most qualified” for a vacancy, “highly qualified” (in the case of an incumbent) or “unqualified.”

### III. DIVERSITY CONSIDERATIONS REGARDING BOTH APPOINTIVE AND ELECTIVE JUDICIAL SELECTION SYSTEMS<sup>61</sup>

The Task Force is committed to a judicial selection system that effectively promotes a diverse judiciary. A diverse judiciary is necessary to ensure that our populations are appropriately represented; to ensure that a broad array of views and experiences are brought to the bench; to regain the public’s confidence in the judiciary, and to restore the judicial system’s credibility in the public’s eyes.

After reviewing a large variety of data, empirical studies and articles generally regarding minorities serving on New York State’s judiciary, the Task Force realized that it was unable to conclude *on the statewide level* whether one of the two systems—appointive or elective—better promotes diversity. Some of the difficulties the Task Force encountered were the following:

- Although statistics on the composition of the population in the twelve judicial districts are generally available, there is a lack of reliable statistics on the diversity of the actual voting population as well as the diversity of the practicing lawyer’s—and thus potential justices’—population. In addition, sometimes the available information does not correspond to the judicial district distributions.
- Where diverse qualifications commissions are not in place statewide to screen the candidates before the appointing authority’s final selection, statistics on the minority justices selected through an appointive system do not demonstrate the efficacy of the appointive system to ensure diversity.
- Available statistics on the percentage of minority justices on the bench (when compared to the percentage of minorities in the underlying population) reveal significantly different results among the various judicial districts, thus rendering any conclusion on the statewide level very difficult.

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61. For purposes of this Report, “diversity” is defined on the basis of race, ethnicity, gender, religion and sexual preference.

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The Task Force believes that the following improvements must be made to both systems to promote a more diverse pool of candidates and, thus, a more diverse bench:

- Provide public financing to all candidates for judicial elections to ensure that none of the minority candidates, nor any candidates in general, are barred because of financial considerations;<sup>62</sup>
- Establish independent and diverse screening commissions; the nominating authorities of the screening commissions should—when viewed as a whole—be diverse; the requirement for diverse nominating authorities and diverse screening commissions should be codified; these nominating authorities and screening commissions must be independent of any controlling influence of the appointing authority or the political leader;
- Educate the general public on the need for a diverse judiciary and the importance of the recommendations of the independent and diverse screening commissions;
- For the convention system in particular, reduce the number of delegates to the judicial district convention in order for minority candidates, and all candidates in general, to be able to succeed with fewer votes; and
- For the appointive system, encourage the appointing authority to commit to the importance of diversity.

The Task Force urges the Legislature to seize the opportunity presented and reform the current judicial selection system.

*December 2006*

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62. The Task Force did not examine the issue of public financing of judicial candidates. The Committee on Government Ethics of the Association examined the issue and released a report in May 2001. See The Committee on Government Ethics, *Report on Judicial Campaign Finance Reform (2001)*, 56 THE RECORD 157.

The Judicial Selection Task Force\*

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# Website Accessibility for People With Disabilities

*The Committee on Civil Rights,  
The Committee on Information Technology Law,  
The Committee on Legal Issues  
Affecting People With Disabilities*

## **1. Interest of the New York City Bar Association**

This report examines the legal arguments that make the World Wide Web less than world wide for people with disabilities and demonstrates how those arguments do not withstand reasoned legal analysis. It is hoped that this report will benefit all concerned by promoting the integration of people with disabilities—and abilities—into mainstream society.

The New York City Bar Association (“the Association”), founded in 1870, has more than 22,000 members residing throughout the United States. Through its standing committees, in particular its Committee on Legal Issues Affecting People with Disabilities and its Committee on Civil Rights, the Association has long been an opponent of unlawful discrimination against people with disabilities and a proponent of their inclusion in society to the fullest extent possible. Through its Committee on Information Technology, it has encouraged the application of information technology to serve people with disabilities and, more generally, to promote equality.

As lawyers, members of the Association represent clients who may find this analysis helpful in determining whether the websites they use or sponsor should be made more accessible. Moreover, many members of the

Association, like the members of society at large, whether with statutorily defined disabilities or not, have vision, hearing, motor and other impairments that require accommodation to enable them to participate in the age of technology. For instance, those with vision impairments or dyslexia know the difficulties of accessing websites with poor color contrast, tiny or ornate print, or without features necessary to use audible screen reading technology; those with hearing impairments know the frustration of trying to navigate a website that relies on audible cues and lacks accompanying textual cues; and those with limited manual dexterity know the hardship of trying to access computer functions designed to require more dexterity than these individuals possess. All of them know the isolation and discrimination of being unable to access factual and legal research tools, discounted on-line purchasing, and a myriad of other features available to their colleagues without disabilities—features that could be available to them, too, with appropriate website design.

## 2. Introduction and Summary

The Americans with Disabilities Act (ADA), passed in 1990, provides, among other things, that “public accommodations,” such as stores, museums and travel services, may not discriminate against people with disabilities. The World Wide Web, created in 1989, came into wide public use about 1995. In 1997 the U.S. Supreme Court described the Web as “both a vast library including millions of readily available and indexed publications and a sprawling mall offering goods and services. From the publishers’ point of view, it constitutes a vast platform from which to address and hear from a world-wide audience of millions of readers, viewers, researchers, and buyers.”<sup>1</sup>

Many businesses with walk-in offices or stores have moved all or part of their transactions to the Web. As the Department of Justice has noted, there is “a wide, and growing, range of services provided over the [I]nternet—from shopping to online banking and brokerage services to university degree courses—[that] are beginning to replace reliance on physical business locations.”<sup>2</sup> Some businesses encourage Web-only transactions,

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1. *Reno v. ACLU*, 521 U.S. 844, 853 (1997).

2. *Hooks v. OKBridge, Inc.*, No. 99-50891, at 9 (5<sup>th</sup> Cir. 2000) (Brief of the United States as amicus curiae in support of Appellant, June 30, 2000) (“*Hooks* brief”), at [www.usdoj.gov/crt/app/briefs\\_disright.htm](http://www.usdoj.gov/crt/app/briefs_disright.htm). (challenging alleged discrimination by a Website that conducted online bridge tournaments). *Hooks v. OKBridge, Inc.*, No. 99-214 (W.D. Tex. Aug 4, 1999), *aff’d without opinion*, 232 F.3d 208 (5<sup>th</sup> Cir. 2000) (holding that Title III does not apply to a Website because of lack of physical space (*but see infra*, Part 4)).

charging more at their walk-in stores than for the same transaction over the Web.<sup>3</sup>

From the earliest days of general Internet use, the United States Department of Justice (DOJ) has stated that "The Internet is an excellent source of information and, of course, people with disabilities should have access to it as effectively as people without disabilities."<sup>4</sup> As technology for accessibility has become more available (such as screen reader technology, which translates text to speech for people with visual disabilities) the DOJ has applied that principle by requiring sponsors of public events to create accessible Websites.<sup>5</sup> State Attorneys General also have demanded accessibility for private Websites, most notably in two 2004 settlements by the New York Attorney General under which the Websites ramada.com and priceline.com agreed to implement assistive technology for people who are blind and visually impaired.<sup>6</sup> State and local laws also cover Website accessibility.<sup>7</sup>

Tim Berners-Lee, inventor of the World Wide Web, states that "The power of the Web is its universality. Access by everyone regardless of disability is an essential aspect."<sup>8</sup> To encourage such universality, the Web Accessibility Initiative (WAI) of the World Wide Web Consortium (W3C), under the direction of Berners-Lee, has published guidelines for Website accessibility<sup>9</sup>

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3. *E.g.*, [www.verizonwireless.com](http://www.verizonwireless.com) ("Online discounts (Instant Rebates) are ONLY available for website purchases and your account must be eligible to participate.") (visited Feb. 16, 2006).

4. Letter from Deval L. Patrick, Ass't Att'y General, Civil Rights Div., U.S. Dep't of Justice, to Hon. Tom Harkin, U.S. Senate (Sept. 6, 1996), at [www.cybertelex.com/ada/adaletters.htm](http://www.cybertelex.com/ada/adaletters.htm), National Disability Law Reporter, Vol. 10, Iss. 6, par. 240 (Sept. 11, 1997). *See, generally*, Hooks brief (arguing that the ADA requires that Websites of Title III entities not discriminate against people with disabilities).

5. *E.g.*, Settlement Agreement between the United States and the New Orleans Jazz and Heritage Foundation, Inc., DOJ File No. 202-32-24 (Nov 1, 2001), at <http://www.usdoj.gov/crt/ada/nojazz.htm>, (requiring "home page and ADA page on the Foundation's website" to be as accessible "as possible").

6. *See, e.g.*, *In the Matter of Priceline.com Inc.*, Attorney General of the State of New York Internet Bureau (April 4, 2004). In a 2000 settlement with the Connecticut Attorney General, the tax-filing services HDVest, Intuit, H&R Block and Gilman & Ciocia agreed to make their Websites accessible. *See* [www.ct.gov/ag/cwp/view.asp?A=1775&Q=283012](http://www.ct.gov/ag/cwp/view.asp?A=1775&Q=283012).

7. Many state and local disability laws are worded more strongly and explicitly than the ADA. *See, e.g.*, N.Y. Human Rights Law, Exec. §§ 290 *et seq.*, N.Y. City Human Rights Law, Admin. Code §§ 8-101 - 8-703.

8. [Http://www.w3.org/WAI/](http://www.w3.org/WAI/).

9. *Id.*; *see also* <http://www.accessweb.ucla.edu/dis-web.htm#blind>; [http://library.uwsp.edu/aschmetz/accessible/pub\\_resources.htm](http://library.uwsp.edu/aschmetz/accessible/pub_resources.htm).

for people with disabilities, including blindness and other visual disabilities, motor limitations, hearing difficulties and cognitive disabilities. Those guidelines have been adopted by the federal Access Board<sup>10</sup> and can serve as an appropriate standard to be followed under Title III.

Examples of accessibility features include:<sup>11</sup>

- Keyboard equivalents for mouse commands;
- Text-to-speech capability;
- Adequately labeled and/or descriptive text equivalents for non-text elements such as images;
- Non-color equivalents for information conveyed with color;
- Identifiable row and column headers for data tables;
- Assistance for completing on-line forms;
- Allowing users to extend the time for timed-response functions;
- Avoiding “streaming” content techniques for conveying material information;
- Where input of letters or numbers (which may not be depicted as text) is required to set up an account, an easy telephone alternative for account formation.

The lack of such features in many “public accommodations” Websites leaves much of the Web “mall, library, bank and marketplace” inaccessible to many Americans.

As the better reasoned court opinions hold,<sup>12</sup> such inaccessibility violates Title III of the ADA.<sup>13</sup> Unfortunately, some courts and commentators disagree, largely because they focus only on the aspect of Title III that

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10. Electronic and Information Technology Accessibility Standards, 36 C.F.R. § 1194.22, implementing Section 508 of the Rehabilitation Act of 1973, as amended, 29 U.S.C. § 794d.

11. See *id.*

12. See *infra* Section 4.

13. Accessibility of government and federally supported Websites is more clearly mandated under statute and regulation. Section 508 of the Rehabilitation Act (29 U.S.C. § 794d) requires that the federal government and companies with federal government contracts make their Websites accessible. Title II of the ADA, 42 U.S.C. §§12131 *et seq.* (and court cases construing it, e.g., *Martin v. MARTA*, 225 F. Supp. 2d 1362 (N.D. Ga. 2002)), mandates that the Websites of state and local governments, and other entities receiving federal funding, provide services through accessible Websites.

requires physical, architectural accessibility to “places of public accommodation.”<sup>14</sup> Such a focus assumes that “place” is defined in the ADA—as it is not—as a location people can enter bodily to offer or to seek goods and/or services. It also assumes that Title III’s requirement of access to “facilities” excludes Website “facilities.” These assumptions do not bear reasonable scrutiny under the ADA. However, confusion fostered by such assumptions has led to the legally hazardous inaccessibility of the Websites of many public accommodations.

The ever more vital role of the World Wide Web in American life makes it crucial to set forth, as we do here, an appropriate legal analysis that will secure the Web’s accessibility to millions of people with disabilities.

**3. Title III of the Americans with Disabilities Act  
Requires Opportunity for “Full and Equal Enjoyment”  
of “Public Accommodations”**

The operative section of Title III of the ADA, entitled “Prohibition of discrimination by public accommodations,” states:

No individual shall be discriminated against on the basis of disability in the full and equal enjoyment of the goods, services, facilities, privileges, advantages, or accommodations of any place of public accommodation by any person who owns, leases (or leases to), or operates a place of public accommodation.<sup>15</sup>

The statute also sets forth categories of “public accommodations,” which include most private entities that offer goods and services to customers.<sup>16</sup> As discussed below, there are two alternative conceptual frame-

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14. *E.g.*, 42 U.S.C. § 12182(b)(2)(A)(iv) (“failure to remove architectural barriers, and communication barriers that are structural in nature”).

15. 42 U.S.C. § 12182(a).

16. 42 U.S.C. § 12181(7): The following private entities are considered public accommodations for the purposes of this subchapter, if the operations of such entities affect commerce—

(A) an inn, hotel, motel, or other place of lodging, except for an establishment located within a building that contains not more than five rooms for rent or hire and that is actually occupied by the proprietor of such establishment as the residence of such proprietor;

(B) a restaurant, bar, or other establishment serving food or drink;

(C) a motion picture house, theater, concert hall, stadium, or other place of exhibition or entertainment;

(D) an auditorium, convention center, lecture hall, or other place of public gathering;



works under which a public accommodation's Website is subject to Title III: (a) as a place of "public accommodation" in its own right, and/or (b) as one of the "goods, services, facilities, privileges, advantages, or accommodations of" a public accommodation.

**A. A Website Is a Place of "Public Accommodation"**

The statute does *not* define, nor set forth examples of, the term "place." In trying to discern a meaning for "place," some courts and commentators have made the twelve categories of "public accommodations" serve as limiting factors that define the sort of "place" to which Title III applies. The result is an assertion that a "place" is a physical "facility" and that the terms "place" and "facility" should be read to require a location people can enter bodily to offer or to seek goods and/or services. No such limitation appears in the ADA.<sup>17</sup>

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(E) a bakery, grocery store, clothing store, hardware store, shopping center, or other sales or rental establishment;

(F) a laundromat, dry-cleaner, bank, barber shop, beauty shop, travel service, shoe repair service, funeral parlor, gas station, office of an accountant or lawyer, pharmacy, insurance office, professional office of a health care provider, hospital, or other service establishment;

(G) a terminal, depot, or other station used for specified public transportation;

(H) a museum, library, gallery, or other place of public display or collection;

(I) a park, zoo, amusement park, or other place of recreation;

(J) a nursery, elementary, secondary, undergraduate, or postgraduate private school, or other place of education;

(K) a day care center, senior citizen center, homeless shelter, food bank, adoption agency, or other social service center establishment; and

(L) a gymnasium, health spa, bowling alley, golf course, or other place of exercise or recreation.

17. The statute uses three different terms to describe the categories of covered "public accommodations": "places" of lodging, exhibition or entertainment, of public gathering, of public display or collection, of recreation, of education and of exercise, 42 U.S.C.A. §§ 12181(7)(A),(C),(D),(H),(I),(J),(L); "establishments" serving food or drink, offering sales or rentals, offering services (such as travel service, shoe repair service, insurance, health care) and offering social services (such as day care or adoption), *id.* §§ 12181(7)(B),(E),(F),(K); and "station[s] used for specified public transportation." *Id.* § 12181(7)(G). "The term 'specified public transportation' means transportation by bus, rail, or any other conveyance (other than by aircraft) that provides the general public with general or special service (including charter service) on a regular and continuing basis." *Id.* § 12181(10). Any assertion that Congress intended to limit applicability of Title III to a certain size or type of "place" is even more absurd than would be a claim Congress excluded from coverage five of the twelve categories of "public accommodations" it described by using a term other than "place."

To the contrary, when discussing public accommodations, Congress spoke in expansive—not restrictive—terms. Thus, in the final list of twelve categories of entities, Title III lists a few examples, then adds “other place of lodging . . . other place of public gathering . . . other sales or rental establishment.” As the House Committee Report on the ADA points out, this ensures that a person alleging discrimination need not prove the discriminating entity is similar to one of the listed examples. “Rather, the person must show that the entity falls within the overall category. For example, it is not necessary to show that a jewelry store is like a clothing store. It is sufficient that the jewelry store sells items to the public.”<sup>18</sup> Thus, the key attribute of the public accommodation is the act of selling to the public, not the nature of the location where it does the selling.<sup>19</sup>

Furthermore, a Website is a “facility,” as defined by the DOJ regulations promulgated at the direction of the ADA.<sup>20</sup> A “facility” includes “all or any portion of . . . sites, . . . equipment, . . . or other . . . personal property . . .” of the public accommodation.<sup>21</sup> Under this definition, a Website clearly has a “site”—a physical location on “equipment” such as a server. People enter this “site” using remote computers, accessing “goods, services, facilities, privileges, advantages, or accommodations”<sup>22</sup> resident

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18. H.R. Rep. No. 101-485, pt. 3, at 54 (1990), *reprinted in* 1990 U.S.C.C.A.N. 445, 447.

19. See *Doe v. Mutual of Omaha Ins. Co.*, 179 F.3d 557, 562 (7<sup>th</sup> Cir. 1999) (Posner, J.) (“Both committee reports . . . give the example of refusing to sell an insurance policy to a blind person, as does the gloss placed . . . by the Department of Justice.”) (*citing* 28 C.F.R., Part 36, App. B § 36.212).

20. 42 U.S.C. § 12186(b). Because they are expressly authorized by Congress, courts must give these regulations “legislative and hence controlling weight unless they are arbitrary, capricious, or plainly contrary to the statute.” *United States v. Morton*, 467 U.S. 822, 834 (1984); *Martin*, 225 F. Supp. 2d at 1374.

21. 28 C.F.R. § 36.104. That “site” is not limited to a plot of ground is emphasized by the continuing language of the definition: “including the site where the building, property, structure, or equipment is located.” The regulations further demonstrate that prohibitions against discrimination are not limited to a “place,” pointing out that a “health care provider” is a “public accommodation,” which must provide nondiscriminatory health care to people with or without disabilities: “A physician who specializes in treating only a particular condition cannot refuse to treat an individual with a disability for that condition, but is not required to treat the individual for a different condition.” 28 C.F.R. § 36.202(b)(2). The same could be said of an “establishment” providing legal or other services, whether operating in a firm, office or from home. See *supra* n. 17, discussing 42 U.S.C. § 12181(7). There is no physical space “trigger” that activates the prohibition against discrimination.

22. 42 U.S.C. § 12181(1).

on that site or in another remote place in the same way people make a telephone call to a bricks-and-mortar store to place an order or walk into a library to read a book.

Although the cyberspace “place” of public accommodation may be smaller than a bricks-and-mortar counterpart (be it a huge department store or a small storefront), it is nonetheless a place. In this place, as in a walk-in place, people may view, evaluate, buy and sell, order, and even perform and deliver goods and services; enjoy a wide variety of entertainment and exhibitions; borrow books, exhibit art and museum collections; pursue games and other recreation; enjoy entertainment; attend lectures and other forms of education; explore and obtain social services; and hold interactive conferences. It is, in short, a “public accommodation” under Title III of the ADA, with obligations not to discriminate,<sup>23</sup> and it must be accessible, whether attached to a bricks-and-mortar entity<sup>24</sup> or existing only in cyberspace.<sup>25</sup>

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23. 42 U.S.C. § 12181(7). Although Congress did not directly contemplate the then nascent World Wide Web in enacting the ADA, coverage of the goods and services offered via Websites clearly was within Congressional intent. See *infra* Section 3.

24. As the DOJ points out (*Hooks* brief at 9-10), “[Any other reading of the statute] permits discrimination by more traditional businesses that provide services in locations other than their premises. For example, many businesses provide services over the telephone or through the mail, including travel services, banks, insurance companies, catalog merchants, and pharmacies. Many other businesses provide services in the homes or offices of their customers, such as plumbers, pizza delivery and moving companies, cleaning services, business consulting firms, and auditors from accounting firms. . . . [T]hose selling car insurance over the telephone would be free to hang up on blind customers, Publisher’s Clearing House could refuse to sell magazines through the mail to people with HIV, and colleges could refuse to enroll the deaf in their correspondence courses.”

25. See *Doe*, 179 F.3d at 559 (“The core meaning of this provision, plainly enough, is that the owner or operator of a store, hotel, restaurant, dentist’s office, travel agency, theater, Web site or other facility (whether in physical space or in electronic space . . . ) that is open to the public cannot exclude disabled persons from entering the facility and, once in, from using the facility in the same way that the nondisabled do.”) (internal citation omitted). See also *The Applicability of the Americans with Disabilities Act (ADA) to Private Internet Sites: Hearing Before the Subcomm. on the Constitution of the House Comm. on the Judiciary*, 106<sup>th</sup> Cong. (2000) 104 (Testimony of Prof. Peter D. Blanck, U. of Iowa) (“My view is that Web-based activities of public accommodations that have an online presence, such as a bookstore, a travel agency that both has a store and an online presence, would be subject to title III provisions. And . . . I would similarly believe that exclusively Web based-service industries such as e-commerce retail sites would be considered title III entities simply offering goods and services to the public.”), at [http://commdocs.house.gov/committees/judiciary/hju65010.000/hju65010\\_0f.htm](http://commdocs.house.gov/committees/judiciary/hju65010.000/hju65010_0f.htm).

**B. A Website Is One of the “Goods, Services, Facilities,  
Privileges, Advantages, or Accommodations of”  
a Public Accommodation”**

Limiting “place” to a location large enough to accommodate human bodies ignores the rest of the section in which Congress uses the term “place.” First, discrimination is prohibited in the full and equal enjoyment of “the goods, services, . . . privileges, advantages, or accommodations,” as well as of the “facilities” of public accommodations.<sup>26</sup> Second, discrimination is prohibited “by” the covered entity—not the “place”—in the enjoyment “of”—not “at” or “in”—the place of public accommodation.<sup>27</sup> Both terms necessarily extend the prohibition of discrimination to more than physical space. “At,” if used, might limit “full and equal enjoyment” to events “at” the physical place.<sup>28</sup> Instead, Congress chose “of.” Even if “of” were ambiguous and could mean “at,” interpretation of the ADA requires that any ambiguity be interpreted to confer more—rather than fewer—rights on the protected class of people.<sup>29</sup> The interpretation is reinforced by the subheading of the statutory section itself, “Prohibition of discrimination *by* [not *at*] public accommodations.”<sup>30</sup>

A further illustration of the applicability of Title III both to non-physical elements associated with a physical entity and to pure-cyberspace entities is found in other prohibitions of Title III that clearly are not limited to physical matters. Thus, in Title III, “failure to remove architectural barriers, and communication barriers that are structural”<sup>31</sup> is only one example of prohibited discrimination, listed only after many other prohibitions.<sup>32</sup> These other prohibitions, not tied to physical places, but

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26. 42 U.S.C. § 12182(a).

27. *Id.*

28. See *Hooks* brief at 8 (“The Services “Of” A Place Of Public Accommodation Need Not Be Provided “At” The Place Of Public Accommodation”).

29. See *Arnold v. United Parcel Service, Inc.*, 136 F.3d 854, 861 (1<sup>st</sup> Cir. 1998) (ADA is a “broad remedial statute” that should be “construed broadly to effectuate its purposes”) (internal citations omitted).

30. 42 U.S.C. § 12182 (emphasis added). The expansive reading of “of” also is reinforced by the language of Title II of the ADA, which prohibits discrimination on the basis of disability in the “services, programs, or activities *of* a public entity.” 42 U.S.C. § 12132. This provision, along with its implementing regulations, has been found to require Website accessibility for public transit information. *Martin*, 225 F. Supp. 2d at 1377.

31. 42 U.S.C. § 12182(b)(2)(A)(iv).

32. These include: “Denial of participation . . . directly, or through commercial, licensing, or other arrangements,” *id.* § 12182(b)(1)(A)(i); “Participation in unequal benefits,” *id.* §

directed to policies, procedures and methods that reflect discriminatory attitudes and thoughtlessness, are as applicable to Websites as they are to bricks-and-mortar sites.

This reading of the statute is further encouraged by focusing on those entities that Congress designated “establishments” rather than “places,” such as stores and restaurants.<sup>33</sup> The listed “establishments” provide services that do not necessarily occur at a physical location. Some restaurants, for instance, provide take-out as well as eat-in service; a take-out restaurant cannot discriminate against a person with a disability. It must agree to read the take-out menu over the phone to a blind person; it could not refuse to deliver food to the home of a person with a mental disability. Similarly, a “store” is an “establishment” rather than a “place.” A store, such as the bookstore Barnes & Noble, must not only make its physical store accessible, but its Website as well, so that people with disabilities can have equal enjoyment of the “services, . . . privileges, advantages, or accommodations” the “establishment” offers to those without disabilities via its Website.

As the Department of Justice has pointed out:<sup>34</sup>

Being offered access to only those services of a public accommodation that are offered on-site, when the public at large is given access to additional services off-site, is hardly “full and equal enjoyment” of the accommodations’ services. And narrowly construing the statute to exclude major areas of discrimination faced by people with disabilities in their day-to-day encounters with commercial service providers—including services

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12182(b)(1)(A)(ii); “Separate benefit . . . [to provide] a good, service, facility, privilege, advantage, or accommodation that is different or separate from that provided to other individuals,” *id.* § 12182(b)(1)(A)(iii); “the imposition or application of eligibility criteria that screen out or tend to screen out . . . individuals with disabilities from fully and equally enjoying any goods, services, facilities, privileges, advantages, or accommodations,” *id.* § 12182(b)(2)(A)(i); “a failure to make reasonable modifications in policies, practices, or procedures, when such modifications are necessary to afford such goods, services, facilities, privileges, advantages, or accommodations to individuals with disabilities,” *id.* § 12182(b)(2)(A)(ii); “a failure to take such steps as may be necessary to ensure that no individual with a disability is excluded, denied services, segregated or otherwise treated differently than other individuals because of the absence of auxiliary aids and services.” *Id.* § 12182(b)(2)(A)(iii).

33. “Establishments” serving food or drink, offering sales or rentals, offering services (such as travel service, shoe repair service, insurance, health care) and offering social services (such as day care or adoption). *Id.*, §§ 12181(7)(B), (E), (F), (K).

34. *Hooks* brief at 11.

provided in a person's home, over the telephone, through the mail, or via the internet—is inconsistent with Congress's clearly expressed intent.

#### **4. Website Accessibility Directly Serves Congressional Intent as Expressed in the ADA's "Findings and Purposes" and its Legislative History**

Neither the ADA nor its legislative history discusses the Internet or the Web, and Congress did not anticipate the application of the ADA to the Internet. This is no barrier, however. The ADA is a "broad remedial statute that should be construed broadly to effectuate its purposes."<sup>35</sup> As the Supreme Court has held, "that [Title III of the ADA] can be applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth."<sup>36</sup> In other contexts, the Supreme Court has continually held that Congressional statutes do not freeze time so as to apply only to situations available at the moment of the law's passage. To the contrary, "[w]hen technological change has rendered its literal terms ambiguous, [an] Act must be construed in light of [its] basic purpose."<sup>37</sup>

All of Congress' "Findings and Purposes"<sup>38</sup> regarding the aim of the ADA point toward Website accessibility. The ADA is "a clear and comprehensive national mandate for the elimination of discrimination against individuals with disabilities."<sup>39</sup> The statute's purpose is to "invoke the sweep of Congressional authority . . . to regulate commerce, in order to address the major areas of discrimination faced day-to-day by people with disabilities."<sup>40</sup> Congress found that "society has tended to isolate and segregate individuals with disabilities," in "public accommodations" and "communications."<sup>41</sup> Discrimination arises through "communication barriers"

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35. *Arnold*, 136 F.3d at 861.

36. *PGA Tour, Inc. v. Martin*, 532 U.S. 661, 689 (2001) (professional golfer with disability must be allowed to use golf cart, rather than walking, on the PGA tour) (internal citation omitted).

37. *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975) (broadcasting a copyrighted work via a restaurant radio does not constitute a separate "performance" of the work requiring additional royalty payment to the copyright holder) (citing *Fortnightly Corp. v. United Artists*, 392 U.S. 390, 395 (1968) ("Our inquiry cannot be limited to ordinary meaning and legislative history, for this is a statute that was drafted long before the development of the electronic phenomena with which we deal here.")).

38. 42 U.S.C. § 12101.

39. *Id.* § 12101 (b)(1).

40. *Id.* § 12101 (b)(4).

41. *Id.* § 12101 (a)(2), (3).

and failure to modify existing “practices,” thereby relegating people with disabilities to “lesser services, programs, activities, benefits [and] other opportunities” and “inferior status in our society” as an “insular minority” that is denied “full participation” in American life.<sup>42</sup>

Public accommodations Websites, although “not anticipated by Congress,” clearly must be subject to Title III. Without Website access to public accommodations, people with disabilities are “isolated and segregated” and relegated to “lesser services.” They are unable to order CDs from online bookstores, to download tunes from online music stores, to take virtual tours and make online reservations at hotels, to read and consider online restaurant menus, to order from online pharmacies and groceries. As more and more advertisements urge customers to visit a store or museum’s Website for goods, services and information, and even grant special deals to online consumers (and the convenience of avoiding long telephone queues), those who cannot access the Website are denied the “full participation” that Congress intends. Website inaccessibility is thus a “communication barrier” that is “faced day-to-day by people with disabilities.”

Congressional intent also is evident from the legislative history of the ADA.<sup>43</sup> The legislative history (the Senate and House Reports on the ADA)<sup>44</sup> is explicit that Congress intended that the language of the ADA not be frozen in time, but that it adapt to changing needs and circumstances, specifically technological change. As the House Report says, “the Committee intends that the types of accommodation and services provided to individuals with disabilities, under all of the titles of this bill, should keep pace with the rapidly changing technology of the times.”<sup>45</sup>

Central to Title III is equal access, not to physical places, but to goods and services, with physical accessibility only a means to that end. “In drafting Title III, Congress intended that people with disabilities have equal access to the array of goods and services offered by private estab-

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42. *Id.* § 12101 (a)(5), (6), (7), (8).

43. See *Carparts Distrib. Cntr., Inc. v. Automotive Wholesalers Ass’n of New England*, 37 F.3d 12, 19 (1<sup>st</sup> Cir. 1994) (“Even if the meaning of ‘public accommodation’ is not plain, it is, at worst, ambiguous. This ambiguity, considered together with agency regulations and public policy concerns, persuades us that the phrase is not limited to actual physical structures.”); but see *Parker v. Metropolitan Life Ins. Co.*, 121 F.3d 1006, 1014 & n.10 (6<sup>th</sup> Cir. 1997) (No need to visit legislative history, because Title III’s statutory language clearly and unambiguously means that “a public accommodation is a physical place”).

44. S. Rep. No. 101-116 (1989), H.R. Rep. No. 101-485 (1990), reprinted in 1990 U.S.C.C.A.N. 267.

45. H.R. Rep. No. 101-485, pt. 2, at 108, reprinted in 1990 U.S.C.C.A.N. 303, 391.

ishments and made available to those who do not have disabilities.”<sup>46</sup> As one judge noted, unless Title III mandates accessible Websites, “[a]s the modern economy increases the percentage of goods and services available through a marketplace that does not consist of physical structures, the protections of Title III will become increasingly diluted.”<sup>47</sup>

### 5. Better Judicial Analysis Requires Website Accessibility

Despite the plain meaning of the statute, some courts and commentators insist that Title III’s obligations apply only to physical “places.” The courts that interpret the statutory duty narrowly demand a “nexus” between the service offered and a physical “place.” Other courts, arriving at a contrary reading, emphasize (correctly, we believe) that the duty is owed by the “public accommodation” itself. The latter interpretation is the only one that gives full meaning to the statute.

In one of the few cases dealing with “public accommodations” Websites, *Access Now, Inc. v. Southwest Airlines Co.*,<sup>48</sup> plaintiffs complained that the Website operated by Southwest Airlines—which offered schedules, information, ticketing and other services—was not accessible to blind people. In dismissing the complaint the court concluded that the Website, standing alone, was not a public accommodation and that “a public accommodation must be a physical, concrete structure.”<sup>49</sup> To reach this conclusion, however, the court incorrectly quoted the “statutorily created right” of Title III as a “prohibition against discrimination *in* places of public accommodation”<sup>50</sup> (ignoring the statutory language “*of* any place of public accommodation”) and mischaracterized the twelve statutory categories as “places of public accommodation,” rather than (correctly) as “public accommodations.”<sup>51</sup>

Other courts have rested holdings on similarly flawed reasoning even when reaching the correct conclusion. In *Rendon v. Valleycrest Prods.*,

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46. S. Rep. No. 101-116, at 58, cited in *Carparts*, 37 F.3d at 19.

47. *Parker*, 121 F.3d at 1020 (Martin, J., dissenting).

48. 227 F. Supp. 2d 1312 (S.D. Fla. 2002), appeal dismissed, 385 F.3d 1324 (11<sup>th</sup> Cir. 2004).

49. 227 F. Supp. 2d at 1318.

50. *Id.* at 1313 (emphasis added).

51. *Id.* at 1317. *Southwest Airlines* is troubling in additional ways. On appeal, the plaintiffs changed their legal theory to allege that, instead of constituting a place of public accommodation in itself, southwest.com is part of a larger Title III entity, *i.e.*, Southwest Airlines (a “travel service”). The Eleventh Circuit dismissed this appeal on the grounds that plaintiffs had not raised this theory below. Additionally, the Eleventh Circuit noted that “airlines such as Southwest are largely not even covered by Title III of the ADA,” but by the Air Carriers Access Act, 49 U.S.C. § 41705. 385 F.3d at 1332. See 28 C.F.R. § 36.104 (aircraft are not covered by the ADA, but indicating no exclusion for other facilities, goods, or services of airlines).



*Ltd.*,<sup>52</sup> the Eleventh Circuit held that the automated fast-finger telephone process used to select contestants for “Who Wants to Be a Millionaire” “is a discriminatory screening mechanism,” violating Title III.<sup>53</sup> In doing so, however, the court characterized the twelve Title III categories as “places of ‘public accommodation,’”<sup>54</sup> finding that the selection process deprived individuals with hearing and mobility impairments of the “privilege of competing in a contest held in a concrete space, [*i.e.*,] Defendants’ theater.”<sup>55</sup> Without such a physical “nexus,” the complaint might have failed.<sup>56</sup>

In *Parker v. Metropolitan Life Ins. Co.*<sup>57</sup> and *Ford v. Schering-Plough Corp.*,<sup>58</sup> two circuit courts refused to extend Title III protection to cover insurance policies that paid lower benefits to people with physical and mental disabilities, because the policies were not offered at a “place,” *i.e.*, a physical structure. The *Parker* court stated that an insurance plan “is not a good offered by a place of public accommodation,” because “a public accommodation is a physical place . . . defined by the applicable regulations [as] a facility.”<sup>59</sup>

52. 294 F.3d 1279 (11<sup>th</sup> Cir. 2002).

53. *Id.* at 1286.

54. *Id.* at 1282. See *id.* at n.3 (misquoting 28 C.F.R. § 36.104 as “defining a public accommodation as a ‘place’ or ‘a facility.’ . . .” The regulation actually defines a “place of public accommodation” as a “facility” within one of the twelve statutory categories and defines “facility” as including a “site” (not necessarily the location of a building), “equipment” and “other . . . personal property.”).

55. 294 F.3d at 1284 & n.8.

56. There might have been a clearer focus on whether there was a need for a bricks-and-mortar space had defendants not conceded the television studio was a “place of public accommodation.” *Id.* at 1283. Instead, the issue for decision was whether the telephone fast-finger screening process itself was a public accommodation. The court concluded that it was precisely the kind of communication barrier the ADA sought to remedy. *Id.* at 1286.

57. 121 F.3d 1006 (6<sup>th</sup> Cir. 1997).

58. 145 F.3d 601 (3d Cir. 1998).

59. 121 F.3d at 1010-11 (ignoring that the statute requires non-discrimination both in “facilities” and in “goods, services, . . . privileges, advantages, or accommodations”—and that the regulation cited does not define “public accommodation,” but, rather, “place of public accommodation,” and defines “facility” to include “all or any portion of . . . sites, . . . equipment, . . . or other . . . personal property . . .” 28 C.F.R. § 36.104). See *Chabner v. United of Omaha Life Ins. Co.*, 225 F.3d 1042, 1047 (9<sup>th</sup> Cir. 2000) (requiring a nexus between goods or service complained of and a physical space); *Stoutenborough v. National Football League, Inc.*, 59 F.3d 580, 583 (6<sup>th</sup> Cir. 1995) (TV broadcast does not involve a “public accommodation,” which must be a physical place); *Noah v. AOL Time Warner, Inc.*, 261 F. Supp. 2d 532, 541 (E.D. Va. 2003) (online chat room not a “place of public accommodation” under Title 2 of Civil Rights Act because not an actual physical structure) (NB: Civil Rights Act, Title II, unlike ADA Title III, specifically prohibits discrimination only in “physical” locations and “premises.” 42 U.S.C. § 2000a(a)).

Most recently, the court in *National Federation for the Blind v. Target Corp.*<sup>60</sup> adopted similar reasoning, allowing a lawsuit that challenges the inaccessibility of Target stores' Website to proceed only insofar as the complaint alleges a nexus between the Website and the physical stores.

Courts reaching the correct conclusion—that “public accommodations” are not limited to physical structures—do so by emphasizing the list of “public accommodations” in the “definitions” section of the statute. This line of cases is led by the Supreme Court itself, which characterizes Title III as prohibiting discrimination “by public accommodations,” as opposed to the “places” they operate.<sup>61</sup> In *Carparts Distrib. Ctr. Inc. v. Auto Wholesalers of New England, Inc.*,<sup>62</sup> the First Circuit concluded that an “insurance office” (a “service establishment” under Title III) might be prevented from discriminating against a person with a disability in the insurance it offered, regardless of whether the insurance company occupied a physical space. (“Congress clearly contemplated that ‘service establishments’ include providers of services which do not require a person to physically enter an actual physical structure.”)

The definition of “public accommodation” . . . provides an illustrative list which includes a “travel service,” a “shoe repair service,” an “office of an accountant, or lawyer,” a “professional office of a healthcare provider,” and “other service establishments.” The plain meaning of the terms do not require “public accommodations” to have physical structures for people to enter. . . . Many travel services conduct business by telephone or correspondence without requiring a customer to enter an office . . . . Likewise, one can easily imagine the existence of other service establishments conducting business by mail and phone without providing facilities for their customers to enter . . . . It would be irrational to conclude that persons who enter an office to purchase services are protected by the ADA, but persons who purchase the same services over the telephone or by mail are not. Congress could not have intended such an absurd result.”<sup>63</sup>

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60. 452 F. Supp. 2d 946 (N.D. Cal. 2006).

61. *PGA Tour, Inc.*, 532 U.S. at 682, *Spector v. Norwegian Cruise Line Ltd.*, 545 U.S. 119, 125 S. Ct. 2169, 2176 (2005) (“Title III of the ADA prohibits discrimination against the disabled in the full and equal enjoyment of *public accommodations*”) (emphasis added).

62. 37 F.3d 12 (1<sup>st</sup> Cir. 1994).

63. *Id.* at 19 (internal citation omitted). On remand, the District Court incorrectly asserted that the Regulations “define[] a *public accommodation* as ‘a facility . . .’” 987 F. Supp. 77, 80

In *Doe v. Mutual of Omaha Ins. Co.*,<sup>64</sup> challenging allegedly discriminatory insurance for AIDS patients the Seventh Circuit bypassed the “place” language entirely and concurred with the *Carparts* holding that public accommodations need not occupy physical space:

The core meaning of [Title III], plainly enough, is that the owner or operator of a store, hotel, restaurant, dentist’s office, travel agency, theater, Web site, or other facility (whether in physical space or in electronic space . . .) that is open to the public cannot exclude disabled people from entering the facility and, once in, from using the facility in the same way that the nondisabled do.<sup>65</sup>

Using similar reasoning, the court in *Walker v. Carnival Cruise Lines*<sup>66</sup> held that “Travel agents fall squarely within the ADA’s definition of public accommodations,” and consequently owe their customers non-discriminatory treatment in the services they offer, “quite apart from the physical accessibility of the Travel Agent’s office.” Thus, to offer individuals with disabilities “inadequate or inaccurate information regarding the disabled accessibility of travel accommodations . . . deprives [travelers with disabilities] of ‘full and equal enjoyment’ of travel information services.”<sup>67</sup>

The *Carparts* court (and courts following its reasoning) reached its conclusion by tracking the statutory language exactly as we suggest.<sup>68</sup> Thus, an “insurance office” or “travel service” is a “public accommodation”

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n.3 (D.N.H. 1997) (emphasis added), which is, to the contrary, how the Regulations define “a place of public accommodation.” 28 C.F.R. § 36.104 (emphasis added).

64. 179 F.3d 557, 563 (7<sup>th</sup> Cir. 1999) (Posner, J.) (holding that Title III does not prevent an insurance company from capping its benefits for AIDS and other diseases, “some of which may also be disabilities”) (internal citation omitted).

65. *Id.* at 559.

66. 63 F. Supp. 2d 1083 (N.D. Cal. 1999).

67. *Id.* at 1092.

68. See *Pallozzi v. Allstate Life Ins. Co.*, 198 F.3d 28, 32-33 & n.3 (2d Cir. 1999) (insurance policy obtained directly from company was covered by ADA, noting that not just access to “offices” are covered, but also to goods/services off-site (also distinguishing *Parker and Ford*)); *Morgan v. Joint Admin. Bd. Retirement Plan of Pillsbury Co.*, 268 F.3d 456, 459 (7<sup>th</sup> Cir. 2001) (“An insurance company can no more refuse to sell a policy to a disabled person over the Internet than a furniture store can refuse to sell furniture to a disabled person who enters the store. . . . The site of the sale is irrelevant to Congress’s goal of granting the disabled equal access to sellers of goods and services. What matters is that the good or service be offered to the public.”).

that owes a duty of non-discrimination in its “goods” and “services.” Further, both are “service establishments,” with obligations beyond physical access to their “facilities.” Such reasoning easily extends to Websites operated by Title III entities and avoids the “absurd result” that Website non-accessibility invites.

Under a contrary reading of the statute, the accessibility requirement of a “travel service”—a travel agency, for instance — applies only to its physical “facilities,” despite that the statute explicitly defines a “travel service” as a “service establishment” rather than as a “place.”<sup>69</sup> Its Website need not be accessible; it needs to be made available only to sighted people, ignoring the blind and visually impaired. So, although a sighted person could access the Website, retrieve schedules, buy tickets and hotel vouchers, a blind person could not. Instead, he would have to maneuver into accessible transportation, travel to the physically accessible office and buy his ticket there—encountering long lines and incurring additional fees for not using the Website. “Congress could not have intended such an absurd result.”<sup>70</sup>

### **Conclusion**

Website access for people with disabilities is mandated both by the letter and spirit of Title III of the ADA. It also is mandated by simple fairness and the policy behind the ADA of removing barriers to “full participation” in American life. Quite apart from law and policy, Title III Website accessibility makes good business sense. American businesses should be eager to welcome to their Websites the 10,000,000 Americans with visual disabilities as well as the millions more with other disabilities their accessible Websites will attract.

*October 2006*

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69. 42 U.S.C. § 12181(7)(F).

70. *Carparts*, 37 F.3d at 19.

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Formal Opinion 2006-3

# Outsourcing Legal Support Services Overseas

*Committee on Professional and Judicial Ethics*

**TOPICS:** Outsourcing Legal Support Services Overseas, Avoiding Aiding a Non-Lawyer in the Unauthorized Practice of Law, Supervision of Non-Lawyers, Competent Representation, Preserving Client Confidences and Secrets, Conflicts Checking, Appropriate Billing, Client Consent.

**DIGEST:** A New York lawyer may ethically outsource legal support services overseas to a non-lawyer, if the New York lawyer (a) rigorously supervises the non-lawyer, so as to avoid aiding the non-lawyer in the unauthorized practice of law and to ensure that the non-lawyer's work contributes to the lawyer's competent representation of the client; (b) preserves the client's confidences and secrets when outsourcing; (c) avoids conflicts of interest when outsourcing; (d) bills for outsourcing appropriately; and (e) when necessary, obtains advance client consent to outsourcing.

**CODE:** DR 1-104, DR 3-101, DR 3-102, DR 4-101, DR 5-105, DR 5-107, DR 6-101, EC 2-22, EC 3-6, EC 4-2, EC 4-5.

### QUESTION

May a New York lawyer ethically outsource legal support services overseas when the person providing those services is (a) a foreign lawyer not admitted to practice in New York or in any other U.S. jurisdiction or (b) a layperson? If so, what ethical considerations must the New York lawyer address?

### DISCUSSION

For decades, American businesses have found economic advantage in outsourcing work overseas.<sup>1</sup> Much more recently, outsourcing overseas has begun to command attention in the legal profession, as corporate legal departments and law firms endeavor to reduce costs and manage operations more efficiently.

Under a typical outsourcing arrangement, a lawyer contracts, directly or through an intermediary, with an individual who resides abroad and who is either a foreign lawyer not admitted to practice in any U.S. jurisdiction or a layperson, to perform legal support services, such as conducting legal research, reviewing document productions, or drafting due diligence reports, pleadings, or memoranda of law.<sup>2</sup>

We address first whether, under the New York Code of Professional Responsibility (the "Code"), a lawyer would be aiding the unauthorized practice of law if the lawyer outsourced legal support services overseas to a "non-lawyer," which is how the Code describes both a foreign lawyer not admitted to practice in New York, or in any other U.S. jurisdiction, and a layperson.<sup>3</sup> Concluding that outsourcing is ethically permitted under the conditions described below, we then address the ethical obligations of

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1. See, e.g., Adam Johnson & John D. Rollins, *Outsourcing: Unconventional Wisdom*, *Accenture Outlook Journal*, (October 2004), at [http://www.accenture.com/Global/Services/By\\_Industry/Travel/R\\_and\\_I/UnconventionalWisdom.htm](http://www.accenture.com/Global/Services/By_Industry/Travel/R_and_I/UnconventionalWisdom.htm); Fakir Chand, *Business Process Outsourcing Propels the 21st Century*, *SME Outsourcing* (October 2003), at <http://smeoutsourcing.com/viewnew.php?id=9bd912e64b470d2f28ea096a56bdebd0>.

2. See, e.g., Jonathan D. Glater, *Even Law Firms Join the Trend to Outsourcing*, *N.Y. Times*, Jan. 13, 2006; Eric Bellman & Nathan Koppel, *More U.S. Legal Work Moves to India's Low-Cost Lawyers*, *Wall St. J.*, Sept. 28, 2005; George W. Russell, *In-house or Outsourced? The Future of Corporate Counsel*, *Asia Law* (July/Aug. 2005); Ellen L. Rosen, *Corporate America Sending More Legal Work, to Bombay: U.S. Firms Face Challenge Over Outsourcing Legal Work to India*, *N.Y. Times*, Mar. 14, 2004; Ann Sherman, *Should Small Firms Get on Board with Outsourcing?*, *Small Firm Business*, Sept. 12, 2005.

3. See, e.g., New York State Bar Association Committee on Professional Ethics Opinion ("N.Y. State Opinion") 721 (1999).



the New York lawyer to (a) supervise the non-lawyer and ensure that the non-lawyer's work contributes to the lawyer's competent representation of the client; (b) preserve the client's confidences and secrets when outsourcing; (c) avoid conflicts of interest when outsourcing; (d) bill for outsourcing appropriately; and (e) obtain advance client consent for outsourcing.<sup>4</sup>

**The Duty to Avoid Aiding a Non-Lawyer  
in the Unauthorized Practice of Law**

Under DR 3-101(A), "[a] lawyer shall not aid a non-lawyer in the unauthorized practice of law." In turn, Judiciary Law § 478 makes it "unlawful for any natural person to practice or appear as an attorney-at-law . . . without having first been duly and regularly licensed and admitted to practice law in the courts of record of this state and without having taken the constitutional oath." Prohibiting the unauthorized practice of law "aims to protect our citizens against the dangers of legal representation and advice given by persons not trained, examined and licensed for such work, whether they be laymen or lawyers from other jurisdictions." *Spivak v. Sachs*, 16 N.Y.2d 163, 168, 211 N.E.2d 329, 331, 263 N.Y.S.2d 953, 956 (1965).

Alongside these prohibitions, the last 30 years have witnessed a dramatic increase in the extent to which law firms and corporate law departments have come to rely on legal assistants and other non-lawyers to help render legal services more efficiently.<sup>5</sup> Indeed, in EC 3-6, the Code directly acknowledges both the benefits flowing from a lawyer's properly delegating tasks to a non-lawyer, and the lawyer's concomitant responsibilities:

A lawyer often delegates tasks to clerks, secretaries, and other lay persons. Such delegation is proper if the lawyer maintains a direct relationship with the client, supervises the delegated work,

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4. This opinion concerns outsourcing of "substantive legal support services," which include legal research, drafting, due diligence reports, patent and trademark work, review of transactional and litigation documents, and drafting contracts, pleadings, or memoranda of law. This is distinguished from "administrative legal support services," which include transcription of voice files from depositions, trials and hearings; accounting support in the preparation of timesheets and billing materials; paralegal and clerical support for file management; litigation support graphics; and data entry for marketing, conflicts, and contact management.

5. See, e.g., NYC Formal Op. 1995-11 ("In the two decades since this committee issued its Formal Opinion on paralegals, see N.Y. City 884 (1974), much has happened with regard to non-lawyers' involvement in the provision of legal services.") (describing the paralegal field as one of the fastest growing occupations in America).

and has complete professional responsibility for the work product. This delegation enables a lawyer to render legal service more economically and efficiently.

In this context, we have underscored that the lawyer's supervising the non-lawyer is key to the lawyer's avoiding a violation of DR 3-101(A). In N.Y. City Formal Opinion 1995-11, we wrote:

Some jurisdictions have concluded that any work performed by a non-lawyer under the supervision of an attorney is by definition not the "unauthorized practice of law" violative of prohibitory provisions, *see, e.g., In re Opinion 24 of Committee on Unauthorized Practice of Law*, 128 N.J. 114, 123, 607 A.2d 962 (1992). This committee does not go so far. However, given that the Code holds the attorney accountable, the tasks a non-lawyer may undertake under the supervision of an attorney should be more expansive than those without either supervision or legislation. Supervision within the law firm thus is a key consideration.

The Committee on Professional Ethics of the New York State Bar Association has specifically addressed the unauthorized practice of law in the context of a lawyer's using an outside legal research firm staffed by non-lawyers. In N.Y. State Opinion 721 (1999), that Committee opined that a New York lawyer may ethically use such a research firm if the lawyer exercises proper supervision, which involves "considering in advance the work that will be done and reviewing after the fact what in fact occurred, assuring its soundness." *Id.* Without proper supervision by a New York lawyer, the legal research firm would be engaging in the unauthorized practice of law. *Id.* That Committee also noted that, "other ethics committees in New York have determined that non-lawyers may research questions of law and draft documents of all kinds, including process, affidavits, pleadings, briefs and other legal papers as long as the work is performed *under the supervision* of an admitted lawyer" (citations omitted).<sup>6</sup>

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6. *See, e.g.,* Ellen L. Rosen, *Corporate America Sending More Legal Work to Bombay*, N.Y. Times, Mar. 14, 2004 (quoting Professor Stephen Gillers of NYU School of Law as stating that "even though the lawyer [in the foreign country] is not authorized by an American state to practice law, the review by American lawyers sanitizes the process."); Jennifer Fried, *Change of Venue; Cost-Conscious General Counsel Step up Their Use of Offshore Lawyers, Creating Fears of an Exodus of U.S. Legal Jobs*, *The American Lawyer*, (Dec. 2003) (Professor Geoffrey Hazard, Jr. of University of Pennsylvania Law School stated that if foreign attorneys are "acting under the supervision of U.S. lawyers, I wouldn't think it would make much difference where they are.").

In this same vein, the Professional Responsibility and Ethics Committee of the Los Angeles County Bar Association recently wrote, “[T]he attorney must review the brief or other work provided by [the non-lawyer] and independently verify that it is accurate, relevant, and complete, and the attorney must revise the brief, if necessary, before submitting it to the . . . court.” L.A. County Bar Assoc. Op. 518 (June 19, 2006) at 8-9. We agree.

The potential benefits resulting from a lawyer’s delegating work to a non-lawyer cannot be denied. But at the same time, to avoid aiding the unauthorized practice of law, the lawyer must at every step shoulder complete responsibility for the non-lawyer’s work. In short, the lawyer must, by applying professional skill and judgment, first set the appropriate scope for the non-lawyer’s work and then vet the non-lawyer’s work and ensure its quality.

**The Duties to Supervise and to Represent a Client  
Competently When Outsourcing Overseas**

The supervisory responsibilities of law firms and lawyers in this context are set forth, respectively, in DR 1-104(C) and (D).<sup>7</sup> DR 1-104(C) articulates the supervisory responsibility of a law firm for the work of partners, associates, and non-lawyers who work at the firm:

C. A law firm shall adequately supervise, as appropriate, the work of partners, associates and non-lawyers who work at the firm. The degree of supervision required is that which is reasonable under the circumstances, taking into account factors such as the experience of the person whose work is being supervised, the amount of work involved in a particular matter, and the likelihood that ethical problems might arise in the course of working on the matter.

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7. DR 1-104(C) requires a law firm, *inter alia*, to supervise the work of non-lawyers who “work at the firm,” whereas DR 1-104(D) describes, *inter alia*, the supervisory responsibilities of a lawyer for the conduct of a non-lawyer “employed or retained by or associated with the lawyer.” Based on this difference in language, it can be argued that DR 1-104(C) should not apply in the case of an overseas non-lawyer because that person does not “work at the firm,” whereas DR 1-104(D) should apply because the overseas non-lawyer is “retained by” the New York lawyer. Nonetheless, the Committee believes that these two phrases were intended to be equivalent. To conclude otherwise and make the individual lawyer, but not the law firm, responsible for supervising the overseas non-lawyer would be difficult to justify and could also easily lead to untoward results. For example, a law firm seeking to cabin responsibility under DR 1-104(D)(2) for the conduct of the overseas non-lawyer could simply refuse to appoint anyone to supervise the non-lawyer.

DR 1-104(D) articulates the supervisory responsibilities of a lawyer for a violation of the Disciplinary Rules by another lawyer and for the conduct of a non-lawyer “employed or retained by or associated with the lawyer”:

D. A lawyer shall be responsible for a violation of the Disciplinary Rules by another lawyer or for conduct of a non-lawyer employed or retained by or associated with the lawyer that would be a violation of the Disciplinary Rules if engaged in by a lawyer if:

1. The lawyer orders, or directs the specific conduct, or with knowledge of the specific conduct, ratifies it; or
2. The lawyer is a partner in the law firm in which the other lawyer practices or the non-lawyer is employed, or has supervisory authority over the other lawyer or the non-lawyer, and knows of such conduct, or in the exercise of reasonable management or supervisory authority should have known of the conduct so that reasonable remedial action could be or could have been taken at a time when its consequences could be or could have been avoided or mitigated.

Proper supervision is also critical to ensuring that the lawyer represents his or her client competently, as required by DR 6-101—obviously, the better the non-lawyer’s work, the better the lawyer’s work-product.

Given these considerations and given the hurdles imposed by the physical separation between the New York lawyer and the overseas non-lawyer, the New York lawyer must be both vigilant and creative in discharging the duty to supervise. Although each situation is different, among the salutary steps in discharging the duty to supervise that the New York lawyer should consider are to (a) obtain background information about any intermediary employing or engaging the non-lawyer, and obtain the professional résumé of the non-lawyer; (b) conduct reference checks; (c) interview the non-lawyer in advance, for example, by telephone or by voice-over-internet protocol or by web cast, to ascertain the particular non-lawyer’s suitability for the particular assignment; and (d) communicate with the non-lawyer during the assignment to ensure that the non-lawyer understands the assignment and that the non-lawyer is discharging the assignment according to the lawyer’s expectations.

**The Duty to Preserve the Client’s Confidences  
and Secrets When Outsourcing Overseas**

DR 4-101 imposes a duty on a lawyer to preserve the confidences and

secrets of clients. Under DR 4-101, a “confidence” is “information protected by the attorney-client privilege under applicable law,” and a “secret” is “other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.” DR 4-101(A). DR 4-101(D) requires that a lawyer “exercise reasonable care to prevent his or her employees, associates, and others whose services are utilized by the lawyer from disclosing or using confidences or secrets of a client.” *See also* EC 4-5 (“a lawyer should be diligent in his or her efforts to prevent the misuse of [information acquired in the course of the representation of a client] by employees and associates.”)

In N.Y. City Formal Opinion 1995-11, this Committee addressed a lawyer’s supervisory obligations regarding a non-lawyer’s maintaining client confidences and secrets. This Committee noted that “the transient nature of lay personnel is cause for heightened attention to the maintenance of confidentiality. . . . Lawyers should be attentive to these issues and should sensitize their non-lawyer staff to the pitfalls, developing mechanisms for prompt detection of . . . breach of confidentiality problems.”

We conclude that if the outsourcing assignment requires the lawyer to disclose client confidences or secrets to the overseas non-lawyer, then the lawyer should secure the client’s informed consent in advance. In this regard, the lawyer must be mindful that different laws and traditions regarding the confidentiality of client information obtain overseas. *See* N.Y. State Opinion 762 (2003) (a New York law firm must explain to a client represented by lawyers in foreign offices of the firm the extent to which confidentiality rules in those foreign jurisdictions provide less protection than in New York); *Cf.* N.Y. State Opinion 721 (1999) (“[i]f the lawyer would have to disclose confidences and secrets of the client [to the outside research service] in connection with commissioning research or briefs, the attorney should tell the . . . client what confidential client information the attorney will provide and obtain the client’s consent”).<sup>8</sup>

Measures that New York lawyers may take to help preserve client confidences and secrets when outsourcing overseas include restricting access to confidences and secrets, contractual provisions addressing confidenci-

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<sup>8</sup> We do not mean to suggest that confidentiality laws and traditions overseas always provide less protection than in New York. *See, e.g.,* M. McCary, *Bridging Ethical Borders: International Legal Ethics with an Islamic Perspective*, 35 *Tex. Int’l L.J.* 289, 313 (2000) (“Although difficult to imagine, a Muslim party or client may expect a higher degree of confidentiality than a [U.S.] lawyer is accustomed to.”).

ality and remedies in the event of breach, and periodic reminders regarding confidentiality.<sup>9</sup>

#### **The Duty to Check Conflicts When Outsourcing Overseas**

DR 5-105(E) requires a law firm to maintain contemporaneous records of prior engagements and to have a system for checking proposed engagements against current and prior engagements. N.Y. State Opinion 720 (1999) concluded that a law firm must add information to its conflicts-checking system about the prior engagements of lawyers who join the firm. In N.Y. State Opinion 774 (2004), that Committee subsequently concluded that this same obligation does not apply when non-lawyers join a firm, but noted that there are circumstances under which it is nonetheless advisable for a law firm to check conflicts when hiring a non-lawyer, such as when the non-lawyer may be expected to have learned confidences or secrets of a client's adversary.

As a threshold matter, the outsourcing New York lawyer should ask the intermediary, which employs or engages the overseas non-lawyer, about its conflict-checking procedures and about how it tracks work performed for other clients. The outsourcing New York lawyer should also ordinarily ask both the intermediary and the non-lawyer performing the legal support service whether either is performing, or has performed, services for any parties adverse to the lawyer's client. The outsourcing New York lawyer should pursue further inquiry as required, while also reminding both the intermediary and the non-lawyer, preferably in writing, of the need for them to safeguard the confidences and secrets of their other current and former clients.

#### **The Duty to Bill Appropriately for Outsourcing Overseas**

By definition, the non-lawyer performing legal support services overseas is not performing legal services. It is thus inappropriate for the New York lawyer to include the cost of outsourcing in his or her legal fees. *See* DR 3-102. Absent a specific agreement with the client to the contrary, the lawyer should charge the client no more than the direct cost associated with outsourcing, plus a reasonable allocation of overhead expenses directly associated with providing that service. ABA Formal Opinion 93-379 (1993).

#### **The Duty to Obtain Advance Client Consent to Outsourcing Overseas**

In the case of contract or temporary lawyers, this Committee has

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9. Mary Daly, *How to Protect Confidentiality When Outsourcing*, Small Firm Business, Sept. 12, 2005.

previously opined that “the law firm has an ethical obligation in all cases (i) to make full disclosure in advance to the client of the temporary lawyer’s participation in the law firm’s rendering of services to the client, and (ii) to obtain the client’s consent to that participation.” N.Y. City Formal Opinion 1989-2; *see also* N.Y. City Formal Opinion 1988-3 (“The temporary lawyer and the Firm have a duty to disclose the temporary nature of their relationship to the client,” citing DR 5-107(A)(1)); EC 2-22 (“Without the consent of the client, a lawyer should not associate in a particular matter another lawyer outside the lawyer’s firm); EC 4-2 (“[I]n the absence of consent of the client after full disclosure, a lawyer should not associate another lawyer in the handling of a matter . . .”). Similarly, many ethics opinions from other jurisdictions have concluded that clients should be informed in advance of the use of temporary attorneys in all situations.<sup>10</sup>

The Committee on Professional Ethics of the New York State Bar Association adopted a more nuanced approach in N.Y. State Opinion 715 (1999), explaining that the lawyer’s obligations to disclose the use of a contract lawyer and to obtain client consent depend upon whether client confidences and secrets will be disclosed to the contract lawyer, the degree of involvement that the contract lawyer has in the matter, and the significance of the work done by the contract lawyer. The Opinion further explained that “participation by a lawyer whose work is limited to legal research or tangential matters would not need to be disclosed,” but if a contract lawyer “makes strategic decisions or performs other work that the client would expect of the senior lawyers working on the client’s matters, . . . the firm should disclose the nature of the work performed by the Contract Lawyer and obtain client consent.” *Id.*

Non-lawyers often play more limited roles in matters than contract or temporary lawyers do. Thus, there is little purpose in requiring a lawyer to reflexively inform a client every time that the lawyer intends to outsource legal support services overseas to a non-lawyer. But the presence of one or

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10. *See, e.g., Oliver v. Board of Governors, Kentucky Bar Ass’n*, 779 S.W.2d 212, 216 (Ky. 1989) (recommending “disclosure to the client of the firm’s intention, whether at the commencement or during the course of representation, to use a temporary attorney service on the client’s case, in any capacity, in order to allow the client to make an intelligent decision whether or not to consent to such an arrangement.”); Ohio Bd. of Comm’rs on Grievances and Discipl. Opinion No. 90-23 (Dec. 14, 1990) (finding a duty under DR 5-107(A)(1) to “disclose to the client the temporary nature of the relationship in order to accept compensation for the legal services”); Los Angeles County Bar Assoc. Formal Opinion 473 (Jan. 1994); New Hampshire Bar Assoc. Ethics Comm. Formal Opinion 1989-90/9 (July 25, 1990).

more additional considerations may alter the analysis: for example, if (a) non-lawyers will play a significant role in the matter, e.g., several non-lawyers are being hired to do an important document review; (b) client confidences and secrets must be shared with the non-lawyer, in which case informed advance consent should be secured from the client; (c) the client expects that only personnel employed by the law firm will handle the matter; or (d) non-lawyers are to be billed to the client on a basis other than cost, in which case the client's informed advance consent is needed.

### **CONCLUSION**

A lawyer may ethically outsource legal support services overseas to a non-lawyer if the lawyer (a) rigorously supervises the non-lawyer, so as to avoid aiding the non-lawyer in the unauthorized practice of law and to ensure that the non-lawyer's work contributes to the lawyer's competent representation of the client; (b) preserves the client's confidences and secrets when outsourcing; (c) under the circumstances described in this Opinion, avoids conflicts of interest when outsourcing; (d) bills for outsourcing appropriately; and (e) under the circumstances described in this Opinion, obtains the client's informed advance consent to outsourcing.

*August 2006*



Formal Opinion 2007-1

# Applicability of DR 7-104 (the “No-Contact Rule”) To Contacts With In-House Counsel

*Committee on Professional and Judicial Ethics*

**TOPIC:** Contact with in-house counsel of a represented party.

**DIGEST:** DR 7-104(A)(1) prohibits a lawyer from communicating with a party that the lawyer knows to be represented in that matter by another lawyer. Nevertheless, DR 7-104(A)(1) does not prohibit a lawyer from communicating with an in-house counsel of a party known to be represented in that matter, so long as the lawyer seeking to make that communication has a reasonable, good-faith belief based on objective indicia that such an individual is serving as a lawyer for the entity.

**CODE:** DR 7-104.

**QUESTION**

Does DR 7-104(A)(1) prohibit communication with in-house counsel

of an organization known to be represented in the matter by outside counsel?

### **INTRODUCTION**

Many business entities and other organizations employ in-house counsel who perform legal (and sometimes other) services solely for the organization. In-house counsel may, without engaging outside counsel, represent the organization with respect to particular matters. An organization may also engage outside counsel to represent it in a matter. In those cases, the inside and outside counsel typically will together provide legal representation to the entity. The precise relationship and division of responsibilities between inside and outside counsel will vary widely from organization to organization and matter to matter. In other instances an in-house counsel may serve generally as a lawyer to the entity without having specific responsibility for the matter on which outside counsel has been retained. The question therefore arises whether, under DR 7-104(A)(1), counsel representing another party in a matter may communicate directly with the organization's in-house counsel, without the consent, knowledge, or participation of the organization's outside counsel. This question most often will arise as an ethical consideration for the lawyer who wishes to bypass opposing outside counsel and to initiate contact with in-house counsel. The question also will apply when an in-house counsel of an organization seeks to initiate contact with an adverse party's outside counsel, who would be obligated to determine whether he or she must decline to participate in the communication. It also will arise when, as is sometimes the case, in-house counsel for one party wishes to have a dialogue with in-house counsel for another party, even though both parties are also represented by outside counsel.

### **DISCUSSION**

DR 7-104(A)(1) states that "[d]uring the course of the representation of a client[,] a lawyer shall not . . . communicate . . . with a party the lawyer knows to be represented by a lawyer in that matter" without the other lawyer's prior consent. When an organization with an in-house counsel retains outside counsel for a particular matter, the question arises whether, for purposes of DR 7-104(A)(1), the inside counsel is "a party . . . represented by" the outside counsel with respect to that matter, or whether the in-house counsel, just like the outside counsel, is a "lawyer"

“represent[ing]” the organization for the purposes of the Rule. If the in-house counsel is a represented party (*i.e.*, a client of the outside lawyer), then DR 7-104(A)(1) would prohibit contact with the in-house counsel by an attorney representing another person in the matter whenever the attorney is aware that outside counsel has been retained. On the other hand, if in-house counsel is a lawyer representing a client, then such contact would not be prohibited, in the same way that, as an ethical matter, a lawyer in a given matter is free to contact any one of several co-counsel (*e.g.*, a local counsel or a lead counsel) representing an opposing party in that matter without the consent of the remaining co-counsel.

Neither the text of the Rule nor the relevant Ethical Consideration (EC-18) distinguishes between outside and inside counsel, and the Code in general views an in-house legal department as the equivalent of a traditional law firm. *See* 22 N.Y.C.R.R. § 1200.1 (definition of “law firm”). When only inside counsel represents an organization, obviously opposing counsel is free to communicate with that inside counsel even though he or she is forbidden from communicating with at least some of the other employees of the same organization.<sup>1</sup> Nothing in the text of the Rule or related Ethical Consideration suggests that the result should change simply because the organization chooses to retain outside counsel to represent it, when it is also represented by in-house counsel. To the contrary, the Rule distinguishes between two (presumably mutually exclusive) categories of persons—lawyers representing a client, on the one hand, and parties represented by a lawyer, on the other. If an in-house counsel represents his or her employer, nothing in the Rule suggests that contact with such a lawyer is barred.

The relatively few courts and other authorities that have addressed this question have not reached a uniform conclusion whether communication with an in-house counsel is proscribed, but the majority view is that such communication is generally permissible.<sup>2</sup> The District Court for the District of Connecticut opined on the issue in *In re Grievance Proceed-*

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1. Whether the Rule prohibits contact with all non-attorney employees of a represented entity, or only a core group of employees, is beyond the scope of this opinion. *Cf. Niesig v. Team I*, 558 N.E.2d 1030, 1035 (N.Y. Ct. App. 1990) (holding that direct communication by adversary counsel is prohibited “with those officials, but only those, who have the legal power to bind the corporation in the matter or who are responsible for implementing the advice of the corporation’s lawyer, or any member of the organization whose own interests are directly at stake in a representation”). (citation omitted)

2. Most of these pronouncements have been interpretations of the corresponding provision of ABA Model Rule 4.2, which is not materially different from DR 7-104(A)(1).

ing, 2002 WL 31106389 (D. Conn. July 19, 2002). In that case, the general counsel for the defendant corporation, in a litigation in which the defendant corporation was also represented by outside counsel, received two letters from plaintiff's counsel. *Id.* at \*1. The letters at issue were (1) a copy to the general counsel of a letter addressed to the defendant corporation's outside counsel regarding ongoing settlement negotiations, and (2) a letter addressed directly to the defendant corporation's general counsel notifying him of the outside counsel's failure to respond to plaintiff's counsel's inquiries. ("[I]t has been several weeks since I have been able to get in touch with your client's [outside] attorney. Please advise if the firm still represents your client.") *Id.* Noting that "[t]he rule's primary concern is to avoid overreaching caused by disparity in legal knowledge . . . [i.e.,] to protect lay parties" and that "communication with a general counsel generally will not raise the same concerns as communication with a lay employee" because "[t]he general counsel's training in the law helps ensure a level playing field of legal expertise in communications with opposing counsel," the court found that "the purpose of [the Rule] is simply not implicated, and [thus] the Rule . . . does not prohibit" such contact. *Id.* at \*2-3. See also ABA Formal Op. 06-443 (2006) ("[contact with] an inside lawyer, unless that lawyer is in fact a party in the matter and represented by the same counsel as the organization . . . is not prohibited"); Washington, D.C. Bar Ass'n, Ethics Op. 331 (2005) ("a lawyer generally is not proscribed . . . from contacting in-house counsel even though the entity is represented by outside counsel" because "the in-house counsel is not also the 'party' within the meaning of [the Rule]"); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 100 cmt. c (2000) (contact with an in-house counsel generally not barred); Carl A. Pierce, *Variations on a Basic Theme: Revisiting the ABA's Revision of Model Rule 4.2 (Part I)*, 70 Tenn. L. Rev. 121, 184-87 (2002) (same).

A few authorities have taken a more restrictive stance. For example, in Philadelphia Bar Ethics Op. 2000-11 (2001), the committee stated without elaboration that "ordinarily [the Rule] prohibits direct contact with in-house counsel"—although it found such contact permissible in that particular case because in-house counsel had actively represented the organization in a prior, related administrative proceeding. See also N.C. State Bar Ass'n, Ethics Op. RPC-128 (1993) (contact prohibited with in-house counsel who appeared in case as management representative).

New York courts have not ruled on this question. See *Tylena M. v. HeartShare Human Servs.*, 2004 WL 1252945, at \*1-2 (S.D.N.Y. June 7, 2004) (raising but declining to resolve the issue). One commentator has stated

that such communications are “ethically risky” under the New York Code of Professional Responsibility and that the question should be decided on a case-by-case basis, upon consideration of a number of highly fact-specific questions. ROY SIMON, *SIMON’S NEW YORK CODE OF PROFESSIONAL RESPONSIBILITY ANNOTATED* 1057-58 (2006 ed.).<sup>3</sup>

The Rule should be interpreted in accordance with its purposes. Although in-house counsel may well be among the category of decision-makers within the organization with whom contact would be prohibited under even a relatively narrow version of the rule, *see Niesig*, 558 N.E.2d at 1031 n.1, the fact that such counsel are trained in the law and often assigned to represent an organization places them in a different position than a non-lawyer employee—a distinction that *Niesig* did not need to, and did not, address. The principal purposes of the Rule are to prevent a lawyer from taking advantage of a non-lawyer who is represented by counsel (for example, in eliciting damaging admissions or agreement to unfair settlement terms) and to preserve the attorney-client relationship once it has been established. *See, e.g., Tylenea M.*, 2004 WL 1252945, at \*1; *In re Grievance Proceeding*, 2002 WL 31106389 at \*2-3. These purposes are at best attenuated when the recipient of the communication is a lawyer, and is acting as such. It fairly may be presumed that an in-house counsel, trained in the law, can exercise judgment as to whether he or she should engage in a given communication. Moreover, in most cases it should be a simple matter for in-house counsel to refuse to engage in such a communication and refer the caller to outside counsel. If the in-house counsel chooses to engage in the communication, the risk of making damaging admissions or entering into prejudicial agreements would seem to be no greater than with any other lawyer-to-lawyer communication.

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3. Professor Simon lists eleven “factors that may be relevant”: (1) size of the corporation whose in-house counsel is to be contacted; (2) size of its legal department; (3) degree of experience of the in-house counsel with the type of litigation involved; (4) degree to which the in-house lawyers are involved in the litigation; (5) assuming the desired contact is motivated by the behavior of the outside counsel, “[w]hat is stopping the . . . corporation from simply instructing its outside lawyers to change their behavior”; (6) who initiated the communication; (7) whether the corporation’s “control group” is aware of the communication or desires it to take place; (8) whether the outside counsel has acted unreasonably or unethically; (9) whether a judge or magistrate has encouraged the communication; (10) whether the communications are “intended to undermine the opposing corporation’s relationship with its outside lawyers,” or whether the communication is occurring “precisely because that relationship has already deteriorated”; and (11) whether the communication will allow the communicating party to “take advantage” of the opposing party or will result in an “unfair agreement.” SIMON, *supra*, at 1057-58.

The reasons why a lawyer may seek to bypass outside counsel and communicate directly with in-house counsel are many and varied; some may be salutary or at least innocuous (*e.g.*, to break an impasse in negotiations with outside counsel; to make a time-sensitive communication when outside counsel is incommunicado; to take advantage of a particularly good working relationship with in-house counsel from prior matters), while others may be less so (*e.g.*, to seek to marginalize outside counsel in order to diminish his or her effectiveness). It is possible that, in some cases, a lawyer in a matter may be attempting to drive a wedge between in-house and outside counsel by contacting in-house counsel directly. Yet, such a communication would not exploit the imbalance of power inherent in lawyer-layperson contact that is the concern of DR 7-104(A)(1). For example, when a party retains two or more outside counsel, it is permissible for a lawyer for another party in the matter to contact any of them without the others' permission. Even though this could indirectly undermine the attorney-client relationship as between the adverse party and the lawyers excluded from the communication, DR 7-104(A)(1) has no bearing on the issue.

As a general proposition, the applicability of the Rule should not turn on the subjective motivations of the communicating lawyer because of the difficulty in assessing actual motivations after the fact and the possibility of mixed or unprovable motives. Nor should the permissibility of contact depend on data likely to be unknowable to the attorney seeking to make the contact. *Cf.* Simon, *supra* note 3. Such a fact-specific, subjective test would reduce the predictive value of the Rules and chill the prudent practitioner from making even those contacts with in-house counsel that are not prohibited by the Rules—effectively turning DR 7-104(A)(1) into a blanket “no-contact” rule for any reasonably cautious lawyer who wishes to communicate with in-house counsel.

A number of authorities have recognized that in-house counsel often play multiple roles in an organization, including purely business roles. *See, e.g., U.S. Postal Serv. v. Phelps Dodge Ref. Corp.*, 852 F. Supp. 156, 160 (E.D.N.Y. 1994) (“[I]n house counsel . . . frequently have multi-faceted duties that go beyond traditional tasks performed by lawyers. House counsel have increased participation in the day-to-day operations of large corporations.”)<sup>4</sup> For that reason, it would be inappropriate to conclusively pre-

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4. Many of those authorities arise in the context of a challenge to the privileged status of a communication between an in-house counsel and another employee of the organization on the ground that the in-house counsel was communicating in a business, not a legal, capacity. Because the application of the attorney-client privilege turns on considerations significantly

sume that every in-house counsel is acting as a lawyer for the organization at all times and for all purposes. It is essential that the in-house counsel be acting as a lawyer for the entity, though not necessarily with respect to the subject matter of the communication at issue, for the communication to be proper. For contact with an organization's in-house counsel to be proper under DR 7-104(A)(1) in a situation where the organization is also represented by outside counsel, the contacting lawyer must have a good faith belief based on objective evidence that the in-house counsel is acting as a lawyer representing the organization, and not merely as outside counsel's client.

Objective indicia that in-house counsel is acting as "lawyer" for the purposes of DR 7-104(A)(1) will vary from case to case, but may include:

(1) *Job title.* Certain titles (*e.g.*, "General Counsel," whether alone or conjoined with an officer title such as "Senior Vice President and General Counsel") presumptively signify that the person acts as lawyer for the organization, unless there is notice to the contrary.<sup>5</sup> By contrast, other titles, such as "Director of Legal and Corporate Affairs" or "Director of Compliance" are ambiguous as to the role performed by the titleholder in a particular matter, and would not, standing alone, give rise to the same presumption.

(2) *Court papers.* If the matter in question is a litigation, papers filed in the case may list the in-house counsel as "Of Counsel." Such a reference would reasonably entitle another lawyer in the case to assume that the listed person is acting as a lawyer.

(3) *Course of conduct.* In both litigation and transactional matters, the course of conduct between the in-house counsel and the lawyer who wishes to contact him or her may give rise to the reasonable presumption that in-house counsel is acting as lawyer. Course of conduct may also include prior, related, or similar proceedings; if in-house counsel actively represented the organization in such a proceeding, one could fairly presume

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different from those implicated in the present ethics question, nothing in this opinion should be read as taking a position on the privileged status of a communication with an in-house counsel.

5. See *In re Grievance Proceeding*, 2002 WL 31106389, at \*3 ("the general counsel by definition is a corporation lawyer and, absent notice that the general counsel is acting in a role other than as a lawyer with respect to a particular matter, opposing counsel can communicate with him or her").

that he or she is fulfilling the same role in the current proceeding as well.<sup>6</sup>

(4) *Membership in an in-house legal department.* Corporations often maintain a legal department whose attorneys serve the needs of the business from a centralized location. In those instances, the similarity of the in-house lawyer's role to that of a member of an outside law firm is most pronounced, and ordinarily would indicate that the members of the department are serving the entity as lawyers.

(5) *Inquiry.* A lawyer who wishes to communicate with in-house counsel of another party can ask the in-house counsel if he or she is acting as attorney for the organization. In-house counsel should exercise candor in clarifying their role to opposing counsel<sup>7</sup> and a lawyer who makes such inquiry can ordinarily rely on the response.

Objective indicia may also establish that in-house counsel is *not* acting as lawyer for the purposes of DR 7-104(A)(1), and is instead merely an employee of a "represented party." For example, if the in-house lawyer was a participant in the events that form the basis of the action (such as drafter or negotiator of a contract now in dispute), one would not generally expect that in-house lawyer to be acting as counsel in the same matter because of, among other considerations, ethical constraints on attorneys serving as witnesses in matters where they represent a party. See DR 5-102.

*February 2007*

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6. See Philadelphia Bar Ass'n, Ethics Op. 2000-11.

7. See DR 1-102(A)(4) ("a lawyer . . . shall not . . . engage in conduct involving . . . misrepresentation.").



Formal Opinion 2007-2

# Secondment of Law Firm Attorneys

*Committee on Professional and Judicial Ethics*

**TOPICS:** Secondment of law firm attorneys; association with a law firm.

**DIGEST:** A law firm may second a lawyer to a host organization without subjecting the law firm to the imputation of conflicts under DR 5-105(D) if, during the secondment, the lawyer does not remain “associated” with the firm. The seconded lawyer will not remain associated with the firm if any ongoing relationship between them is narrowly limited, and if the lawyer is securely and effectively screened from the confidences and secrets of the firm’s clients. Both during the secondment and afterward, the seconded lawyer and his or her employer should be mindful of the lawyer’s former-client conflicts under DR 5-108.

**CODE:** DR 4-101; DR 5-104; DR 5-105; DR 5-108.

**QUESTION**

Under what circumstances may a law firm “second” a lawyer to a host organization without subjecting the law firm to the imputation of conflicts under DR 5-105(D)?

## DISCUSSION

Originally a British military term meaning “[t]o remove (an officer) temporarily from his regiment or corps, for employment on the staff, or in some other extra-regimental appointment,”<sup>1</sup> in legal circles, secondment has come to describe the practice under which a lawyer from a law firm temporarily acts as inside counsel for a host organization, such as a client, a governmental agency, or a charity.<sup>2</sup> Secondments provide mutual benefit: the law firm benefits because the secondment strengthens the firm’s relationship with the host organization, the host organization benefits because the seconded lawyer provides needed assistance, and the seconded lawyer benefits because he or she gains an insider’s perspective into the business of the host and similar organizations.

A secondment may take many forms, depending, for example, on whether (a) the seconded lawyer has access to the confidences and secrets of the firm’s clients or of the host organization; (b) the host organization or the firm compensates the seconded lawyer; (c) the firm is compensated for making the secondment; and (d) the secondment is a partial one, in which the seconded lawyer devotes only a portion of the lawyer’s time to the host organization. The many forms that a secondment may take naturally have different ethical implications, to which we now turn.

### **I. Ethical Issues Arising from a Seconded Lawyer’s Continuing Association with the Law Firm**

Under DR 5-105(D), lawyers associated in a law firm cannot knowingly accept or continue employment when any one of them would be prohibited from doing so because of a conflict of interest:

While lawyers are associated in a law firm, none of them shall knowingly accept or continue employment when any one of them practicing alone would be prohibited from doing so under DR 5-101(A), DR 5-105(A) or (B), DR 5-108(A) or (B) or DR 9-101(B) except as otherwise provided therein.<sup>3</sup>

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1. *Oxford English Dictionary Online* (2006).

2. The term “host organization” refers to the entity to which the secondment is made.

3. Model Rule 1.10(a) of the Model Rules of Professional Conduct is substantially the same:

While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless the prohibition is based on a personal interest of the prohibited lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm.

We discuss below the meaning of being “associated” with a law firm. As a threshold matter, under DR 5-105, when the seconded lawyer remains associated with the firm, conflicts may abound. For example, DR 5-105(A)-(B) prohibit the seconded lawyer who remains associated with the law firm from representing the host organization in litigated and transactional matters against the interests of a current client of the law firm, and DR 5-108 prohibits that seconded lawyer from acting adversely to the interests of a former client of the law firm in substantially related matters.

Another significant source of potential conflicts in this context arises from the possibility that the seconded lawyer may learn confidential information from the host organization that is imputed to the law firm under DR 5-105(D) and that is material to one of the firm’s other clients. For example, the seconded lawyer may learn that the host organization has been approached on a confidential basis to extend critical working-capital financing to Corporation Y. At the same time, the firm may represent Client Z that intends to launch a hostile bid for Corporation Y. Through its continuing association with the seconded attorney, the law firm would be considered to possess information that “is so material to the second representation,” *i.e.*, of Client Z, that the law firm would be representing “differing interests,” so as to create a conflict under DR 5-105, “in the sense that the representation of one client cannot be accomplished without violating the rights of another.” *See* ABCNY Formal Op. 2005-2. Similarly, “continued employment [could] mean violating . . . the requirement of DR 4-101(B)(3) that a lawyer may not use a confidence or secret for the advantage of another client.” *Id.* Accordingly, because obtaining the informed consent of both Client Z and the host organization would require each to make disclosures to the other that neither is likely to agree to make, the law firm and the seconded attorney would be precluded from continuing to represent either one.

Moreover, when the seconded lawyer is associated with both the law firm and the host organization, the conflicts of the law firm become the conflicts of the host organization, and vice versa.<sup>4</sup> *See* N.Y. State 793 (2006) (when a lawyer is “of counsel” to two law firms, the lawyer is ordinarily associated with both, and thus the conflicts of the one firm are imputed to the other). Thus, DR 5-105 would prohibit, for example, all the attorneys in the host organization’s law department from acting adversely to any client of the firm.

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4. Under the Code, a law firm is defined to include the legal department of a corporation. *Code, Definitions.*

This analysis leads to the conclusion that a secondment should be structured so that the seconded lawyer is not associated with the law firm during the secondment. The key to achieving this lies in the meaning of being associated with a law firm.

## II. Being “Associated” with a Law Firm

The test for determining whether a lawyer is associated with a law firm has been addressed in two ethics opinions, ABA Op. 88-356 (1988) and N.Y. State 715 (1999), and in a recent opinion by the United States Court of Appeals for the Second Circuit, *Hempstead Video, Inc. v. Village of Valley Stream*, 409 F.3d 127 (2d Cir. 2005). As noted in N.Y. State 715 (1999), “[t]he Code does not define the term associated.” The two ethics opinions, both of which addressed whether a temporary lawyer is associated with a law firm, concluded that “[t]he question whether a temporary lawyer is associated with a firm at any time must be determined by a functional analysis of the facts and circumstances involved in the relationship between the temporary lawyer and the firm consistent with the purposes for the Rule.” ABA Op. 88-356 (1988); *see also* N.Y. State 715 (1999) (association “depends upon the nature of the relationship”).

In *Hempstead Video, Inc.*, the Court of Appeals for the Second Circuit addressed whether the conflicts of an attorney acting “of counsel” to a law firm should be imputed to the firm. The Court of Appeals rejected any *per se* rule, and instead held that the “substance of the relationship” and the “procedures in place” should be examined in determining whether an association exists:

[T]he better approach for deciding whether to impute an “of counsel” attorney’s conflict to his firm for purposes of ordering disqualification in a suit in federal court is to examine the substance of the relationship under review and the procedures in place. The closer and broader the affiliation of an “of counsel” attorney with the firm, and the greater the likelihood that operating procedures adopted may permit one to become privy, whether intentionally or unintentionally, to the pertinent client confidences of the other, the more appropriate will be a rebuttable imputation of the conflict of one to the other. Conversely, the more narrowly limited the relationship between the “of counsel” attorney and the firm, and the more secure and effective the isolation of nonshared matters, the less appropriate imputation will be.

409 F.3d at 135. The Court of Appeals concluded on the facts presented

that conflicts should not be imputed to the law firm because the relationship between the lawyer and the law firm was “narrowly limited,” “attenuated,” and “remote.” *Id.* at 136.

Under these authorities, the touchstones for determining association are the nature of the lawyer’s relationship with the law firm and whether the lawyer has access to the confidences and secrets of the law firm’s clients. *Hempstead Video, Inc.*, 409 F. 3d at 135-36. *See also* N.Y. State 715 (1999) (when an attorney “has general access to the files of all clients of the firm and regularly participates in discussions of their affairs, then he or she should be deemed ‘associated’ with the firm”). Relatedly, whether an attorney “should be deemed to have access to the confidences and secrets of [the] clients of [a] firm depends upon the circumstances, including whether the firm has a system for restricting access to client files and for restricting informal discussions of client matters.” *Id.* “The more narrowly limited the relationship between the . . . attorney and the firm, and the more secure and effective the isolation of nonshared matters, the less appropriate imputation will be.” *Hempstead Video*, 409 F. 3d at 135. The firm may use formal means, including ethical screens, to deny access to those confidences and secrets. *Id.* at 134 (“Whether an attorney is associated with a firm for purposes of conflict imputation depends in part on the existence and extent of screening between the attorney and the firm”);<sup>5</sup> N.Y. State 715 (1999) (“if the firm has adopted procedures to ensure that the . . . Lawyer is privy only to information about clients he or she actually serves, then, in most cases, the . . . Lawyer should not be deemed to be ‘associated’ with the firm for purposes of vicarious disqualification”) (citing ABA Op. 88-356 for the proposition that an employing firm should “screen each temporary lawyer from all information relating to clients for which the temporary lawyer does no work”).

We therefore conclude that when (i) any ongoing relationship between the seconded lawyer and the law firm is narrowly limited, including that the seconded lawyer works solely under the direction of the host organization, and (ii) the seconded lawyer is securely and effectively screened from the confidences and secrets of the law firm’s clients, the seconded lawyer should not be considered associated with the law firm, and conflicts should not be imputed to the law firm. Our conclusion is not altered by the mere fact, for example, that the seconded lawyer (a) is expected to return to the firm at the end of the secondment, (b) retains the

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5. See ABCNY 2006-2 for a discussion of the factors that courts analyze in determining whether a screen is effective.

lawyer's "class rank" at the firm, (c) retains the lawyer's benefits under the firm's pension plan, or (d) can send and receive e-mails through the firm's e-mail servers (but without access to confidences and secrets of the firm's clients).

On the other hand, when the seconded lawyer spends some of the lawyer's time at the host organization and the balance at the law firm, working for other clients of the firm (a "partial secondment"), the seconded lawyer remains associated with the firm. *See* ABCNY Formal Op. 1996-8, ABA Op. 90-357 (1990).

### **III. The Law Firm's Continuing Supervision of the Seconded Lawyer**

We now consider whether the seconded lawyer remains associated with the law firm if the law firm continues to supervise the seconded lawyer in connection with the seconded lawyer's representation of the host organization.

In approaching this question, we are mindful of the recent admonitions of the Court of Appeals for the Second Circuit in *Hempstead Video, Inc.*, in which the Court rejected any *per se* rule in determining the analogous question whether an "of counsel" attorney was associated with a law firm, and held:

A *per se* rule has the virtue of clarity, but in achieving clarity, it ignores the caution that "[w]hen dealing with ethical principles, . . . we cannot paint with broad strokes. The lines are fine and must be so marked." *Silver Chrysler [Plymouth, Inc. v. Chrysler Motors Corp.]*, 518 F.2d 751, 753 n. 3 (1975) (quoting *United States v. Standard Oil Co.*, 136 F.Supp. 345, 367 (S.D.N.Y.1955)).

409 F.3d at 135. The Court of Appeals underscored that:

Imputation is not always necessary to preserve high standards of professional conduct. Furthermore, imputation might well interfere with a party's entitlement to choose counsel and create opportunities for abusive disqualification motions.

*Id.* at 135-36.

We consider first the circumstance when the host organization requests the law firm to continue to supervise the seconded lawyer in concluding a representation of the host organization that the seconded lawyer began while at the law firm. In this limited, transitional circumstance, we do not believe either that any additional conflicts would be imputed

to the law firm, or that the seconded lawyer would remain associated with the firm. First, the law firm has been representing the host organization all along in the matter, so the law firm continuing to work on the matter does not by itself create any additional conflict. Second, there is little difference between the law firm continuing to supervise the seconded lawyer in this circumstance, and the host organization engaging the law firm to complete that representation and to work with the seconded lawyer as a representative of the host organization. To conclude either that additional conflicts would be imputed or that the seconded lawyer would remain associated with the law firm would elevate form over substance and create an unjustifiable rift between the host organization on the one hand and the seconded lawyer and the law firm on the other, undermining the host organization's right to the counsel of its choice. *Levine v. Levine*, 56 N.Y.2d 42, 451 N.Y.S.2d (1982) (recognizing, in the context of law-firm conflicts, that the right to counsel is a fundamental right).

But these considerations are entitled to less weight if the law firm supervises the seconded lawyer in connection with one or more new representations of the host organization. Moreover, even one significant new representation in which the law firm supervises the seconded lawyer could result in the sort of close and regular relationship between the seconded lawyer and the law firm that would likely result in conflicts being imputed and the lawyer being considered associated with the firm. *Hempstead Video, Inc.*, *supra*.

Finally, if the law firm supervises the seconded lawyer in connection with the seconded lawyer's representing other clients of the law firm, this would be a partial secondment, and, as discussed above, conflicts would be imputed to the law firm.

**IV. The Effect of Different Compensation Arrangements  
on the Determination of Association and the Imputation of Conflicts**

We next consider whether, if the firm continues to pay the seconded lawyer during the secondment, or if the host organization pays the firm for the secondment, the seconded lawyer remains associated with the firm, or conflicts are otherwise imputed to the firm. If the law firm pays the seconded lawyer during the secondment, this alone does not result in the imputation of conflicts to the firm, or make the lawyer associated with the firm, so long as the seconded lawyer's professional judgment is not directed by the firm and the lawyer lacks access to the confidences and secrets of the firm's clients. *Cf.* DR 5-107(B) (with the consent of the client, a lawyer may accept compensation for legal services from one other

than the client, but shall not permit a person who pays the lawyer “to direct or regulate his or her professional judgment in rendering such legal services, or to cause the lawyer to compromise the lawyer’s duty to maintain the confidences and secrets of the client . . .”). It is advisable in this situation to record in writing that the firm will not be directing the professional judgment of the seconded lawyer.<sup>6</sup>

For the same reasons, this analysis is not altered if the host organization pays the firm for the secondment.<sup>7</sup> We hasten to point out that when the host organization pays the firm for the secondment, the firm must satisfy the requirements of DR 5-104, which provides in part that when a lawyer seeks to do business with a client, and if the client expects the lawyer to exercise professional judgment in order to protect the client in the transaction, the transaction must be fairly described “in writing to the client in a manner that can be reasonably understood by the client.” In addition, the lawyer must recommend that the client consult with independent counsel in connection with the arrangement, and the client must consent in writing. In all these cases, a written contract clearly explaining the terms of the secondment is essential.

#### **V. Avoiding Conflicts with Former Clients**

Even assuming that the secondment is structured so that the seconded lawyer is not associated with the firm, the seconded lawyer must, of course, still conform to DR 5-108. Thus, while at the host organization, the seconded lawyer is prohibited from undertaking a representation in a matter that is substantially related to a matter that the lawyer worked on at the firm, if the new representation would be adverse to the interests of the former client at the firm. It also bears reminding that if the seconded lawyer is associated with the legal department of the host organization, no lawyer in that legal department may act adversely to the interests of the seconded lawyer’s former clients on substantially related matters, without the former clients’ consent.<sup>8</sup> See DR 5-105(D). Of course, the seconded

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6. Best practices also dictate that the law firm’s procedures to screen the seconded lawyer be in writing. See ABCNY 2006-2.

7. In effect, the firm would be acting as a placement agency for the seconded lawyer, as if the seconded lawyer were a contract lawyer. See ABA Op. 88-356 (1988). There is no reason why the firm, like a placement agency, cannot temporarily place its lawyers with host organizations and charge for that service. The fee is justified because the firm not only loses its ability to bill the lawyer’s time during the secondment, but the firm may also be paying the lawyer during the secondment.

8. See ABCNY 2003-03 for a discussion of avoiding conflicts with former clients of “laterals,”



lawyer may continue to work on matters in which the lawyer previously represented the host organization while associated with the firm.

If the lawyer returns to the firm when the secondment ends, the firm may be conflicted if the firm seeks to represent, or currently represents, a client whose interests are materially adverse to the host organization. Most often, the host organization is already a client of the firm. Therefore, it would be unlikely that the firm would act adversely to the host organization, except with its consent, or if the firm has ceased to represent the host organization. But conflicts may arise even when the host organization is a current client because of the returning lawyer's access to confidential information while seconded. In the example discussed above, the seconded lawyer learned that the host organization had been approached to extend critical financing to an acquisition target of Client Z. Even if the seconded lawyer was not associated with the firm during the secondment, when the seconded lawyer returns to the firm, if that information is still material to Client Z, the provisions of DR 5-105(D) will nonetheless apply, and the firm may then be disqualified from representing Client Z unless informed consent can be obtained.

Furthermore, if the host organization is a former client of the law firm when the seconded lawyer returns, the law firm may be precluded from accepting an engagement in which the firm would be adverse to the host organization if that representation is substantially related to the formerly seconded lawyer's representation of the host organization.<sup>9</sup>

## CONCLUSION

A lawyer may be seconded to a host organization without thereby subjecting the law firm to the imputation of conflicts under DR 5-105(D) if, during the secondment, the lawyer does not remain associated with the firm. The seconded lawyer will no longer be associated with the firm if any ongoing relationship between the two is narrowly limited and if the lawyer is securely and effectively screened so that the lawyer does not have access to the confidences and secrets of the firm's clients. If the seconded lawyer splits the lawyer's time between the host organization and the firm, the lawyer will be associated with both the firm and the host

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such as the seconded lawyer. The host organization should establish appropriate safeguards, such as a conflicts database, to ensure that conflicts with the seconded lawyer's former clients are avoided.

9. It is thus advisable for the seconded lawyer to keep a record of the matters on which he or she worked while seconded, to the extent feasible.

organization, and the conflicts of one will be imputed to the other. If the law firm supervises the seconded lawyer in concluding a representation for the host organization that the seconded lawyer began while at the firm, additional conflicts should not be imputed to the firm and the lawyer should not be considered associated with the firm, again if the lawyer is securely and effectively screened. Neither the firm paying the seconded lawyer nor the host organization paying the firm for the seconded lawyer's services affects the determination whether the lawyer is associated with the firm during the secondment. Both during the secondment and afterward, the seconded lawyer and his or her employer should be mindful of the lawyer's former-client conflicts under DR 5-108.

February 2007

## The Committee on Professional and Judicial Ethics

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# Report of the Task Force on the Lawyer's Role in Corporate Governance (Excerpts)

*What follows are excerpts from the Report of the Task Force on the Lawyer's Role in Corporate Governance, issued November 2006. The excerpts printed here include the Introduction, the Executive Summary, and Section VII, "The Role of Lawyers in Conducting Internal Investigations," and its accompanying appendix. Footnotes, page references and cross references in the text follow the full report, which can be found on the City Bar's website at <http://www.nycbar.org/CityBarReport.htm>. In addition, most of the other sections of the Report are scheduled to be published in the May 2007 issue of The Business Lawyer.*

## **INTRODUCTION**

In March 2005, Bettina B. Plevan, then President of the New York City Bar Association (the "Association"), appointed this Task Force with the following charge:

The Task Force will examine the role of counsel, both in-house and outside, with respect to counseling about corporate conduct. The Task Force will examine all aspects of the role of individual lawyers and law firms by examining recent failures to perform that role effectively as alleged by government agencies, Congress and the courts. The Task Force will also consider the interplay between ethical rules, privileges and the evolving enforcement climate. It will include within its focus an examination of decision-making within law firms, and the possible need for enhanced procedures to strengthen the oversight by law firms of the conduct of their attorneys.

The Task Force, with a diverse membership of 30,<sup>1</sup> has examined this

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1. The membership of the Task Force includes: four present or former general counsel to public companies; sixteen partners, counsel and associates of law firms (eleven litigators,

broad subject through interviews with many knowledgeable lawyers (government, in-house and law firm),<sup>2</sup> analysis of the publicly known facts concerning recent corporate scandals, review of relevant case law and ethical standards, and survey of the extensive relevant literature.<sup>3</sup> In addition, the Task Force conducted a CLE program at the Association on February 28, 2006, and conducted an open hearing at the Association on May 9, after posting its preliminary draft recommendations on the Association's website. After the May 9 hearing the Task Force received written comments from other Association committees, business and professional associations, and practitioners. The Task Force's full draft report was submitted for comment to relevant Association committees. This final report incorporates some, but not all, of the comments in the two letters received that took issue with points made in the draft.<sup>4</sup>

The Task Force's focus has been on public companies, not privately held firms.<sup>5</sup> Further, with the exception of internal investigations, the

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three of whom were formerly on the enforcement staff of the Securities and Exchange Commission ("SEC"), four transactional lawyers, and one expert in legal ethics); two plaintiffs class action attorneys; two professors of law specializing in corporate law and legal ethics, respectively; three government attorneys; one federal judge; one general counsel to a major auditing firm; and one non-attorney who has served on the audit committees of two public companies.

2. The interviewees included two former SEC Commissioners (Richard Breeden and Harvey Goldschmid) and present and former SEC Directors of Enforcement (Stephen Cutler and Linda Thomsen). Appendix A to the Full Report lists the individuals interviewed by the Task Force or its various subcommittees. These interviews were conducted with the understanding that no remarks would be attributed to specific speakers, in order to encourage free and open discussion. Individuals are cited in the report only with respect to statements already in the public record.

3. Appendix B to the Full Report is a Table of Authorities for this report. These authorities, to the extent not generally available, will be on file at the Association.

4. Not all members of the Task Force endorse each recommendation and every view expressed in this report, but the report taken as a whole reflects a consensus of the members of the Task Force.

We note that some prior reports issued by Association committees have taken positions that differ from certain of our recommendations, such as on whether a lawyer should have the right, as a matter of ethics, to report out a threatened client financial fraud. We believe such changes in position, following similar changes by the ABA implemented by 2003 amendments to its Model Rules, are warranted given the many recent significant corporate scandals, the resulting heightened focus on the lawyer's role in corporate governance, and the mandatory reporting up provisions of the SEC's lawyer conduct rules promulgated in 2003 under the Sarbanes-Oxley Act (see p. 22, below).

5. As used in this Report, the term "public company" means generally a corporation that has a class of stock sufficiently widely held as to require registration under Section 12 of the Securities Exchange Act of 1934 (the "1934 Act") or the filing of reports pursuant to Section 15(d) of that Act.

Task Force has examined only the role of lawyers as corporate advisors and transactional attorneys. This report does not deal with the quite different role of lawyers who represent public companies in adversary proceedings.<sup>6</sup>

The Task Force has addressed itself generally to the question of how lawyers, whether in-house or outside counsel, can be more effective in helping the public companies they advise avoid problematic conduct that, as Enron, WorldCom and other recent scandals have dramatically emphasized, can injure many thousands of investors and employees. Lawyers are often in a position to influence or facilitate the conduct of their corporate clients. Thus the question of what role lawyers can and should play to minimize wrongdoing by their public company clients is an important one.<sup>7</sup>

Often this subject, in the literature and public forums, gets reduced to the single question of whether a lawyer who learns of a client fraud (past, present or planned) should be obligated to “blow the whistle” to avert or mitigate the fraud. Under what circumstances, for example, should lawyers be permitted or required to “report up” wrongful conduct by management officers to the Board of Directors, or “report out” the conduct to regulators when the Board fails or refuses to act. Although we do address this whistle-blowing question below, the subject of the lawyers’ role in corporate governance is far broader.

The subject is also a complex one, involving three different sources of rules or guidelines that speak to a lawyer’s role in advising public companies. The first source flows from legal duty, defined by statutes, regulations and common law concepts, the breach of which can subject a lawyer to liability in civil, regulatory or criminal proceedings. This report, generally, does not speak to questions of liability,<sup>8</sup> except to review the

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6. The Task Force has not given specific attention to the possibly different roles played by lawyers representing auditing firms or underwriters, except in the due diligence context (see pp. 135-42, below). The Task Force also has not focused on the unique regulatory setting of management investment companies registered under the Investment Company Act of 1940, or the roles of lawyers advising these companies, their directors or independent directors. Finally, issues unique to the representation of foreign private issuers are beyond the scope of this report.

7. The extensive academic commentary on this subject has reached no apparent consensus. For example, compare John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301 (2004) (urging imposition of several client-monitoring responsibilities on lawyers), with Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing, Future Enrons?*, 48 Vill. L. Rev. 1097 (2003) (arguing against the utility of imposing such responsibilities on lawyers).

8. For an analysis of the possible theories of lawyer liability in connection with the Enron

state of the law, unsettled in several areas, as a matter of background (*see* Full Report at pp. 30-50).

Ethical rules are the second source, the breach of which can subject a lawyer to disciplinary charges and, possibly, liability claims based on departures from customary professional standards. These rules form the backdrop for recommendations in this report (*see* pp. 51-56) In addition, we advance some specific recommendations for New York in this area, namely that it embrace a series of 2003 amendments to the Model Rules of Professional Conduct ("Model Rules") of the American Bar Association ("ABA") that speak to the lawyer's responsibilities when confronted with violations of law affecting her client (*see* Full Report at pp. 72-96).

The third source consists of suggestions, neither ethically nor legally mandated, of "best practices," *i.e.*, recommendations to help lawyers steer their public company clients away from fraudulent or illegal behavior, or conduct that approaches perilously close to the line separating right from wrong. We advance best practice recommendations below for General Counsel and other in-house lawyers, for outside counsel and for law firms as institutions, and also for lawyers dealing with auditors and financial disclosure issues and, finally, for lawyers conducting internal investigations (*see* Full Report at pp. 96 *et seq.*).

## EXECUTIVE SUMMARY OF RECOMMENDATIONS

### **A lawyer's legal duties: confidential advisor to clients**

The subject of the lawyers' role in advising public companies has been an active subject of debate for many decades (*see* pp. 30-40, below). It has received heightened focus as a result of the spate of recent major corporate scandals, which have again raised the oft-asked question, "where were the lawyers?", *i.e.*, why were such scandals not averted by either inside or outside lawyers? The Task Force reviewed the available public record concerning nine recent scandals in an attempt to answer this question on an empirical basis.

Our conclusion, necessarily a tentative one absent definitive fact-finding, is that lawyers, either in-house or outside, appear to have been strategically positioned with respect to a significant number of these scandals. Though not necessarily culpable in any actual wrongdoing, a matter for determination by courts or other tribunals, lawyers often were sufficiently familiar with aspects of client conduct later alleged to have been fraudulent to have asked questions about that conduct. They appear to have

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affair, *see* Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 Bus. Law. 143 (2002).

done so in certain instances. Where questions were not asked or pressed, it is reasonable to believe that more assertive action might have avoided or mitigated wrongdoing in some of these situations (*see* Full Report at pp. 21-30).

This conclusion suggests that lawyers are potential “whistleblowers” or “gatekeepers” with respect to incipient or past client wrongdoing, thus posing the question of whether they should be duty-bound to play that role for the protection of the investing public. The Task Force does not recommend that lawyers be required to play such a role (*see* Full Report at pp. 57-64). To the contrary, we believe that to impose general whistleblowing or gatekeeping duties on lawyers, so contrary to their traditional role as confidential advisors to their clients, would be counterproductive. It probably would result in a chilling of client-lawyer communications, the exclusion of lawyers from some strategic meetings, and generally degrade the ability of lawyers to render well-informed advice to their corporate clients.<sup>9</sup> It might also lead to a defensive advising on the part of lawyers concerned about the possibility of their own liability.

The traditional limitation of the lawyer’s duties of loyalty to his or her client, and the correlative obligation to preserve client confidences, is in the public interest as facilitating the rendition of well-informed legal advice to public companies. By rendering well-informed legal advice, even in the face of client or employer pressures to the contrary, lawyers can play their most productive role in avoiding future corporate scandals. The forthright rendition of such advice is every lawyer’s duty. The professional courage necessary to press such advice, sometimes at the risk of losing a client or a job, is indispensable to a lawyer’s ability to play an effective role in corporate governance (*see* Full Report at pp. 95-96).

Thus we do not recommend a fundamental change in a lawyer’s responsibilities, such as by recognizing a general legal (or ethical) duty to the investing public.<sup>10</sup> However, because the lawyer’s public company client has clear legal duties to the investing public, including its shareholders, the effect of corporate action on the investing public must be a matter of active concern for the lawyer in advising the client (*see* pp. 65-66, below).

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9. We recognize that the SEC’s mandatory reporting up rules under SOX, and permissive reporting out rules, which we support, also may produce these impacts to some degree. *See* Full Report at n. 68 and pp. 70-72, 86-91, below.

10. Of course lawyers, in common with all other participants and advisers involved in the offering of securities by public companies, do have legal duties to the public to the extent prescribed by regulations and statutes, such as the SEC’s Rule 10b-5. For example, a lawyer cannot, any more than a corporate officer, make materially misleading representations to the public in connection with a client’s offering of securities.

Nor should a lawyer restrict his or her advice to narrow questions of legal compliance. Much conduct that may not violate the law nonetheless may harm the client, or appear to the lawyer to be unfair or unjust. The lawyer's role properly includes advice on such broader questions (*see* Full Report at pp. 67-70).

#### **Changes in the ethical rules**

Notwithstanding the central importance to the lawyer's role of preserving client confidences, limited exceptions to that duty have always existed that recognize other important values. The prevention and mitigation of corporate fraud, particularly in instances where a client has used a lawyer's services in the wrongdoing, is one such value.<sup>11</sup> In this context we recommend that New York's proposed Rules of Professional Conduct, currently under consideration by the House of Delegates of the New York State Bar Association ("NYSBA"), include a series of 2003 amendments to the ABA Model Rules of Professional Conduct ("Model Rules").<sup>12</sup> Specifically, we recommend that New York adopt the 2003 amendments to:

ABA Model Rule 1.13(b), requiring, presumptively, a lawyer for a corporate client who learns of an ongoing impending violation of law likely to cause substantial injury to the client to report the matter up through the corporate hierarchy, including to the Board of Directors if necessary;

ABA Model Rule 1.13(c), permitting a lawyer, if the Board insists upon or fails to address a clear violation of law, to make limited disclosures of client confidences (such as to regulatory bodies) to the extent necessary to prevent substantial injury to the corporate client;

ABA Model Rule 1.13(e), requiring a lawyer who believes he has been discharged for reporting up pursuant to Rule 1.13(b), or who withdraws for related reasons, to insure that the Board is informed of this fact;

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11. In this and in several other respects we follow and second the recommendations in the thoughtful report issued in 2003 by the ABA's Task Force on Corporate Responsibility ("ABA Task Force Report"), 59 *Bus. Law.* 145 (2003).

12. The proposed New York rules have been put before the NYSBA House of Delegates by the Committee on Standards of Attorney Conduct ("COSAC") in a two volume Report and Recommendations dated September 30, 2005 ("COSAC Report"). Contrary to the views of this Task Force, the COSAC Report does not recommend that New York adopt the "reporting out" features of the ABA 2003 amendments to Model Rules 1.13(c) and 1.6(b)(2) and (3).



ABA Model Rules 1.6(b)(2) and (3), permitting a lawyer to make limited disclosures of client confidences (such as to regulatory bodies) to prevent, or to rectify or mitigate, crimes or frauds in which the lawyer's services have been used (*see* Full Report at pp. 71-95).

### **Best practices**

Most of our recommendations consist of "best practices": suggestions concerning the preferred way for lawyers to act, within the framework of law and ethical rules but usually beyond the minimum obligations they impose, to enhance their role in corporate governance and better secure their clients' compliance with the law. Because of the wide variation in the size and other characteristics of America's over 9,400 active public companies,<sup>13</sup> and of the law firms and in-house legal staffs that advise them, very few of these recommendations should be seen as having universal applicability: one size generally does not fit all.

#### **i) the role of General Counsel**

The role of the General Counsel of a public company is central to an effective system of corporate governance. We offer a series of suggestions to strengthen and facilitate the General Counsel's role, involving as it does the difficult challenge of reconciling service as a member of a company's senior management with the task of securing management's compliance with the law and the company's articulated ethical standards (*see* Full Report at pp. 96-112).

To strengthen the General Counsel's ability to discharge her compliance responsibilities, the Board of Directors should review the tenure and terms of compensation of the General Counsel. Specifically, the Board should approve the hiring and compensation of the General Counsel, articulate its expectations as to General Counsel's role and approve any decision to discharge the General Counsel.

The General Counsel's role should be clearly defined by the Board to include alerting it and other appropriate decision-makers to potential significant law violations and potential damage to the company.

Structures, processes, and procedures should be put into place to em-

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13. Some 4,958 public companies, 52.6% of the 9,428 public companies, have a market capitalization of \$128.2 million or less, and are termed "microcap" companies by the SEC's Advisory Committee on Smaller Public Companies. Final Report, Apr. 23, 2006, at 5, 7 n.13. Another 2,444 public companies, termed "smallcap" by the Advisory Committee, have a market capitalization of between \$128.2 million to \$787.1 million. The remaining 2,026 larger companies, with a market cap of above \$787.1 million, constitute only 21.5% of all public companies, but embody 94% of total U.S. equity market capitalization (*Id.*).

phasize the importance of the General Counsel's function in promoting compliance with the law and ethical standards, and to ensure that the General Counsel has the resources and authority necessary to perform this role.

The General Counsel, to be effective, must be seen as a senior, influential, and respected officer of the corporation and member of the company's senior management, recognized as having strong qualities of independence, judgment and discretion. His or her reporting relationships, access to management and the Board, and compensation all need to be consistent with senior status in the company.

The General Counsel must have sufficient direct access to senior management and to the Board so that problems can be elevated and dealt with at the appropriate level. The General Counsel should report to one of the highest ranked company executives, typically the CEO. He or she should have ready access, as well, to any other executives or directors responsible for compliance, governance or ethics issues, and to any company ombudsman.

The General Counsel should have opportunities to meet with the independent (non-management) members of the Board separately from management, on a regular basis, as distinguished from only ad hoc meetings initiated by the General Counsel when a special need for consultation arises. The regularity of such meetings would facilitate the raising and discussion of important issues.

In most if not all companies, the General Counsel should regularly attend meetings of the full Board, the Audit Committee, and any legal compliance committee.

When internal lawyers are assigned to subsidiaries or discrete business units, and have their direct reporting relationship to a business manager, they should have at least a "dotted line" reporting relationship to the General Counsel, who should have a significant voice in their hiring, firing and compensation.

Processes and procedures should be put into place to ensure that internal lawyers of appropriate seniority are involved in decisions on matters involving disclosure or other legal risk. For example, a company should insure that internal lawyers are present at appropriate meetings or are members of relevant committees.

A company should clearly inform employees to whom within the internal legal department they can bring concerns. It should also establish employee hotlines, and ensure that lawyers are involved in resolving any legal issues presented through that medium.

Junior lawyers should have training specific to their position and have access to sufficiently senior and experienced internal lawyers—if necessary including the General Counsel—to obtain support and to discuss and elevate issues where required.

The compensation of internal lawyers should not be determined in a manner that undermines the independence of their legal advice, and deters them from raising and appropriately dealing with issues. Such a situation might be presented, for example, were the compensation of a lawyer to be determined solely by a business manager to whom she reported. The Board, as stated above, should review the compensation of the General Counsel, and the General Counsel should have a substantial role in reviewing the compensation of other internal lawyers.

The General Counsel should have ultimate authority with respect to the selection of the principal external lawyers retained by the company and should clearly define their roles. The General Counsel's expectations of outside counsel, including to "report up" any apparent wrongdoing by corporate agents, must be clearly understood by outside firms.

The General Counsel (or his/her designee) should consider meeting regularly, at least once a year if not more often, with any outside firm performing substantial ongoing work for the company.

**ii) the role of outside counsel**

The role of outside counsel has evolved in recent decades from a general counseling role to one more focused on specific transactions and on projects that require special expertise. This narrowing of the role of each outside counsel creates the risk that such counsel may render certain services without a full understanding of the context in which the services are requested or to be used.

Another change in the profession over this period has been its evolution toward a more competitive, bottom line orientation, with client relationships often in play and critical to the compensation of partners. This environment creates pressures on law firms and lawyers to acquiesce in questionable client conduct rather than place the client relationship at risk by pressing unwelcome advice. Consequently, it is important for the profession to adhere to professional standards that support the rendition of forthright advice and the rejection of clearly improper client conduct (*see* Full Report at pp. 112-18).

Outside counsel, through dialogue with the company's General Counsel or management, should endeavor to be aware of the context in which and the purpose for which her services are being requested and used. Counsel

cannot guarantee that her services will not be put to some improper purpose, but she can reduce this risk through appropriate inquiries when circumstances suggest some reason for concern.

When in the course of the representation outside counsel becomes seriously concerned about the legality of the company's actual or intended conduct, counsel should make reasonable inquiry of the company, regardless of whether the concern rises to the level of requiring a report under the SEC's lawyer conduct rules (17 C.F.R. § 205) promulgated under Section 307 of the Sarbanes-Oxley Act ("SOX"), Public Law 107-204, 15 U.S.C. § 7245, or comparable state ethical rules. If such inquiries and subsequent counseling do not allay the concern, counsel should seriously consider withdrawing from the representation.

In the rare situation when a company's Board of Directors declines to consider or take action in response to counsel's report of a threatened or ongoing clear and material violation of law by the company, counsel should seriously consider reporting such violation to the appropriate regulatory or governmental authorities (as permitted, under specified circumstances, by the SEC's lawyer conduct rules, ABA Model Rules 1.6(b) and 1.13(c) and the ethics rules of most states). The case for reporting out will be especially compelling if a substantial reason exists to doubt the independence of the company's directors.

When a company asks a law firm or lawyer to succeed other counsel in connection with corporate advice or a transaction, and the circumstances suggest that the predecessor firm's withdrawal or discharge may have involved an issue concerning the client's conduct, before accepting the engagement successor counsel should request that the company permit it to discuss with prior counsel the reasons for its withdrawal or discharge. A refusal by the company so to permit should usually disincline successor counsel from accepting the engagement.

### iii) the role of law firms

The responsibility of law firms as institutions has recently received increased attention in discussions of the ethical responsibilities of the profession.<sup>14</sup> The SEC's lawyer conduct "reporting up" rules appear to have stimulated a heightened focus by firms on their responsibilities to provide ethical guidance to their attorneys in the rendition of legal ser-

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14. See generally Elizabeth Chambliss & David E. Wilkins, *A New Framework for Law Firm Discipline*, 16 *Geo. J. Legal Ethics* 335 (2003); Symposium, *How Should We Regulate Large Law Firms? Is a Law Firm Disciplinary Rule the Answer?*, 16 *Geo J. Legal Ethics* 203, 210-12 (2002).

vices. We offer several suggestions for law firms in this area (*see* Full Report at pp. 121-27).

Every firm with significant public company representations should adopt written procedures for implementing the “up-the-ladder” obligations imposed by applicable ethical rules and the SEC’s lawyer conduct rules.

Firm procedures should include, among other things: mechanisms within the firm to report possible violations; clear assurance that lawyers—especially junior attorneys—will be protected against any retaliatory action by reason of reporting up a perceived problem; education and training sessions; and the establishment of designated senior lawyers or committees to facilitate compliance. (One example of such procedures is set forth in Appendix F to the Full Report).

Because a law firm’s culture has a significant impact on how ethics rules are interpreted and enforced within a firm, firms should also adopt for the guidance of their attorneys a statement of best practices in advising public companies. (One example of such a statement is set forth in Appendix G to the Full Report).

Firms are encouraged to designate a partner (or other senior lawyer), committee or outside counsel as an ethics adviser available to consult with all firm attorneys and otherwise to advance the firm’s promotion of high ethical standards.

The attorney-client privilege should be applied to protect consultations between lawyers and their law firm’s in-house ethics counsel (or specially retained outside counsel) on matters of professional conduct, including issues pertaining to clients. This protection will facilitate compliance with applicable rules and statutes, and enable the firm to enforce its ethical standards internally, thereby strengthening the lawyer’s role in corporate governance. We recommend that the courts review such privilege issues in light of this strong public interest.

#### **iv) the lawyer-auditor relationship and financial disclosures**

Almost all of the recent high-profile corporate scandals have involved financial frauds, typically focused on accounting manipulations. This lends urgency to the need to examine the role of lawyers with respect to client financial disclosures, including the manner in which lawyers and auditors work together, or fail to do so, as they render their respective services to a common client (*see* Full Report at pp. 127-35).

The distinctly different roles of auditors and lawyers, the former independent of the client and owing direct duties to the investing public, and the latter confidential advisors owing their sole duties to their cli-

ents, precludes any facile notion of collaboration between the two. Each relationship necessarily must be controlled by the client. The present climate surrounding the auditing of public companies, with the risk of litigation or regulatory action ever present, likely means, regrettably, a continuation of the traditional arm's-length relationship between auditors and lawyers.

Nonetheless, lawyers do have a role to play in connection with a client's financial disclosures. Because accounting concepts are so frequently central to disclosure issues and other matters on which companies require legal advice, a basic familiarity with the relevant accounting concepts is essential for a lawyer advising a public company on financial disclosure and financial structuring. Law firms (and companies) should provide adequate training programs for their attorneys in these areas.

Lawyers should be actively consulted on matters of financial disclosure, as many accounting issues have taken on legal overtones. Processes and procedures should be set up (for example, the now frequently utilized "disclosure committee" format) to insure that disclosure issues are properly vetted among all who have relevant input, including lawyers.

In designing internal controls and procedures, pursuant to Section 404 of SOX, companies should require that the relevant internal and/or external counsel be consulted in connection with preparation of the company's financial statements to insure that information possessed by counsel relevant to the accuracy of those statements is adequately communicated to the financial personnel responsible for their preparation.

The process a company develops to support the CEO and CFO certifications of financial statements mandated by SOX Section 302 also should include input from the company's lawyers as to matters on which they have been engaged that are material to the financial statements.

The 1975 ABA-AICPA "Treaty," providing guidance as to how lawyers should respond to auditors' inquiries concerning asserted and unasserted claims (loss contingencies), need not be modified in light of such recent developments as adoption of the SEC's lawyer conduct rules and the 2003 amendments to the ABA Model Rules. Those new rules, however, can impact lawyer conduct consistent with the Treaty, such as by requiring a report up if management resists the lawyer's advice that a clearly material unasserted claim be disclosed to its auditors and in its financial statements.

As recommended in the Treaty, outside counsel confirm in their responses to auditors' letters that their practice is to consult with clients when they learn of unasserted claims that may require financial statement disclosure. These consultations typically occur only with company management. This practice should be modified in one respect, consistent

with the spirit if not the literal requirements of the SEC's lawyer conduct rules: counsel should insure that the Audit Committee is also made aware of such unasserted claims, and of any advice, if rendered to management, that such claims should be disclosed.

Due diligence with respect to financial (and other) disclosures, including in public offerings of securities, is also an important concern that may not be receiving sufficient attention from issuers, underwriters, their respective lawyers and the SEC (*see* Full Report at pp. 135-42). Lawyers play an essential role in due diligence programs for both issuers and underwriters. Law firms should review the adequacy of their due diligence training programs and practices, including the need to assign qualified personnel to lead due diligence teams. Issuer's inside counsel and (where involved) outside counsel should advise the client's Board or Audit Committee and management on the extent of due diligence work done in connection with the client's public disclosure documents and its material corporate transactions. Oversight of issuer due diligence practices by Audit Committees and other independent directors is part of sound corporate governance.

The SEC's accelerated securities offering procedures, available since the early 1980s for many frequent (or "well seasoned") issuers, leave little time for traditional due diligence by underwriters. This creates a risk that whatever diligence is performed with respect to such issuers, even if sufficient to sustain the underwriters' due diligence defense to claims under § 11 of the Securities Act of 1933 (the "1933 Act"), may not adequately protect the issuers from absolute liability, or purchasers in the offering from harm, as a result of inaccurate or incomplete disclosure. The SEC has provided no meaningful guidance on this subject since adoption of its Rule 176, promulgated 24 years ago.

When the SEC authorized these accelerated procedures, it expected that many eligible issuers, in collaboration with their chosen underwriters and their lawyers, would adopt "continuous" due diligence programs. However, the number of companies today using such continuous due diligence programs appears not to be extensive, and opinions vary on their effectiveness.

Lawyers and their public company and underwriter clients should focus on the development of new techniques, better suited than traditional due diligence to the current realities of the marketplace, which could serve as a sound basis for SEC rulemaking in the future.

**v) the role of lawyers conducting internal investigations**

The frequency with which inside counsel and law firms are called on to conduct internal investigations for public companies, either at the

company's initiative or the initiative of the SEC, some other regulatory agency, or the company's auditors, has sharply increased in recent years. The ethical parameters of such investigative assignments have not yet been clearly delineated. However, the perceived failure of a number of such investigations has highlighted some important basic ground rules (*see* Section VII of Full Report, pp. 143-79, reprinted at pp. 181-209 below).

Before undertaking any investigation, outside counsel should consider, and discuss with the company, the following:

- Any prior or current relationships of counsel (or counsel's firm) with the company, or with any of its officers, directors, or principal employees, and whether those relationships, including any role of counsel or counsel's firm as the company's regular outside counsel, will undermine the fact or appearance of counsel's independence and thus adversely affect how the investigation will be viewed by regulators and others;
- To whom counsel should report in connection with the investigation, and whether the reporting relationship will undermine the fact or appearance of counsel's independence or otherwise affect the investigation;
- The scope of the investigation, including any limitations on the scope;
- To whom and the manner in which the results of the investigation will be disclosed.

While the scope of an investigation is a client decision, and can be limited by a number of valid considerations, counsel must be alert to any restriction motivated by factors contrary to law or the company's interest, such as an attempt to cover up apparent wrongdoing. Any such concerns need to be elevated within the company.

Counsel should be authorized to communicate to regulators the scope of the investigation, whether any limitations have been placed on the scope, and to whom counsel is reporting in the company.

Counsel should continually reassess whether the company has a reporting obligation to the regulators, or the markets, or others, and discuss with the company the pros and cons of voluntary self-reporting.

Counsel should exercise independent judgment in determining whether improper conduct has occurred and should be cognizant of pressures that might cause counsel to "under charge" (*i.e.*, be too lenient in judging corporate conduct) or "over charge" (*i.e.*, be too quick to find a violation).



In giving its advice, counsel should always consider the fiduciary duties of the company's officers and directors to safeguard the best interests of the company and should offer advice consistent with those interests, as opposed to any differing interests of individual officers and directors, or counsel's own interest in his or her reputation or career.

The extent of the General Counsel's involvement in internal investigations must depend upon the facts (including the existence of conflicts) and the capabilities of the relevant in-house department. The General Counsel and/or internal lawyers can and often should be involved in many internal investigations. However, the Board might well decide that certain investigations, such as those involving a material allegation concerning the CEO or other senior management, should be conducted by independent external counsel engaged by the Board, given the position of General Counsel and the inherent conflicts such an investigation would present. The advantages and disadvantages of involving the General Counsel in such investigations should be discussed with the Board.

The corporation should also take into account conflicts (or the appearance of conflicts) in determining whether an internal lawyer should be in charge of an investigation of a peer, or of another officer with whom counsel conducts significant business, or of a matter on which the internal lawyer rendered significant legal advice. Where an apparent conflict could compromise an investigation, the investigation should be handled by an outside counsel or another internal lawyer who would not be similarly conflicted.

#### **Other issues**

We have reviewed a number of other suggestions that have been made with respect to the lawyer's role in corporate governance, but for various reasons do not recommend them. In this category are proposals that lawyers should be required to certify the accuracy of their clients' SEC filings or other public disclosures, a concept that we think would not be cost-effective and would be inconsistent with the traditional and valued role of lawyers as counselors (*see* Full Report at pp. 118-19).

We also considered whether New York should enact a statute protecting lawyers (and others) from retaliatory discharge as a result of the reporting of client wrongdoing. This is an issue we recommend be further considered by this Association, including by reviewing of the experience of other states that do provide such protections (*see* Full Report at pp. 180-83).

Finally, we reflected on whether aiding and abetting liability in civil

litigation under the securities laws should be reestablished by Congress, reversing the impact of the Supreme Court's decision eliminating such liability in *Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A.*, 511 U.S. 164 (1994). We believe that consideration of such legislation at this time would be premature (*see pp. 180-183, below*). It is important, first, to assess the impact on lawyer conduct of the SEC's interpretation and enforcement of its lawyer conduct rules. In addition, the courts need to resolve the present uncertainty concerning the extent to which lawyers (and other "secondary actors") may be held as primary violators of the securities laws for conduct previously thought to constitute aiding and abetting (*see Full Report at pp. 42-45*).

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## **VII THE ROLE OF LAWYERS IN CONDUCTING INTERNAL INVESTIGATIONS\***

### **A. Background and Context**

#### **1. Introduction**

When conducting an internal investigation on behalf of a company, investigative and company counsel face many challenges, from determining the proper scope of the inquiry, to making findings of fact and recommending remedial action, to addressing the expectations and demands of regulators and prosecutors. Some commentators have suggested that good corporate governance dictates that counsel must follow all leads of possible unlawful conduct, address every instance of wrongdoing and cooperate fully with the authorities. Others take as their starting point the interests of the corporation's shareholders, as determined by their appointed representatives (the Board of Directors or a committee of the Board), and use as their guiding principle the obligation to maintain shareholder value.

Often these two approaches will not be in conflict. An independent, comprehensive investigation, coupled with full cooperation with government authorities, will be consistent with, and indeed mandated by, the need to preserve shareholder value. There are other circumstances, however, where a company may properly determine that, on balance, an investigation that has no limitations will result in a waste of assets, or that

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\* The footnotes in this section are numbered as in the Full Report. This Section VII of the report was prepared by the Task Force's subcommittee on internal investigations: Daniel Kramer, Chair, and members Wayne Carlin, Eric Corngold, Charles Gerds, Barbara Gillers, Lewis Liman, Claudius Sokenu, Betty Whelchel and Frederic Yerman.

compliance with certain government demands will have such negative collateral consequences as not to be in the best interest of the corporation's shareholders.

We believe that the second approach is more consistent with the proper role of a lawyer to a client, and in the end is the best prescription for good corporate governance. The determination of the scope and timing of an investigation, the remedial actions taken, and the level of cooperation are choices for the client, advised by counsel, subject to the duties and constraints imposed by state or federal law. The responsibility for establishing the client's own standards of corporate governance resides with the corporation's directors and managers.

But the fact that the ultimate decision-making responsibility rests with the client does not provide an excuse for the lawyer to acquiesce passively in client decisions the lawyer believes are contrary to the client's interests. The lawyer has an obligation in an internal investigation, as in other areas of practice, to analyze and understand the facts with impartiality and to provide impartial, sometimes tough advice. A legal regime that preserves the ability of counsel to provide such advice is necessary to assist directors and managers in discharging their duties.

## **2. Internal investigations in today's enforcement environment**

In today's regulatory enforcement environment, internal investigations are a fact of life for corporations. The federal government and market regulators are aggressively investigating, prosecuting, and seeking severe penalties for wrongdoing. And because prosecutors and regulators now place unprecedented emphasis on and have, in fact, come to *expect* companies' full cooperation with investigations, companies tap lawyers with ever-increasing frequency to conduct internal inquiries. As then General Counsel of the SEC, Giovanni P. Prezioso, recently commented, "The strong incentives for cooperation, in both criminal and Commission investigations, appear to have greatly increased the number of independent investigations undertaken by companies presented with evidence of potential misconduct."<sup>176</sup> In order to effectively guide clients through government and internal investigations, lawyers must understand this enforcement landscape.

The proliferation of internal investigations has largely tracked the government's evolving enforcement strategies and priorities. Historically, the Department of Justice (the "DOJ" or "Justice Department") and the

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176. Giovanni P. Prezioso, Remarks Before the Vanderbilt Director's College (Sept. 23, 2004) ("Vanderbilt Remarks"), available at <http://www.sec.gov/news/speech/spch092304gpp.htm>.

SEC pursued a reactive approach to business-crime and regulatory actions.<sup>177</sup> When wrongdoing was exposed, law enforcement and regulators typically addressed it by conducting extensive inquiries and meting out appropriate sanctions. As such, lawyers and clients responded to government inquiries from a more defensive posture.

However, in recent years the government has become more proactive in its enforcement activities and has encouraged companies also to be proactive in reporting problems. Cooperation with government investigators has always been a way potentially to mitigate charges or penalties or avoid them altogether. But in 2001 and 2003, respectively, the SEC, in its "Seaboard Report,"<sup>178</sup> and the DOJ, in its "Thompson Memo,"<sup>179</sup> formally set forth their expectations in memos detailing the factors their staffs would take into account in charging companies. While the nature and seriousness of the underlying conduct and its pervasiveness within a corporation will always be the dominant consideration, cooperation with investigatory proceedings stands out as the next most important factor affecting the outcome. Both agencies underscore that working with the government, voluntary disclosure of wrongdoing, and internal investigations are strongly encouraged and will be substantially credited; but these efforts must be authentic and effective in getting the facts out. The government is more than willing to pursue perjury and obstruction-of-justice charges when it believes the evidence is sufficient to support them. Coupled with this cooperation bias is an increased emphasis on, and rewarding of, effective compliance and ethics programs, both as prophylactic and remedial measures.

To further these enforcement goals, the government has allocated enormous resources to prosecuting corporate wrongdoing and is actively pursuing harsh penalties against companies and individuals. In addition, parallel criminal and civil proceedings have become increasingly common,

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177. See, e.g., Stephen M. Cutler, Remarks Before the District of Columbia Bar Association (Feb. 11, 2004) ("*Remarks Before D.C. Bar*"), available at <http://www.sec.gov/news/speech/spch021104smc.htm>.

178. On October 23, 2001, using its authority under Section 21(a) of the 1934 Act, the SEC issued its *Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*. SEC Rel. No. 34-44969, 76 SEC Docket 220 (Oct. 23, 2001) ("*Seaboard Report*"). Section 21(a) of the 1934 Act authorizes the Commission to issue a report of investigative findings if it determines that an enforcement action is not warranted.

179. Memorandum from Larry Thompson, Deputy Att'y Gen., to Heads of Dep't Components & U.S. Atty's (Jan. 20, 2003) ("*Thompson Memo*"), available at [http://www.usdoj.gov/dag/cftf/business\\_organizations.pdf](http://www.usdoj.gov/dag/cftf/business_organizations.pdf).

with the Justice Department and the SEC coordinating investigations and prosecutions, and sharing information. The stakes and risks that companies face are extremely high.

Now, more than ever, cooperation is key. Although the 2001 SEC and 2003 Justice Department corporate charging statements remain their official policies, these agencies' expectations and aspirations have since shifted and been heightened further.<sup>180</sup> Stephen Cutler, the former Director of the SEC's Division of Enforcement, committed to, and the current Director Linda Thomsen has continued, a "forward looking-approach," which involves "seeing around the corner," "identifying trends, practices, and risks within our capital markets," and nipping problems in the bud.<sup>181</sup> Similarly, the Justice Department now pursues "real-time enforcement," a strategy that depends upon swift investigations and indictments, and "stresses rooting out corporate fraud and restoring public confidence in the integrity of our markets."<sup>182</sup> Long and comprehensive investigations and indictments have largely been replaced by "segmented" and prompt ones, often for less complex violations.

Today, full cooperation is essentially expected. Although the SEC and Justice Department statements may stress that self-policing and self-reporting are encouraged and will be credited, in practice a company may now be punished for failing to cooperate adequately with government investigations, judged from the perspective of the investigators. Indeed, Cutler has explained that cooperation is currently assessed using a "more graduated scale" and that the Commission takes into account both cooperation, and "lack thereof," in making charging decisions.<sup>183</sup> Similarly, federal prosecutors "now take a harder look at whether the company is really [fully] cooperating" in deciding whether to bring charges.<sup>184</sup> Moreover, the government often expects companies to waive the attorney-client privilege and work-product protection as part of a company's full cooperation.<sup>185</sup> Evidence of these enhanced overall expectations can also

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180. Cutler, *Remarks Before D.C. Bar*, n. 177 above.

181. *Id.*; Linda Thomsen, *SEC Enforcement Director Responds to Questions About Program's Direction*, SEC Today, at 1 (Nov. 16, 2005).

182. Christopher Wray, then Assistant Att'y Gen., Crim. Div., *Remarks to the ABA White Collar Crime Luncheon* (Feb. 25, 2005) ("*ABA Remarks*"), available at [http://www.usdoj.gov/criminal/press\\_room/speeches/2005\\_3853\\_rmrkCrimLuncheon030205.pdf](http://www.usdoj.gov/criminal/press_room/speeches/2005_3853_rmrkCrimLuncheon030205.pdf).

183. Cutler, *Remarks Before D.C. Bar*, n. 177 above.

184. Wray, *ABA Remarks*, n. 182 above.

185. See Marcia Coyle, *Waiving Privilege a Crucial Sentencing Issue*, Nat'l L.J., Aug. 29, 2005,

be found in the New York Stock Exchange's ("NYSE" or "Exchange") recent pronouncement that members will be charged if they do not comply with their twin affirmative duties to (1) cooperate with Exchange reviews and investigations, and (2) fully disclose violations of Exchange rules and the securities laws. NYSE Information Memo No. 05-77: *Factors Considered in Determining Sanctions* (Oct. 7, 2005).

Appendix H to this report (pp. 209-225, *infra*) reviews in detail the DOJ, SEC, and the NYSE corporate-prosecution policies, the recently revised U.S. Sentencing Guidelines for Organizations, as well as Section 10A of the 1934 Act, which imposes reporting obligations on outside auditors. The NASD and the Commodity Futures Trading Commission (CFTC) and others also have similar guidelines.<sup>186</sup> Together these complimentary and competing forces shape today's enforcement climate. But in conducting internal reviews, lawyers and clients should also appreciate that government expectations have clearly risen since their issuance.

In sum, today public companies and their lawyers face a demanding regulatory and enforcement environment. Government and market regulators are serious about rooting out corporate wrongdoing, and restoring and maintaining trust in our markets. In aggressively investigating, charging, and sanctioning misconduct, they have come to expect that companies will fully cooperate with them and self-report problems. Recent enforcement trends and government statements, in fact, indicate that companies will be punished if they impede governmental investigations or otherwise do not provide the level of cooperation expected by prosecutors and regulators. Similarly, corporations are both encouraged and rewarded for installing strong corporate governance and ethics programs that can help deter and identify violations. In this climate of compliance, internal investigations are more prevalent and important than ever.

### 3. The ethical and legal framework

The lawyer has an obligation, incident to his or her membership in the Bar, to provide unflinching legal advice, even in those circumstances where the client does not want to hear it. Under our system of justice, that function of the private bar is integral to ensuring compliance with the

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at 6 ("In practice, companies are finding that they have no choice but to waive these privileges whenever the government demands it.").

186. See, e.g., NASD, *Sanction Guidelines*, available at [http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw\\_011038.pdf](http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf); CFTC, *Enforcement Advisory: Cooperation Factors in Enforcement Division Sanction Recommendations*, available at <http://www.cftc.gov/files/enf/enfcooperation-advisory.pdf> ("CFTC Cooperation Factors").

law. If the lawyer fails in the satisfaction of that obligation, it is not only the client who suffers, but—in many cases—the investing public as well.

As set forth below, counsel conducting an investigation, and a company subject to an investigation, must seriously consider the degree to which it should cooperate with prosecutors and regulators. The wrong decision on this issue may, in certain circumstances and depending on the gravity of the underlying conduct, sound the death knell for the corporation. But, while this is an important question, we do not believe it is the proper starting point for the inquiry. Nor do we believe that this starting point is helpful either in resolving the practical problems that arise in investigations or, ultimately, in assisting corporations to abide by the best principles of corporate governance. By highlighting a number of the practical issues that arise in internal investigations other than cooperation, and by providing some of the considerations that counsel must consider in providing advice, we hope to enlist the Bar in providing advice to the client of not just what is strictly required by the law, but as to what actions are most conducive to an environment that fosters corporate compliance. That advice often will be that the client cooperate fully with governmental or regulatory investigations. Other times, however, it may not.

Counsel in conducting an internal investigation into allegations of illegal conduct must be guided by basic ethical duties, including: to represent the client competently and zealously within the bounds of the law;<sup>187</sup> to abide by client's decision-making authority,<sup>188</sup> after advising the client as to the relevant considerations;<sup>189</sup> and to represent the interests of

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187. NYCPR, Canon 7 ("The duty of a lawyer, both to the client and to the legal system, is to represent the client zealously within the bounds of the law . . ."); DR 7-101 ("A lawyer shall not intentionally fail to seek the lawful objectives of the client through reasonably available means permitted by law and the Disciplinary Rules . . ."); DR 7-102 (requiring zealous advocacy within the bounds of the law).

188. NYCPR EC 7-7 provides that the "authority to make decisions is exclusively that of the client and, if made within the framework of the law, such decisions are binding on the lawyer." See also p. 91, above (Model Rule 1.2(a)).

189. The lawyer should try to ensure that the client's decisions are made only after the client has been advised as to the potential ramifications of each legally permissible alternative course of action, including the possibility of harsh consequences that might result from the likely reactions of regulators.

EC 7-5 provides that a lawyer "furthers the interest of the client by giving a professional opinion as to what he or she believes would likely be the ultimate decision of the courts on the matter at hand and by informing the client of the practical effect of each decision." See also Canon 7. EC 7-8 allows a lawyer to "emphasize the possibility of harsh consequences that might result from assertion of legally permissible positions." However, "the lawyer should

the public company, not any conflicting interest of individual officers or directors.<sup>190</sup>

From these principles come certain practical considerations that should guide counsel conducting an investigation. Counsel must always consider the legal obligations that an officer or director owes to the corporation before providing the client advice. These obligations include duties imposed by federal and state law. For example, federal securities laws impose liability for misleading disclosures made by public companies, and such liability can extend to directors and officers who may be controlling persons of the corporation or be responsible for the statements under the group-published doctrine.<sup>191</sup>

Under state law, officers and directors have the familiar duties of due care, loyalty, and good faith. These duties encompass the obligations to consider and react with requisite process to reasonably available material information, to act in the best interests of the corporation and to prioritize the interests of the corporation, to act when there is a known duty to act, and not to act with intent to violate applicable positive law.<sup>192</sup> As a

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always remember that the decision whether to forego legally available objectives or methods because of non-legal factors is ultimately for the client and not for the lawyer." *Id.*

190. While "the decisions of constituents of the organization ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful" and "[d]ecisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province," the lawyer has no duty to obey an instruction of an officer or director that is in violation of that person's legal obligation to the organization and that would substantially injure it. Model Rule 1.13, cmt. [3]; see Sarah Helene Duggin, *Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview*, 2003 Colum. Bus. L. Rev. 859, 936 (2003):

The client to whom [investigative counsel] owes undivided loyalty, fealty, and allegiance cannot speak to him except through voices that may have interests adverse to his client. He is hired and fired by people who may or may not have interests diametrically opposed to those of his client.

191. As articulated by the Ninth Circuit:

In cases of corporate fraud where the false or misleading information is conveyed in . . . annual reports . . . or other 'group published information,' it is reasonable to presume that there are the collective actions of the officers . . . Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading misrepresentations with particularity and where possible the role of individual defendants in the misrepresentations.

*Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987) (citations omitted).

192. See *In re Walt Disney Co. Derivative Litig.*, No. Civ. A. 15452, 2005 WL 1875804, at \*35 (Del. Ch. Aug. 9, 2005) (describing fiduciary duties under Delaware law), *aff'd*, No. 411,2005, 2006 WL 1562466 (Del. June 8, 2006); see, e.g., *Enron*, 284 F. Supp. 2d at 657-



part of their fiduciary obligations, directors have the specific duty to investigate “red flags” indicative of wrongdoing by corporate agents.<sup>193</sup>

Finally, corporate charters, bylaws and other internal policies and procedures can impose additional obligations on directors. They may require directors to receive reports of wrongdoing<sup>194</sup> and, where appropriate, to conduct investigations. They may also assign certain investigative obligations to committees of the Board of Directors such as the Audit Committee. Where a designated committee or director fails to fulfill its oversight responsibilities, it is possible that a violation of the duty of care has occurred.<sup>195</sup>

### B. Recommendations

We now address several questions counsel typically confronts with respect to internal investigations.

#### 1. *Who should conduct the investigation and to whom does that counsel report?*

After determining that an internal investigation is required, the first issue presented is who should direct the investigation. Typically, there are three alternatives: the Audit Committee or other committee of the Board composed of independent directors, the full Board of Directors, or management of the corporation (often the General Counsel or a lawyer in the office of the General Counsel). Various regulatory bodies have expressed their preferences with respect to how this issue is resolved. The *Thompson*

58 (S.D. Tex. 2003) (finding that plaintiffs had stated a claim as to breach of fiduciary duty for directors’ failure to act given their access to material information about the actual financial condition of Enron).

193. See *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (“[A] director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.”); see also *In re Citigroup, Inc. S’holders Litig.*, Civ. A. No. 19827, 2003 Del. Ch. LEXIS 61, at \*6-7 (June 5, 2003) (describing a failure to provide oversight claim under *Caremark*); *In re Worldcom, Inc. Secs. Litig.*, No. 02 Civ 3288 (DLC), 2005 WL 638268, at \*8 (S.D.N.Y. Mar. 21, 2005) (“[D]irectors . . . may not fend off liability by claiming reliance where ‘red flags’ regarding the reliability of an audited financial statement, or any other expertised statement, emerge.”); cf. *WorldCom*, 346 F. Supp. 2d at 684 (“If red flags arise from a reasonable investigation, underwriters will have to make sufficient inquiry to satisfy themselves as to the accuracy of the financial statements, and if unsatisfied, they must demand disclosure, withdraw from the underwriting process, or bear the risk of liability.”)

194. SOX §307 and various listing standards currently require audit committees of public companies regularly to receive reports of wrongdoing.

195. Cf. *Walt Disney Derivative Litig.*, 2005 WL 1875804, at \*35 (describing violation of fiduciary duty claim where directors fail to act in the face of a legal obligation to act).

*Memo*, for example, indicates that, in making the decision whether to criminally charge a corporation, the DOJ considers whether the corporation's directors "exercise[d] independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations." Similarly, the SEC's *Seaboard Report* suggests that one factor the SEC will consider in evaluating the level of the corporation's cooperation is whether the investigation was run by a committee consisting solely of independent, non-management directors. In assessing whether to recommend sanctions, the CFTC also looks at whether the company "use[d] an independent entity to investigate and report on the misconduct." *CFTC Cooperation Factors*, n. 186 above.

Those pronouncements do not and cannot relieve counsel from the duty to advise as to the best reporting line for an investigation in the particular case. There is no single "right" entity or person to supervise an investigation and, in most instances, corporations will have some discretion. However, in addition to the expressed regulatory preference for investigations run by Board committees, often it will be in the company's best interest to have non-management directors run an investigation. Such directors are independent from management and thus best able to judge the evidence with respect to management. In addition, an investigation run by independent directors, if properly performed, may have particular credibility with the government, regulators and the company's auditors, possibly eliminating the need for those entities to conduct their own parallel investigations. Moreover, investigations run by non-management directors, such as a company's Audit Committee, are often a sensible and cost-efficient path because it is frequently difficult to determine at the outset of the inquiry whether senior management had a role in alleged wrongdoing. Choosing the wrong person to run the investigation may result not only in a waste of that person's time, but also can lead to increased cost, delay and loss of credibility when it turns out that the alleged wrongdoing is more extensive. In those circumstances, a Board committee may be forced to redo the investigation, after hiring its own counsel.

However, in other instances, an investigation led by senior management may be more appropriate and efficient. The use of management and in-house counsel to lead an investigation offers premiums in terms of efficiency and cost-savings for the corporation and its directors. This seems particularly true where, for instance, misconduct seems safely localized. Thus, for example, where the wrongdoing occurred in a foreign affiliate of a United States-based corporation, or occurred in the past and under the watch of a different management team, current management or the chief

legal officer may be the most appropriate choice to supervise the investigation. Likewise, where there is a premium on speed in conducting an investigation and high-level management does not appear to be involved, a corporation may well choose to have its in-house counsel conduct the investigation.

Counsel advising a corporation should inform the client of the impact of choosing one representative or entity to conduct the investigation, as, in all but the most unusual circumstances, the client will have a choice as to who is to conduct the investigation. Moreover, where senior management is chosen to supervise an investigation, counsel should regularly revisit that decision as the investigators learn more about the nature and scope of the conduct being investigated. The decision initially to launch an investigation led by management does not foreclose a later conclusion that the Board is the best body to supervise the investigation.

The extent of General Counsel's involvement in internal investigations must depend upon the facts (particularly the existence of conflicts) and the capabilities of the relevant in-house department. The General Counsel and/or internal lawyers can and often should be involved in many internal investigations. However, there are other circumstances, such as where a material allegation is made involving the CEO, or other senior management, when the Board might well desire that the General Counsel not be present. Such decisions should be made in consultation with the corporate body conducting the investigation.

Conflicts (or the appearance of conflicts) also should be taken into account in determining whether an internal lawyer should be in charge of an investigation of a peer or a major direct client or of a matter where the internal lawyer rendered significant legal advice. The client should be advised of such apparent conflicts and of the risk that the investigation will be compromised.

There is one circumstance where a lawyer's duty does not end with the advice that the company can choose who is to conduct the investigation from a range of options. In some circumstances, an officer or director's instruction that investigative counsel report to him or her may violate a fiduciary duty of that officer or director. For example, a director implicated in wrongdoing who insists that investigative counsel report to him or her alone, or retains as investigative counsel a personal friend, may be considered to have violated the fiduciary duty of loyalty by elevating personal interests above those of the corporation.

A decision with respect to the management of an internal investigation is no less subject to the laws of fiduciary duty than any other important decision. If made by officers in a self-interested fashion that causes

harm to the corporation, the lawyer may need to bring it to the Board's attention, including pursuant to the SOX reporting up rules (*see* pp. 70-72, above). In those circumstances, counsel has no duty to obey the corporate officer or director and turn a blind eye to the breach of fiduciary duty. Counsel's duty is to the corporation—not to the particular director or officer—and, in those circumstances, should be unstinting in providing the corporation's Board his or her advice.

After the individuals who are directing the investigation are chosen, investigative counsel must be chosen. Again, this is a choice for the client. With few exceptions, the client has broad discretion over whom it *may* choose. The law does not dictate that a corporation must hire a particular lawyer or even a particular type of lawyer.

The more complicated question is whom it *should* choose. One factor in this decision is assessing how regulators will view the independence of prospective investigative counsel. In some circumstances, regulators have expressed skepticism regarding the independence of an investigation and the reliability of its results if the investigation has been conducted by counsel who has recently defended the corporation before a regulatory agency or as an advocate in litigation.<sup>196</sup> Likewise, regulators might well question the independence of an investigation conducted by a company's regular outside counsel, or by any counsel that does a significant amount of work for the client or its officers or directors. The retention of regular company outside counsel to conduct internal investigations undermined the credibility of investigations in two prominent scandals: Enron<sup>197</sup> and Global Crossing.<sup>198</sup>

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196. There has been such criticism of investigative counsel's role in the accounting scandal in the city government of San Diego, California. There counsel, also defending the City of San Diego before the SEC, led two internal investigations. The first investigation was characterized by an outside auditor as "insufficient." The SEC told city officials that the second internal investigation also lacked independence, since counsel had provided some information to employees in advance of their interviews. *See* Deborah Solomon, *Lost City: After Pension-Fund Debacle, San Diego is Mired in Probes*, *Wall St. J.*, Oct. 10, 2005, at A1.

HealthSouth's retention of Fulbright & Jaworski both to conduct an internal investigation of inside trading allegations against CEO Richard Scrushy, and to represent the company in an SEC investigation concerning these allegations, received similar criticism. *See HealthSouth Committee Hearings*, n.124 above, Part 2, Nov. 5, 2003, at 55, 70-71, 77-78 (Board overruled recommendation of Audit Committee to appoint independent counsel to investigate).

197. *See Enron*, 235 F. Supp. 2d at 600-01, 657-58, 665-69, 705; Timothy E. Hoeffner & Susan M. Rabii, *Maintaining the Integrity of Internal Probes*, *Nat'l L.J.*, June 23, 2003, at 19; Julie Mason, *Houston Law Firm Probed for Role in Fall of Enron*, *Houston Chron.*, Mar. 14, 2002, at A13.

198. Christopher Stern, *Report Criticizes Global Crossing's Outside Counsel*, *Wash. Post*, Mar. 11, 2003, at E05. The criticism in *Global Crossing* in part focused on the fact that the

Those concerns must be considered by counsel advising the corporation in every instance. There are costs to hiring counsel who is too close to current management. If true wrongdoing has occurred, counsel with ties to management might not be best suited to discovering it and rooting it out. If the company chooses wrong and there is wrongdoing where it was not believed to exist, the failure to act through independent counsel can be expensive.<sup>199</sup> Even where there is no true wrongdoing, the use of regular counsel to conduct the investigation can cause credibility problems, and possibly lead regulators or the Board to conclude that a new investigation must be conducted by independent counsel.

There are, however, some investigations where the benefit of hiring a law firm that is familiar with the company, or has prior experience in the subject matter of the investigation, will outweigh the disadvantages arising out of the prior relationship. Counsel knowledgeable of the company and its personnel, and familiar with the regulatory and factual framework, will have a shorter learning curve, will get up to speed more quickly and efficiently on a matter, and presumably will be better suited to evaluate evidence in context than counsel who lacks this background. This is a benefit both from the standpoint of shareholder value and from the standpoint of corporate governance.

Once again, counsel for the corporation should lay these choices out for those supervising the investigation and let them make their own choice. During the course of the investigative process, they should periodically assess whether outside counsel remains independent of the influence of interested directors and officers.

*2. How should the scope of the investigation be determined?*

After determining who should supervise an investigation and which counsel should be retained, the client must define the scope of the investigation. This issue usually is, and should be, resolved by the corporation in consultation with investigative counsel. It is an extremely important issue that can be addressed only with sensitivity to the facts giving rise to the investigation itself.

State and corporate fiduciary duty law and federal securities law and other federal obligations provide relevant guideposts. State corporate law

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Acting General Counsel supervising the investigation continued to be an active partner of the firm allegedly charged with investigating. See D-15, below.

199. See *Report of Investigation in the Matter of Cooper Companies, Inc.*, SEC Rel. No. 34-35082, 58 S.E.C. 591, 594-96 (Dec. 12, 1994) (faulting internal investigation where co-chair and CFO of company had refused to cooperate with outside counsel's investigation, and the Board of Directors did not act).

requires directors to investigate red flags.<sup>200</sup> Under federal securities laws, a corporation is liable to investors if it intentionally or recklessly makes a false material statement. That liability may extend to all persons who make or participate in the making of the false statement.<sup>201</sup> Accordingly, officers and directors who are faced with red flags indicating that a material statement made by the issuer may be wrong, or that there may be material misconduct at the company, should conduct an inquiry that addresses those warning signs. While “[d]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong,” if red flags go unheeded, “then liability of the directors might well follow.”<sup>202</sup>

There are several factors that should be considered in determining the proper scope of an investigation. The guiding principle should be the need to uncover wrongdoing suggested by the allegations: at a minimum, the investigation must address those allegations. As the investigation proceeds, investigative counsel should continually reassess the breadth of the engagement, and recommend expanding (or contracting) the scope of the investigation as the circumstances warrant. If there is a reasonable likelihood that limitations in scope will lead regulators, auditors, lenders, or other important constituents to discount the findings and conclusions of the investigation, the company should consider expanding the scope of the investigation appropriately.

Nevertheless, directors have a fiduciary obligation to set appropriate limitations on investigative counsel and avoid wasting corporate assets. Internal investigations are often costly, and companies have an obligation to ensure that they are conducted efficiently. In addition to the cost of the investigation itself, extended investigations may have other negative collateral consequences for a company, such as delaying its submission of critical financial releases (which may cause the company's stock to be delisted from a stock exchange or constitute an event of default under loan agreements or significant contracts), depressing the price of the

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200. See, e.g., *In re Chepak*, SEC Rel. No. 34-42356, 2000 WL 49226 (SEC Jan. 24, 2000).

201. See *Ernst & Ernst vs. Hochfelder*, 425 U.S. 185, 211 (1976) (requiring allegations of more than negligence alone to sustain a 10b-5 action for failure to make proper inquiry); see also *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268 at \*1 (describing the standards for imposing liability on directors of public companies under Section 11 of the 1933 Act and under the controlling person provisions in the 1933 and 1934 Acts).

202. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); see also *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268 at \* 8 (articulating strict liability standard applicable to corporations under the 1933 Act.).

company's stock value, generating low employee morale, hampering employee recruitment or the company's ability to obtain new contracts, and protracting regulatory investigations. In addition, facts discovered through the investigation, even where there is no wrongdoing, may serve as fodder for litigation against the company. None of these factors excuse ignoring red flags. However, all of these factors should be considered in determining the proper scope of an investigation.

To be clear, where allegations are serious and appear to have substance and where, if true, they would have a material effect on the company's financial statements, officers and directors are obligated to conduct investigations that are broad enough to get to the bottom of the issues. In other circumstances, however, such as where the possibility of serious wrongdoing appears improbable or speculative, a full scale investigation may not be necessary. In short, issues regarding the proper scope of the investigation should be the subject of discussion. The scope of the investigation, including its limitations, should be clearly expressed to regulators.<sup>203</sup>

Finally, while the client ultimately is responsible for determining the scope of the investigation,<sup>204</sup> there may be circumstances where a limitation in scope may violate a duty to the corporation or may be otherwise illegal. It is possible that the client will determine to limit investigative scope to prevent implication of a key employee or to cover up the wrongdoing of senior management. As discussed above, counsel's duty is not to the particular director or member of management but to the corporation as a whole. Upon becoming aware of illegal activity, or even of a decision that—if implemented—would violate a fiduciary duty and cause harm to the corporation, counsel under ethical rules should elevate the issue within the corporation. If such efforts prove unfruitful, counsel has permissive grounds for withdrawal or even, if the violation is likely to cause substantial injury, to report client confidences to the SEC. 17 C.F.R. § 205.3(d)(2).

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203. Many of the risks inherent in limiting investigative scope were dramatized by the criticism of Vinson & Elkins' Enron investigation, the scope of which was severely limited as to persons interviewed and material reviewed, and was subject to an extremely tight time deadline. See Timothy E. Hoeffner & Susan M. Rabii, n. 197 above.

An investigation for Qwest by Boies Schiller also received similar poor reviews from some. Anne C. Mulkern, *Internal Probe of Qwest's Deals Found Few Problems*, Denver Post, Oct. 4, 2002, at C-01 (independence of firm questioned); Andrew Backover, *Blame Spreads Far in Telecom's Fall*, USA Today, Aug. 18, 2003, at B (investigation found no problems with transactions that Qwest later admitted were improper).

204. EC 7-7.



### 3. Self-reporting

Another important issue is whether and when to report the possibility of unlawful activity to regulatory authorities. Regulators' published commentaries and rules on compliance suggest that prompt self-reporting of unlawful conduct is always in the client's best interests (see Appendix H below). The *Thompson Memo* provides: "In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors." Similarly, the *Seaboard Report* factors include whether the company promptly reported to SEC staff the results of its review: "Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered?" In the *U.S. Sentencing Guidelines for Organizations* (Appendix H at H-5), punishment is mitigated based on a company's efforts in self-reporting, cooperation with authorities, and acceptance of responsibility. The CFTC states that it considers the company's good faith in uncovering and investigating misconduct, the company's cooperation with Division's staff in reporting misconduct, and the company's actions with respect to Division's staff. The NASD likewise states that it considers whether, prior to detection or intervention by the regulator, the company accepted responsibility to a regulator, voluntarily employed corrective measures, revised procedures to avoid recurrence of the misconduct, and attempted to pay restitution or otherwise remedy the misconduct. NYSE Rule 351 and NASD Conduct Rule 3070 go even further, requiring companies promptly to report any violation of securities laws or regulations.

In light of these regulatory pronouncements, clients often ask counsel whether self-reporting a recently discovered problem is legally required or only a matter of prudence.<sup>205</sup> Ethical considerations and legal requirements do not always mandate full, real time disclosure of all potential problems to regulators, although they mandate truthful disclosure when disclosure is made. In many, if not most, circumstances, reporting evidence of unlawful activity to regulators will be the proper or even required course of action. Some entities, particularly those in highly regulated industries, or with a history of problems, may adopt a policy approaching zero tolerance, and will determine that virtually any evidence of wrongful conduct must be reported promptly to regulators.

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205. This does not apply to on-going illegal activity, such as the improper destruction of documents, which constitutes obstruction of justice. Counsel have an affirmative obligation to try to ensure preservation of documents relevant to the potential wrongdoing.



Often, however, the decision whether to self-report is a difficult one. Given the substantial costs to a corporation of many regulatory investigations, a public company may justifiably determine not to self-report in some circumstances. Those circumstances cannot be determined in advance. Each case is different. What is mandated is careful consideration by the client, with the assistance of counsel, of the relevant considerations. In general, a client determining whether to self-report should consider the following, among other relevant factors: (1) the nature and extent of possible wrongdoing and the circumstances of its discovery (for example, if the problem was discovered in the context of an acquisition transaction requiring regulatory approval, self-reporting might be desirable even if the issue could be remediated promptly); (2) whether the possible wrongdoing is in the past or is ongoing; (3) the cost and collateral consequences of reporting; (4) the possibility of harm to the corporation, its shareholders, or other constituencies; (5) who is alleged to have engaged in wrongdoing; and (6) whether there are (or are likely to be) other investigations or proceedings with respect to the possible wrongdoing or related matters, including by a governmental or regulatory body. The client should consider that a decision not to disclose likely will be viewed as a failure to cooperate if the government later discovers the wrongdoing, and may lead to a corporate penalty or even indictment—the ultimate penalty that could put the corporation out of business. Where the possibility of wrongdoing appears high-level or widespread, or where it is ongoing, establishing a satisfactory compliance program is essential to a corporation's interests, and, therefore, full disclosure of the problem will often be the only sensible course.

#### 4. Exercise of judgment

Supreme Court Justice Robert H. Jackson famously observed that “[w]ith 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.”<sup>206</sup> That observation applies no less to investigative counsel hired by a corporation than to a federal prosecutor working

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206. Robert H. Jackson, *The Federal Prosecutor* (Apr. 1, 1940) (published in 24 J. Am. Jud. Soc’y 18 (1940)). See Abraham S. Goldstein, *Conspiracy to Defraud the United States*, 68 Yale L.J. 405, 408 (1959) (observing that the terms “conspiracy” and “defraud” have taken on very broad and unspecific meanings); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 Duke L.J. 945, 954-55 (1993) (noting that mail and wire fraud statutes, whose underlying doctrine “posits a duty of agents to inform their principals of material facts such as kickbacks,” have been interpreted to criminalize a “wide range of conduct involving conflicts of interest, alleged misrepresentations, or the failure of agents to inform alleged principals of certain facts”).

for the government. Investigations often address conduct that is problematic, but not clearly unlawful, and the investigative record is never perfect. Counsel is required to exercise discretion concerning how to characterize events, to judge witness credibility and motive, and to determine whether conduct crossed the line from questionable or inadvertent to improper. In making these assessments, investigative counsel has a client—a client who may be keenly interested in whether conduct is characterized as improper or criminal and in how investigative counsel exercises discretion. Sometimes that client will have an interest in protecting the employees under investigation; other times, it will have an interest in trying to build a case against those employees. It will rarely be disinterested. It is important for investigative counsel to be aware of the different constituents who have a stake in how counsel's discretion is exercised, and to be cognizant of the consequences that would flow from exercising discretion broadly or narrowly.

Most of the commentary on this issue involves situations where counsel “under charged” during the course of an investigation. We have all read about investigations conducted by counsel who is too close to management, or had some prior involvement with the transactions under review, and were not sufficiently skeptical of motives and events and, consequently, failed to ferret out wrongdoing. But the issue can also arise in the other direction, and investigative counsel also may err by being too quick to find there was unlawful conduct based upon minimal or equivocal evidence.

There are many incentives that may cause investigative counsel to “over charge.” For example, the various Justice Department and regulatory pronouncements reward corporations (and their counsel) who uncover wrongdoing and root out wrongdoers.<sup>207</sup> There is a one-way regula-

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207. See Cutler, *Remarks Before D.C. Bar*, n.177 above, at 6:

The larger lesson is the continuing importance of what we refer to as cooperation . . . First, I believe the Commission is placing a greater emphasis than ever before on assessing and weighing cooperation when making charging and sanctions decisions. . . . Second, I think the Commission is using a more graduated scale when it assesses cooperation. There are cases in which the Commission has found cooperation early in an investigation to have been inadequate, and taken that into consideration, even if the conduct of the same party was later exemplary. In other words, the Commission no longer begins and ends its assessment by asking, ‘did this party cooperate, yes or no?’ Now, it routinely goes on to consider, if the party did cooperate, how much? How often? You should expect that we will seek to reflect the answers to these sorts of questions when we resolve investigations and actions.

*Thompson memo:*

The main focus of the revisions is increased emphasis on and scrutiny of the authen-

tory ratchet; except in rare instances, regulators do not punish corporations and their counsel for being overly aggressive in determining that unlawful conduct occurred.

Similarly, investigations undertaken when there is new company management who were not employed at the time of the transactions under review, or where there has been a decision to restate financial statements, often find problems in a broad swath of conduct, as there is an incentive in those situations to redress even marginal issues so the company, under new management, can have a fresh start and not be burdened by grey area decisions made by former management. In addition, no counsel is a hero for missing conduct that is later characterized as a crime, so investigative counsel often has an incentive to stretch to find problems.

Balancing these concerns may be difficult. There are substantial costs of not finding all unlawful conduct. Improper conduct may go unremedied. If later found, the original investigation may be undermined, wasting time, money and goodwill. The failure to uncover wrongdoing may also call into question, in the eyes of prosecutors and regulators, the adequacy of the company's cooperation. And, a wrongdoer may be allowed to stay in place.

However, counsel's decision to characterize as criminal conduct that no reasonable prosecutor would prosecute is also not cost-free. An overly aggressive decision to characterize innocent conduct as wrongful is not just unfair. It can also impose regulatory costs on a corporation, result in a drop in shareholder value, lead to the departure of key executives, and cause the loss of business. Such an outcome would injure the shareholders directors are charged with protecting. Just as under enforcement may compromise corporate governance, so too may over enforcement: a too zealous investigation, and one that does not take into account all the

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ticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation. . . . [S]uch conduct should weigh in favor of a corporate prosecution. The revisions also address the efficacy of the corporate governance mechanisms in place within a corporation, to ensure that these measures are truly effective rather than mere paper programs.

See also Arthur F. Matthews, *Defending SEC and DOJ FCPA Investigations and Conducting Related Corporate Internal Investigations: The Triton Energy/Indonesia SEC Decree Settlements*, 18 Nw. J. Int'l L. & Bus. 303, 418 (1998); SEC Litig. Rel. No. 19517, *SEC Charges Six Former Officers of Putnam Fiduciary Trust with Defrauding Clients of \$4 Million* (Jan. 3, 2006) (announcing that the SEC was not commencing an enforcement action against corporation because of corporation's "swift, extensive and extraordinary cooperation" including terminating and disciplining any responsible employees).

facts and circumstances and draw the right distinctions, can create a perception of unfairness antithetical to good corporate governance and can undermine the trust between client and counsel which is so integral to good corporate governance in the first place.

There is no substitute for judgment. We believe that, in characterizing the evidence, counsel should not act as a zealous advocate for the client in construing the facts in the light most favorable to the client. But counsel also should not act like an overzealous prosecutor and take the worst view of the evidence from the client's perspective.

#### **5. Employee discipline**

Retaining a key employee in the face of some evidence of wrongdoing is likely to strain the corporation's relations with regulators. The DOJ and SEC view continued employment of potentially culpable employees as serious flaws in the corporation's compliance program, giving rise to potential enforcement consequences. The *Thompson Memo* states:

In evaluating a corporation's response to wrongdoing, prosecutors may evaluate the willingness of the corporation to discipline culpable employees of all ranks and the adequacy of the discipline imposed. The prosecutor 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.

The *Seaboard Report* includes among its factors in determining whether the corporation is complying, "[a]re persons responsible for any misconduct still with the company? If so, are they still in the same position?" Similarly, the CFTC considers whether the company "adequately addressed the employment of the persons responsible for the misconduct, to the extent that they were employed by the company when the conduct was discovered." Then U.S. Attorney for the Southern District of New York, James Comey, stated that the government views a company's continued employment of an individual in the face of evidence of criminal activity as a "serious flaw in the corporation's compliance program and reflective of a problematic corporate culture." Interview with United States Attorney James B. Comey, 51 *United States Attorneys' Bulletin* 1, 5 (Nov. 2003).

Notwithstanding these pronouncements, the decision whether to retain key employees can be a difficult one and the lodestar remains the exercise of business judgment. A lawyer acting to further corporate governance should guide the corporation in its consideration of a number of

factors, in addition to the impact a decision to retain a wrongdoer will have on the company's relationship with prosecutors and regulators, including (1) whether the purported wrongdoing occurred in a personal or professional capacity; (2) the nature and extent of alleged wrongdoing; (3) the strength of the evidence of wrongdoing; (4) whether the employee gained a personal benefit from the conduct; (5) whether the employee had a supervisory role or was otherwise responsible for setting the tone at the top of the company; (6) whether the employee played a role in sensitive areas such as internal controls or financial reporting; (7) the employee's compliance history; and (8) the presence or absence of mitigating circumstances.

In some instances, such as where the corporation is trying to send a message about compliance, the corporation may choose to terminate the employment of all employees involved in the conduct, even those who did not personally engage in wrongdoing, but who supervised others and failed to detect a problem. Board or Audit Committee members may conclude that their own fiduciary obligations require them to terminate an employee in whom they have lost confidence based on the investigative findings, even in the absence of a conclusion of wrongdoing. In other instances, such as where the employee in question is particularly valuable to the company, the Board might properly determine that actual evidence of wrongdoing (as opposed to serious, but unsupported, allegations by regulators) is required before it will take action. And, in still other instances, the Board might determine that termination is not required, notwithstanding evidence of improper conduct. This may be the case where the conduct was modest in scope, and historical, or where the conduct in question is the product of bad professional advice. The client should weigh whether a termination or other discipline (or administrative suspension) best serves the shareholders' interests by considering the value of the employee to the corporation or the impact of discipline on other employees, as compared with the possible harm to the corporation's reputation or stock value or to the corporation's relations with regulators if no action is taken.

A related, and somewhat easier question is what to do with employees who refuse to cooperate with investigators. In many situations, employees will owe a fiduciary duty to their employers to cooperate with investigations. If employees fail to cooperate with an investigation, employers may justifiably refuse to indemnify attorney's fees and terminate that person's employment.

#### **6. Paying counsel fees, retention of counsel and severance**

A frequent issue is whether the company should retain counsel for

employees or pay fees for counsel representing employees. The *Thompson Memo* suggests that corporations may be at risk for doing so, except when required. It states that prosecutors, "in weighing the extent and value of a corporation's cooperation," may consider "a corporation's promise of support to culpable employees and agents . . . through the advancing of attorneys fees."<sup>208</sup>

Resolution of this issue is easy in some circumstances, such as where contract or corporate law requires corporations to advance counsel fees. Recent Delaware case law suggests that such fees should be advanced even where the liability does not necessarily relate to actions by the employee in his official capacity.<sup>209</sup>

Moreover, paying counsel fees may help achieve more accurate results of the investigation or may serve to boost employee morale. The rote incantation that lawyers can sometimes act in ways that delay or impede an investigation wrongfully assumes the worst of the legal profession. Lawyers are guided by ethical principles and can and often do play an important role in ensuring the integrity, accuracy and fairness of the investigation and thus ultimately for corporate governance and the regulators as well. Counsel can aid the investigative process by advising their clients of the importance of cooperating, if they believe their clients' interests will be thereby well served. They may also bring to the attention of the investigating attorney context and extenuating factors necessary for the investigation to render a balanced, fair and accurate result, freeing investigative counsel to focus on the inculpatory facts—secure in the knowledge that any mitigating facts will not be ignored by individual counsel. In some circumstances, cost and speed factors will counsel against hiring

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208. This prosecutorial pressure has received some recent criticism. Judge Lewis Kaplan held that government pressure on KPMG to cut off paying the legal fees and other defense costs of former employees criminally charged with promoting illegal tax shelters violated the Fifth Amendment due process rights and the Sixth Amendment right to counsel of those defendants. *United States v. Stein*, 435 F. Supp. 2d 330, 338-81 (S.D.N.Y. 2006).

See also Duggin, 2003 Colum. Bus. L. Rev. at 963:

Prosecuting attorneys should not attempt to influence the ability of corporate constituents to retain counsel. An organization's advancement of legal fees to individuals under investigation or charged with crimes related to their responsibilities as officers, directors or employees of the entity should not be considered as an adverse factor against the organization in charging decisions, plea negotiations, or in determining the government's position with respect to criminal sentencing proceedings.

209. *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005) (holding that Homestore executive entitled to advancement of legal fees to defend civil and criminal charges, notwithstanding Homestore's contention that executive had acted out of personal greed and not in his official capacity).

lawyers for the employees, but that decision should not be based on an assumption that counsel will impede an investigation.

A related issue is whether a corporation should pay severance to a recently released member of senior management prior to completion of the investigation. Regulators occasionally object to such payments believing that they create a presumption there will not be a finding of wrongdoing, which may prejudice the investigation or give the appearance that the company condones wrongdoing. There are circumstances, however, where payment of severance is contractually obligated. Also, severance payments may help insure that the corporation gains valuable compliance from a potentially culpable person who would otherwise refuse to cooperate, or bring closure to a civil settlement agreement that would be extremely valuable to the corporation.

As a practical matter, providing severance payments will in some instances be impractical or even imprudent, in light of Section 1103 of SOX, which empowers the SEC to “petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision,” any “extraordinary payment” to a corporate officer while an SEC investigation is ongoing.<sup>210</sup> The statute does not define “extraordinary payments,” though the SEC has made clear that it interprets the term broadly, and, in the sparse litigation under Section 1103 thus far, courts have generally adopted the SEC’s view.<sup>211</sup> The statutory language has been interpreted broadly enough to encompass any severance payment, even a payment pursuant to a previously existing contractual obligation. Section 1103 requires a minimal showing by the SEC in order for a 45-day freeze to be entered, which is then extendible to 90 days.<sup>212</sup> If the SEC commences an enforcement action against the prospective recipient of the frozen payment prior to the expiration of the freeze, the freeze then stays in place until the conclusion of the SEC’s enforcement action on the merits.<sup>213</sup>

Section 1103 has thus added a potent new weapon to the SEC’s arsenal, and the SEC has been alert for opportunities to use it. In some instances, upon being informed of a corporation’s intention to make such a payment, the SEC has requested that the funds be placed in escrow.<sup>214</sup>

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210. 15 U.S.C. 78u-3(c)(3)(A)(i).

211. See, e.g., *SEC v. Gemstar-TV Guide Int’l, Inc.*, 401 F.3d 1031, 1034 (9th Cir. 2005) (en banc).

212. 15 U.S.C. 78u-3(c)(3)(A)(iv).

213. 15 U.S.C. 78u-3(c)(3)(B)(i).

214. See, e.g., SEC Press Release No. 2003-184, *Commission Settles Civil Fraud Action Against Vivendi Universal, S.A., Its Former CEO, Jean-Marie Messier, and Its Former CFO*,



This is a request that any corporation seeking to be viewed as a cooperator may find difficult to reject. Indeed, given the government's greatly heightened sensitivity to severance payments, many corporations will not even attempt to make such payments, out of concern such an attempt will be viewed as uncooperative. In short, a contemplated severance payment may never reach its intended recipient, as a result of a negotiated escrow or a court-ordered freeze, followed by an enforcement action in which—if successful—the SEC obtains a monetary recovery which it can satisfy with the escrowed or frozen funds.

A Board of Directors should carefully weigh the costs and benefits of such payments in light of the evidence that exists at the time and the stage of the investigation. In some circumstances, the advantage of paying severance may outweigh concerns about regulators' perceptions. When a Board concludes that severance is appropriate, it may be advisable for it to precondition any payment of severance on full cooperation and on the absence of any finding that the employee in question is culpable.

#### **7. Waiving attorney-client privilege**

Though the *Thompson Memo* provides that waiving attorney-client privilege is not an "absolute requirement," the DOJ often expects organizations that are the subject of investigations to waive attorney-client privilege. Similarly, the CFTC assesses whether the company willingly waives attorney-client privilege and work product protection for internal investigation reports, corporate documents, and employee testimony. Moreover, regulators often cite waiver of privilege as a factor in determining cooperation.<sup>215</sup> One difficulty for clients, among others, is that waiver of the privilege renders otherwise privileged documents, information, and advice readily discoverable by future civil litigants.

Recently, regulators have been increasingly willing to enter into partial waiver agreements, whereby the privilege is ostensibly waived only as to the regulators. Courts, however, have been reluctant to recognize the limited waiver exception and many courts have held that the privilege, once waived as to regulators, is waived as to all.<sup>216</sup>

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*Guillaume Hannezo*, (Dec. 23, 2004) (former CEO was required to relinquish claim to severance package that SEC had escrowed under Section 1103); Yochi J. Dreazen, *SEC, In Inquiry Into Vivendi, Seeks to Freeze Messier Payouts*, *Wall St. J.*, Sept. 17, 2003, at A18.

215. See, e.g., SEC Litig. Rel. No. 19517, n. 207 above (SEC not commencing an enforcement action against corporation because of corporation's cooperation, including not asserting any applicable privileges).

216. See, e.g., *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 230 F.R.D. 433, 438 (D. Md. 2005)



The determination of whether to waive is a critical one for the corporation. A waiver may be the most effective way for a corporation to root out wrongdoing, to ensure that it is compliant in the future, and to win credit from the government, avoiding either a criminal charge or hefty civil penalties. For a corporation faced with true wrongdoing, there may be no practical alternative to self-reporting and a waiver: where a corporate employee engages in misconduct, the corporation itself is harmed. It is thus perfectly appropriate and may be in the best interests of the corporation both to report such misconduct to the government and to provide the government with all the materials, including memoranda of witness interviews, necessary for the government to prosecute the wrongdoer. Such swift and pro-active cooperation can send a message to employees that the corporation is committed to compliance and has a zero tolerance policy with respect to corporate misconduct.

However, a reflexive decision to waive is not cost-free. The promiscuous waiver of the privilege can have several deleterious consequences that must be considered by the corporation and that prudent counsel will raise with the corporation both during an investigation and, ideally, even before an investigation. First, the privilege exists in part to promote good corporate governance—it encourages employees to consult with counsel regarding conduct they observe or participate in. The waiver of the privilege may undermine sound corporate governance by chilling the very consultation and informed decision-making that the privilege is designed to promote. Second, survey results suggest that if the attorney client privilege continues to be eroded, it may undermine pro-active corporate self-regulation, and vigorous internal investigations. *See ACC Survey*, n. 67, above. Even though employees can be given no assurance of absolute confidentiality in consulting with company counsel (*see pp. 86-87, above*), a waiver of the privilege may lead employees to be hesitant to discuss sensitive or difficult issues since the waiver all but guarantees that their every word will end up in the hands of a government regulator. In addi-

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(holding that limited confidentiality agreement under which interview memos were disclosed to the government was not sufficient to preserve confidentiality of interview memos from class action plaintiffs); *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 314 (6th Cir. 2002) (rejecting concept of selective waiver); *In Re Natural Gas Commodity Litig.*, 03 Civ 6186 (VM) (AJP), 2005 U.S. Dist. LEXIS 11950, at \*22-33 (S.D.N.Y. June 25, 2005) (discussing case law concerning non-waiver agreements). *But see Saito v. McKesson HBOC, Inc.*, Civ. A. No. 18553, 2002 Del. Ch. LEXIS 125 (Oct. 25, 2002) (holding that “the corporation did not waive the work product privilege when it gave documents to the SEC and the USAO under [a] confidentiality agreement”).

tion, it has been suggested that the lack of a clearly defined government privilege waiver policy may undermine the willingness of corporations to cooperate with prosecutors. Waiving attorney-client privilege to government authorities can mean waiving the privilege to the world, providing ammunition to the plaintiffs' bar to bring lawsuits deleterious to shareholder value.<sup>217</sup>

A similar privilege issue exists as to auditors. Many outside auditors demand access to attorney work product from the internal investigation as a precondition to signing off on outstanding audits and continuing to work with the client.<sup>218</sup> A client is often torn between the likelihood that attorney work product, including interview memos, will be fully discoverable by future civil litigants and the auditor firm's demand that it satisfy itself with respect to the scope and results of the internal investigation before it will issue a report on the company's financial statements.

This presents a difficult issue for many public companies—an issue just as difficult as whether to waive the privilege. If the auditor demands access to the work product of counsel, the company may have no choice but to accede. The auditor can refuse to issue an opinion in the form necessary for a company to file financial statements with the SEC and, frequently, to meet reporting requirements under debt covenants, whether in public or private instruments. Few new auditors will agree to an engagement that would entail restricted access to company documentation and the large auditing firms have generally refused to accept such limitations in their engagement letters. There may be, however, circumstances

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217. Richard Ben-Veniste & Raj De, *Federal Privilege Waiver Demands Impact Corporate Compliance*, 20 No. 7 White Collar Crime Rep. 2 (Mar. 30, 2006).

218. The ABA's Task Force on the Attorney-Client Privilege believes the auditor's needs and the interests served by the privilege should be balanced as follows:

[A]uditors can be provided with summaries of the factual information that has been developed, including access to transcripts of interviews that are not otherwise protected. We do not believe, however, that the auditor should have access to the investigating counsel's notes of interviews, legal assessments or legal advice to the client. The requirement by auditors that any of those materials generated by counsel be shared with it would unnecessarily impede the ability of counsel fully to investigate, report and advise the corporate client and potentially would interfere with and weaken the ability of corporations to engage in self-policing. Instead, we suggest that the auditor can rely on investigating counsel's provision of non-protected materials and its assurance, as contemplated by the Treaty, that counsel fulfills its professional responsibility in advising the client with respect to its disclosure obligations.

*Report on Audit Issues*, June 14, 2006, at 10, available at [www.abanet.org/buslaw/attorneyclient/materials/hod/0806\\_report.pdf](http://www.abanet.org/buslaw/attorneyclient/materials/hod/0806_report.pdf).

where it is neither in the corporation's interest nor the auditor's for work product to be produced to the auditor.

### 8. Withdrawal

One particularly problematic issue is when to withdraw as investigative counsel and how to withdraw. In general, counsel must withdraw from representation of a client where such representation would result in a legal or ethical violation (*see* pp. 93-94, above). Model Rule 1.16(a)(1) compels a lawyer to withdraw if "the representation will result in violation of the rules of professional conduct or other law." Similarly, DR 2-110B.2 requires withdrawal if "[t]he lawyer knows or it is obvious that continued employment will result in violation of a Disciplinary Rule." Moreover, Model Rule 1.2(d) prohibits a lawyer from assisting a client in conduct the lawyer knows to be criminal or fraudulent. *See* pp. 52-53, above.

In certain circumstances, discord between investigative counsel and the client may serve as a basis for permissive withdrawal. Model Rule 1.16(b)(4) and DR 2-110C both allow counsel to withdraw upon disagreement with a client as to future course of action.<sup>219</sup> Both rules permit withdrawal, moreover, if withdrawal can be accomplished without a "material adverse effect on the interests of the client."<sup>220</sup>

Thus, ethical rules contemplate permissive withdrawal where outside counsel disagrees with the client as to future action, or whenever such withdrawal does not harm the client. Theoretically, grounds for permissible withdrawal include disagreement between outside counsel and the client as to issues arising from internal investigations, such as investigative scope, disclosure issues, employee discipline decisions, and whether to self-report possible wrongdoing or turn over interview memos or key documents to the regulators.

Sometimes counsel and client will differ based on good faith disagreement over the corporation's interests. Other times, however, they will differ because the client will want to do the investigation in a manner that the lawyer views as inconsistent with his or her reputation. There may be matters in which counsel will have an interest in using all of the resources possible to uncover potential wrongdoing, while the client de-

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219. Model Rule 1.16(b)(4) allows withdrawal where "the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement," while DR 2-110C.1.e allows withdrawal where the client "[i]nsists, in a matter not pending before a tribunal, that the lawyer engage in conduct that is contrary to the judgment and advice of the lawyer but not prohibited under the Disciplinary Rules."

220. DR 2-110C; Model Rule 1.16(b)(1).

cides that such a use of resources is not in the company's interests. There also may be situations in which investigative counsel believes that a wrongdoing employee must be disciplined in order for the company, and counsel, to maintain credibility with the regulators, while the client believes that such action will come at an unacceptable cost to the client.

This poses a conundrum. Lawyers frequently are retained for internal investigations because they have a reputation for "uncovering and discovering all the facts" and "making the tough calls against management." Various regulators may feel they can trust certain lawyers because they will report to them a bad fact if there is one. The client's decision to end or restrict an investigation, or to make decisions concerning management that will not be well received by regulators—even though lawful and consistent with their fiduciary obligation to act in the shareholders' best interest—may not only be contrary to the investigative lawyers' advice, but may also hurt the lawyer's reputation and diminish his or her ability to get similar work in the future. Under these circumstances, the investigative lawyer's decision to resign—for his or her own reputational reason—may have an adverse effect on the client as it may signal to the regulator that there is a problem with the investigation and that the client may not be as hard-nosed as they might like the client to be. Faced with this dynamic, companies may feel they are hostage to their investigative counsel, who, through the threat of withdrawal, may dictate the scope and course of the investigation.

This problem has been compounded by a heightened scrutiny of the activities of lawyers, including an interest by regulators in pursuing aiding and abetting charges against lawyers.<sup>221</sup> The prospect of becoming a

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221. As discussed above, the SEC may proceed against attorneys for aiding and abetting fraud or participating in or causing misstatements, and may be pressing such charges more frequently against lawyers for providing improper advice. See pp. 47-49, above; see also *In re Feldman*, Rel. No. 33-7014 (Sept. 20, 1993) (finding that an attorney aided and abetted Section 5 violations when he persisted in advising his client of an erroneous legal position even after being put on notice that the Commission staff disagreed with such position). See generally Carrie Johnson, *SEC Chairman Faults Corporate Advisers*, Wash. Post, Mar. 5, 2005, at E03 (reporting that the SEC has lodged 76 cases against lawyers in the past three years).

Though the SEC has not initiated noteworthy proceedings against lawyers for conducting improper internal investigations, the Commission's reported service in 2004 of a Wells notice on an attorney in connection with his role in conducting an internal investigation for Endocare suggests that such cases may be forthcoming. See Otis Bilodeau, *SEC Threatens Ex-Brobeck Lawyer Over Client's Probe*, People Say, Bloomberg.com, Dec. 6, 2004, available at [www.bloomberg.com](http://www.bloomberg.com). See also SEC Press Rel. No. 2004-67 at 28 (May 17, 2004) (describing Lucent settlement agreement; penalty imposed, in part, because of interview between former

target for regulators may cause investigative counsel to advocate future actions by corporate clients that are not necessarily in the shareholders' interests, but rather formulated to preserve investigative counsel's reputation for thoroughness.

If such a disagreement does arise, the lawyer needs to defer to the client's decision-making authority, assuming it involves no unethical or illegal course of action. The lawyer cannot allow his or her self-interest, such as concerns regarding his or her reputation, to interfere with vigorous representation of the client's interests.<sup>222</sup> With adequate consultation and a clear retainer agreement before the investigation proceeds, such tension between investigating counsel and the client should be a rare occurrence.

When counsel does withdraw, regulators should not necessarily draw any inference from the withdrawal. As is true with all other difficult issues, handling corporate investigations requires the exercise of judgment. No two corporations are exactly alike and no two investigations are exactly alike. Investigative counsel should be sufficiently flexible to apply judgment to the facts presented by the engagement and help the client safeguard its best interests. Great lawyers may counsel non-cooperation just as they may counsel cooperation. A corporation devoted to corporate compliance may choose not to cooperate in a particular instance just as a corporation with lax ethics might decide that it must cooperate in a different instance. What is called for is honesty; care and thoroughness in the areas that are investigated; and tough and unconflicted advice. The best lawyers—and those who are recognized as the best at promoting good corporate governance—have those characteristics.

If the foregoing is true, then the decision of counsel to withdraw or the decision of the client not to continue with counsel need not be understood to be a red flag with respect to cooperation. Counsel may withdraw because the client wants him or her to cooperate and counsel thinks that is unwise, or counsel may withdraw because he or she wants to coop-

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CEO, outside counsel, and *Fortune* magazine, in which outside counsel characterized Lucent's fraudulent booking as a "failure of communication," where interview occurred after Lucent and SEC had already agreed to settle); cf. Michael Bobelian, *Ex-General Counsel Pleads Guilty in Case of Securities Fraud*, N.Y.L.J., Sept. 23, 2004, at 2 (former General Counsel of Computer Associates concealed information from law firm conducting internal investigation: *United States v. Woghin*, 04 CR 847 (E.D.N.Y.) (ILG)).

222. See DR 5-101: lawyer shall not accept or continue employment "if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own . . . personal interests . . . ."

erate and the client says no. The ethical principles need not be bent for internal investigations. Counsel who prevails, through hard-nosed advice, is the best counsel for corporate governance regardless whether in a particular case the advice is to cooperate or not.

November 2006

## The Task Force on the Lawyer's Role in Corporate Governance

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The Task Force gratefully acknowledges the counsel of James A. Grayer, and the drafting and research assistance of Joshua Hill, Joshua A. Naftalis and Alexander Solomon.

## APPENDIX H

### Government and Exchange Guidelines on Corporate Cooperation and Internal Investigation

#### A. DEPARTMENT OF JUSTICE AND U.S. SENTENCING GUIDELINES FOR ORGANIZATIONS

##### 1. Thompson Memo

In 2003, then Deputy Attorney General Larry Thompson issued a memorandum, entitled “Principles of Federal Prosecution of Business Organizations,” that revised<sup>1</sup> the guidelines prosecutors are to follow in considering charges against corporations.<sup>2</sup> Now referred to as the Thompson Memo, this document clarified that prosecutors should always consider the company itself as a potential defendant, and it underscored that a company’s cooperation is a key factor that the government will consider in its charging decisions. The Memo also explained that “[t]he main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation’s cooperation.”<sup>3</sup> In addition to these two goals, the revisions to the policy “address the efficacy of the corporate governance mechanisms in place within a corporation, to ensure that these measures are truly effective rather than mere paper programs.”<sup>4</sup>

The Memo indicated that, in addition to the considerations applicable to individuals,<sup>5</sup> federal prosecutors should weigh nine factors in deciding whether to investigate, charge, or negotiate a plea with a com-

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1. On June 16, 1999, Deputy Attorney General Eric E. Holder, Jr. authored the predecessor memo, entitled “Federal Prosecution of Corporations.” Memorandum from Eric E. Holder, Jr., Deputy Att’y Gen., to All Component Heads & U.S. Atty’s (June 16, 1999).

2. Memorandum from Larry Thompson, Deputy Att’y Gen., to Heads of Dep’t Components & U.S. Atty’s (Jan. 20, 2003) (“*Thompson Memo*”), available at [http://www.usdoj.gov/dag/cftf/business\\_organizations.pdf](http://www.usdoj.gov/dag/cftf/business_organizations.pdf).

3. *Id.*

4. *Id.*

5. The *Thompson Memo* noted the following 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.” *Id.* at ¶ II.A.

pany. These factors fall into roughly three groups: (1) the nature and extent of the wrongdoing; (2) cooperation with the investigation and self-reporting of malfeasance; and (3) the collateral consequences of prosecution and the adequacy of other remedies. While the nature and extent of the company's wrongdoing will typically be the most important consideration, it is notable that three of the nine factors address cooperation and compliance, and they are:

4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection[];<sup>6</sup>

5. the existence and adequacy of the corporation's compliance program; [and]

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[.]<sup>6</sup>

Id.

**a. Cooperation and Self-Reporting**

The General Principle set forth in Paragraph VI of the *Thompson Memo* makes clear the Justice Department's emphasis on cooperation and voluntary disclosure by organizations: "In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrong-

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6. In 2005 the Department of Justice directed each U.S. Attorney and department head to establish a review process for supervisory approval of all requests to corporate entities for waiver of the attorney-client privilege and work product protection. See Memorandum from Robert D. McCallum, Jr., Acting Deputy Atty Gen., to Heads of Dep't Components & U.S. Atty's (Oct. 21, 2005), available at <http://www.abanet.org/poladv/mccallummemo212005.pdf>. While this directive appears to be intended to assure appropriate supervision and review of waiver requests, it does not appear to indicate a weakening of the DOJ's interest in obtaining privileged materials. Indeed, the October 21 memo reiterates the importance that the DOJ continues to attach to such materials, by quoting from the *Thompson Memo*, which continues in force as the DOJ's statement of policy on charging corporations. The directive further notes that waiver review processes may vary from district to district, so that each U.S. Attorney will retain the prosecutorial discretion to determine how best to seek "timely, complete, and accurate information from business organizations." *Id.*



doing and its willingness to cooperate with the government's investigation may be relevant factors."<sup>7</sup> It goes on to explain that cooperation is multifaceted: "In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection."<sup>8</sup> Likewise, the *Thompson Memo* warns corporations that efforts to impede a government investigation or prosecution will count against them:

Another factor to be weighed by the prosecutor is whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction). Examples of such conduct include: overly broad assertions of corporate representation of employees or former employees; inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation including, for example, the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed production of records; and failure to promptly disclose illegal conduct known to the corporation.<sup>9</sup>

**b. Ethics and Compliance Programs**

As part of this emphasis on cooperation, the *Thompson Memo* also states that federal prosecutors will consider the quality and vitality of a company's compliance program:

Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all 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 conduct undertaken by its officers, directors, employees, or agents. Indeed, the commis-

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7. *Thompson Memo* at ¶ VI.A.

8. *Id.*

9. *Id.* at ¶ VI.B.

sion of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program.<sup>10</sup>

Companies will receive credit only if the programs are “designed for maximum effectiveness in preventing and detecting wrongdoing by employees” and if management enforces them rather than “tacitly encouraging or pressuring employees to engage in misconduct.”<sup>11</sup> A program that only exists “on paper” is simply insufficient.<sup>12</sup>

### c. Remediation

The *Thompson Memo's* final cooperation factor states that the government rewards companies’ “willingness to make restitution and steps already taken to do so.”<sup>13</sup> The remedial measures that a company takes, including disciplining employees and making full restitution, “says much about its willingness to ensure that such misconduct does not recur.”<sup>14</sup> Overall, it is the “integrity and credibility” of these measures that count.<sup>15</sup>

## 2. U.S. Sentencing Guidelines for Organizations

The U.S. Sentencing Guidelines for Sentencing of Organizations (“*USSG*” or “*Sentencing Guidelines*”) dovetail with the *Thompson Memo's* emphasis on cooperation and corporate compliance.<sup>16</sup> The introductory commentary explains that “[t]hese guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program.”<sup>17</sup>

Perhaps more so than the *Thompson Memo*, the *Sentencing Guidelines* place great emphasis on corporate compliance programs.<sup>18</sup> Section 8B2.1

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10. *Id.* at ¶ VII.

11. *Id.* at ¶ VII. B.

12. *Id.*

13. *Id.* at ¶ VIII.A.

14. *Id.* at ¶ VIII.B.

15. *Id.*

16. These *Sentencing Guidelines* are found in United States Sentencing Commission, *2006 Federal Sentencing Guidelines Manual*, Chapter Eight (Sept. 19, 2006), available at [www.uscc.gov/2006guid/tabcon06\\_1.htm](http://www.uscc.gov/2006guid/tabcon06_1.htm).

17. *USSG* ch. 8, introductory cmt.

18. See David Meister & Albert Berry III, *Revised Guidelines Stress Self-Audits*, Nat'l L.J., Mar. 21, 2005, at S1 (noting § 8B2.1 is the “centerpiece” of the revised Organizational Guidelines).

“sets forth the requirements for an effective compliance and ethics program.”<sup>19</sup> Amended in response to § 805(a)(5) of SOX, it institutes more rigorous criteria for compliance programs and places greater responsibility on directors and management to oversee these programs. Section 8B2.1(a) provides that in order “[t]o have an effective compliance and ethics program . . . an organization shall—(1) exercise due diligence to prevent and detect criminal conduct; and (2) otherwise promote an organizational culture that encourages ethical conduct and commitment to compliance with the law.” It then goes on to set forth seven steps of an effective management’s responsibilities to monitor the program.<sup>20</sup>

Section 8C2.5 sets forth the “culpability score” calculus that district judges are to consider in imposing fines, and it rewards companies that are considered to be, in effect, good corporate citizens. For example, subsection (f) provides for a downward departure if a company had in place an effective compliance program.<sup>21</sup> Subsection (g),<sup>22</sup> entitled “Self Reporting, Cooperation, and Acceptance of Responsibility,” provides for a downward adjustment of varying amounts if the organization self-reports wrongdoing, “fully cooperate[s] in the investigation,” and accepts responsibility for its actions.<sup>23</sup> The application notes clarify that

[t]o qualify for a reduction under subsection (g)(1) or (g)(2), cooperation must be both timely and thorough. To be timely,

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19. *USSG* § 8B2.1, cmt. background.

20. *Id.* at § 8B2.1(b).

21. *Id.* at § 8C2.5(f).

22. *Id.* at § 8C2.5(g) provides:

(1) If the organization (A) prior to an imminent threat of disclosure or government investigation; and (B) within a reasonably prompt time after becoming aware of the offense, reported the offense to appropriate governmental authorities, fully cooperated in the investigation, and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract 5 points; or

(2) If the organization fully cooperated in the investigation and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract 2 points; or

(3) If the organization clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct, subtract 1 point.

23. *Id.* *USSG* § 8C4.1 provides credit, similar to a *USSG* § 5K1.1 credit (“substantial assistance to authorities”), to a corporate defendant that “has provided substantial assistance in the investigation or prosecution of another organization that has committed an offense, or in the investigation and prosecution of an individual not directly affiliated with the defendant . . . .”

the cooperation must begin essentially at the same time as the organization is officially notified of a criminal investigation. To be thorough, the cooperation should include the disclosure of all pertinent information known by the organization. A prime test of whether the organization has disclosed all pertinent information is whether the information is sufficient for law enforcement personnel to identify the nature and extent of the offense and the individual(s) responsible for the criminal conduct. However, the cooperation to be measured is the cooperation of the organization itself, not the cooperation of individuals within the organization. If, because of the lack of cooperation of particular individual(s), neither the organization nor law enforcement personnel are able to identify the culpable individual(s) within the organization despite the organization's efforts to cooperate fully, the organization may still be given credit for full cooperation.<sup>24</sup>

Moreover, the Sentencing Guidelines punish, or provide for an upward departure, where a corporation obstructs justice and impedes a government investigation.<sup>25</sup>

In a significant development, the U.S. Sentencing Commission voted unanimously on April 5, 2006, to delete the following sentence from the application notes (which had been added to the notes only two years ago):

Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.

The proposed change took effect on November 1, 2006.

This action by the Sentencing Commission followed public hearings in March 2006 at which the Commission heard testimony urging repeal of the language in question. Also in March 2006, the House Judiciary Subcommittee on Crime, Terrorism and Homeland Security heard testimony from organizations urging Congress to use its oversight powers to restrain prosecutors from routinely seeking privilege waivers as part of corporate cooperation.

This amendment to the Guidelines commentary may relieve some of

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24. *Id.* at § 8C2.5, cmt. n.12 (emphasis added).

25. *Id.* at § 8C2.5(c).

the pressure that corporations have felt to waive privilege in connection with government investigations. At the same time, the *Thompson Memo*—including its discussion of waiver of privilege—remains in force as the Justice Department's statement of policy on charging corporations. Accordingly, unless parallel changes are made to the *Thompson Memo*, corporations will likely continue to be asked to waive the attorney-client privilege in order to minimize the risk of criminal prosecution.

### 3. Recent DOJ Statements

Recent statements by Justice Department officials reinforce this expectation of full and extensive cooperation. In a February 2005 speech, Christopher Wray, then the Assistant Deputy Attorney General for the Criminal Division, underscored that cooperation is both expected and must be “true” and “authentic”:

Our message on this point is two-fold: Number one, you'll get a lot of credit if you cooperate, and that credit can make the difference between life and death for a corporation. Number two, you'll only get credit for cooperation if it's *authentic*. You have to get all the way on board and do your best to help the Government.<sup>26</sup>

He explained that the bar has been raised both by the DOJ's increasing expectations and by companies that have successfully navigated and survived government investigations with “A+” cooperative efforts.<sup>27</sup> Wray volunteered that a company that promptly discloses problems will receive credit, but a company that at first tries to “lay low” is less likely to receive a break from the government.<sup>28</sup> David Kelley, then the U.S. Attorney for the Southern District of New York, in fact implied that companies that impede governmental investigations will be punished: “Those who do not respond fully and truthfully, or who willfully turn a blind eye to protect a business relationship, will face the risk of criminal prosecution and conviction.”<sup>29</sup>

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26. Wray, *ABA Remarks*, n.182 in Report above (emphasis in original).

27. *Id.*

28. *Id.*; see also George J. Terwilliger III, *Responding to Investigations*, Nat'l L.J., Aug. 15, 2005, at 13 (“Failure to cooperate can harden prosecutors' attitudes significantly and render a bad situation even worse.”).

29. U.S. Attorney's Office, S.D.N.Y., Press Release, *Nine Individuals Charged for Submitting False Audit Confirmation Letters to Ahold Subsidiary U.S. Foodservice* (Jan. 13, 2005), available at <http://www.usdoj.gov/usao/nys/pressreleases/january05/aholdvendorpressrelease.pdf>.

Further reflecting the trend of crediting cooperation, many companies subject to federal criminal investigations have negotiated deferred prosecution and even non-prosecution agreements.<sup>30</sup> These “alternative resolutions” can “work to ensure that companies accept responsibility and cooperate” with the government.<sup>31</sup> While such “pretrial diversion” had been offered to companies in the past, there has been a noticeable increase in its use since the Thompson Memo explicitly announced the government’s preference for corporate cooperation and implementation of compliance programs.<sup>32</sup>

#### 4. Summary

Thus, the Department of Justice and the U.S. Sentencing Commission both reward and expect cooperation with federal prosecutors. Significant credit is given to organizations that get the facts out and aid the government in its investigations, and that have instituted compliance and ethics procedures. Failure to cooperate may increase the likelihood of criminal charges being brought and more severe penalties being pursued.<sup>33</sup>

### B. Securities and Exchange Commission

#### 1. Seaboard Report

On October 23, 2001, using its authority under Section 21(a) of the Securities Exchange Act of 1934, the SEC issued a “Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions.”<sup>34</sup>

30. See generally Steven R. Peikin, *Deferred Prosecution Agreements: Standard for Corporate Probes*, N.Y.L.J., Jan. 31, 2005, at 4; Alan Vinegrad, *Deferred Prosecution of Corporations*, N.Y.L.J., Oct. 9, 2003, at 4.

31. Wray, *ABA Remarks*, n.182 in Report above.

32. See Peikin, *Deferred Prosecution Agreements*, n.30 above (“A sea-change in the use of DPAs in corporate cases can be traced to January 2003,” when the *Thompson Memo* was issued.); see also, e.g., U.S. Attorney’s Offices, E.D.N.Y., S.D.N.Y., Press Release, *The Bank of New York Resolves Parallel Criminal Investigations Through Non-Prosecution Agreement with the United States* (Nov. 8, 2005) (stating non-prosecution agreement was result of “BNY’s acceptance of responsibility, continued cooperation, remedial measures, and agreement to compensate victims of its unlawful conduct”), available at <http://www.usdoj.gov/usao/nys/pressreleases/November05/BankNYnonprosecutionagreementpr.pdf>.

33. See E. Lawrence Barcella, Jr., Kirby D. Behre, & James D. Wareham, *Cooperation with Government is a Growing Trend*, Nat’l L.J., July 19, 2004, at S2 (noting “emerging trend in the prosecution and defense of corporate crime: Cooperating with the government—not by choice—is often the only road to survival for both corporations and their executives.”).

34. SEC Rel. No. 34-44969, 76 SEC Docket 220 (Oct. 23, 2001) (“*Seaboard Report*”). Section 21(a) of the 1934 Act authorizes the Commission to issue a report of investigative findings if it determines that an enforcement action is not warranted.

*The Seaboard Report*, as it is known, reaffirmed and clarified the Commission's policy of giving credit to companies for "self-policing, self-reporting, remediation" of misconduct, and "cooperation" with SEC investigations.<sup>35</sup> The report presents the Commission's formal framework for approaching corporate cooperation.

The *Seaboard Report* arose out of the SEC's investigation of Chestnut Hill Farms, a division of the Seaboard Corporation. The Report announced a settled administrative proceeding against the controller of Chestnut Hill Farms, whom the Commission determined had misstated certain assets and expenses in the company's financials. While the SEC entered a cease-and-desist order against the controller, it explained that it would not be taking action against Seaboard, the parent company. The Commission then took the extraordinary step of explaining *why* it did not bring charges against the company and then laid out the criteria it would consider in deciding whether to charge companies that cooperate.

Before outlining the specific factors it would weigh, the Commission included three caveats to its general approach. "First, the paramount issue in every enforcement judgment is, and must be, what best protects investors."<sup>36</sup> Second, the SEC explained that it will approach cooperation on a case-by-case basis; the guidelines are not rules or commitments, and they do not "confer[] any 'rights' on any person or entity."<sup>37</sup> Third, the Commission underscored that the factors the report laid out are not exhaustive and do not establish a safe harbor from enforcement proceedings.<sup>38</sup> It also emphasized that cooperation is essential to the Commission's overall enforcement mission because it conserves the SEC's resources.<sup>39</sup>

Next, the SEC set forth thirteen factors that it would consider in determining whether to award "credit for self-policing, self-reporting, remediation[,] and cooperation."<sup>40</sup> These factors can be divided into roughly four categories: (1) the nature, level, and impact of the misconduct; (2) the amount of self-policing and self-reporting by the company; (3) any internal remedial measures adopted in response to the misconduct; and (4) cooperation with law enforcement and regulatory investigations. The *Seaboard Report* highlighted the central role of an effective internal inves-

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35. *Id.*

36. *Id.* at 2.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 2-4.

tigation in discussing the criteria that the Commission would consider in assessing a corporation's cooperation:

Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?<sup>41</sup>

## **2. Evolution of *Seaboard*: Punishing Efforts that Impede Investigations**

As noted, the *Seaboard Report* exists as the Commission's stated policy regarding cooperation. In the view of some practitioners, however, the SEC's enforcement program has evolved to a point of appearing in some cases to affirmatively punish companies for inadequate cooperation.

For example, in a May 2004 press release announcing its \$25 million settlement with Lucent, the SEC underscored that its decision to sanction the company (in addition to the individual wrongdoers) was based on Lucent's "lack of cooperation."<sup>42</sup> Similarly, Banc of America agreed to a settled a cease-and-desist order that made findings of, among other things, inadequate responses to document requests that had the effect of impeding the SEC staff's investigation and delaying their investigatory work.<sup>43</sup>

Furthermore, SEC officials have admonished companies that efforts to interfere with Staff investigations will be punished. Associate Director of Enforcement Paul Berger explained that "[c]ompanies whose actions delay, hinder[,] or undermine SEC investigations will not succeed. Stiff sanctions and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interests of investors."<sup>44</sup> Likewise, then Enforcement Director Cutler commented, "Any ef-

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41. *Id.* at 3-4.

42. SEC Press Release 2004-67, *Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud* (hereinafter, "SEC Press Release 2004-67"), available at <http://www.sec.gov/news/press/2004-67.htm>.

43. See *In re Banc of America Securities LLC*, SEC Rel. No. 34-49386, 82 SEC Docket 1264 (Mar. 10, 2004).

44. SEC Press Release 2004-67, n.42 above.



fort to impede an SEC investigation may itself become the subject of an enforcement proceeding."<sup>45</sup> And, on multiple occasions, Cutler stressed that the "integrity of the investigative process" is sacred and a complementary goal to cooperation.<sup>46</sup> Former SEC General Counsel Prezioso has also warned that independent investigations "are worse than useless if conducted ineffectively."<sup>47</sup>

### 3. Sanctions

Coupled with this evolving expectation of cooperation is the SEC's escalation of the level of monetary penalties. In an April 2004 speech, Cutler explained that the SEC's approach to fines had changed: "We're clearly in the midst of an evolution, if not a revolution in thinking. In a decade, we've gone from a regime in which monetary penalties were imposed only rarely to one in which large penalties seem to be part of virtually all significant settlements."<sup>48</sup> He also noted that the SEC now "start[s] with the *presumption* that any serious violation of the federal securities laws should be penalized with a monetary violation."<sup>49</sup> While sanctions of more than \$10 million were considered large only a few years ago, hundred-million-dollar penalties are now not uncommon. Thus, the incentives to cooperate, and the costs of not cooperating have increased dramatically.

On January 4, 2006, acting unanimously, the SEC issued a Statement Concerning Financial Penalties, setting forth the factors it will consider in deciding whether and how to impose penalties in enforcement actions against corporations.<sup>50</sup> The Statement identifies two principal considerations that will guide the SEC's determination whether a corporate penalty is appropriate: (1) [t]he presence or absence of a direct benefit to the corporation as a result of the violation, and (2) the degree to which the penalty will recompense or further harm the injured shareholders.

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45. Kathleen Day, *SEC Gets Tough on Hindering Investigations*, Wash. Post, Mar. 19, 2004, at E1 (quoting Cutler).

46. Cutler, *UCLA Speech*, p. 49 in Report above; see also Cutler, *Remarks Before D.C. Bar*, n.177 in Report above.

47. Prezioso, *Vanderbilt Remarks*, n.176 in Report above.

48. Stephen M. Cutler, Speech at 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), available at <http://www.sec.gov/news/speech/spch042904smc.htm>.

49. *Id.* (emphasis added).

50. SEC Press Release No. 2006-4, *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, available at <http://www.sec.gov/news/press/2006-4.htm>.

The January 4 Statement also highlights seven additional factors that will bear upon the decision whether to impose a corporate penalty: (1) the need to deter the particular type of offense charged in the proceeding; (2) the extent of the 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) the presence or absence of remedial steps taken by the corporation; and (7) the extent of cooperation with the SEC and other law enforcement agencies shown by the corporation.

Thus, the SEC continues to identify cooperation as a factor that will be considered in the process of determining sanctions. It remains to be seen, through the development of future cases, whether the weight attached to cooperation will change and whether the Commission will continue to impose civil money penalties at the recent, escalated levels.

#### **4. Culture of Compliance**

Finally, the SEC has underscored the importance of instilling a culture of compliance in companies. Then SEC Chairman William H. Donaldson suggested that the first priority of any Board of Directors should be to fix the company's "moral compass" and define the ethical standards that make up the "corporation's DNA."<sup>51</sup> Furthermore, Cutler has directly compared the Seaboard Report's concern with a culture of compliance with the parallel emphasis found in the Thompson Memo and the Sentencing Guidelines.<sup>52</sup> Like Donaldson, Cutler noted that it is important that directors and executives set the "tone at the top," and that means "[y]ou've got to talk the talk; and you've got to walk the walk."<sup>53</sup> Every company must have a strong culture of ethics that is communicated to employees, and every company and employee must live by this code.

### **C. New York Stock Exchange**

#### **1. Cooperation Memo**

On September 14, 2005, the NYSE issued its "Cooperation Memo" to all member firms detailing the Exchange's position on cooperation.<sup>54</sup> Like

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51. William H. Donaldson, Remarks at 2003 Washington Economic Policy Conference (Mar. 24, 2003), available at <http://www.sec.gov/news/speech/spch032403whd.htm>.

52. See Stephen M. Cutler, *Tone at the Top: Getting it Right*, Speech at Second Annual General Counsel Roundtable, (Dec. 3, 2004), available at <http://www.sec.gov/news/speech/spch120304smc.htm>.

53. *Id.*

54. See Susan Merrill, Exec. V.P., NYSE Div. of Enforcement, NYSE Information Memo No.

the SEC and Justice Department, the NYSE rewards cooperation. In the NYSE's view, its member firms are obligated both to (1) "cooperate with Exchange reviews, examinations[,] and investigations," and (2) "provide disclosure to the Exchange of, among other things, violations of the rules of the Exchange or the federal securities laws."<sup>55</sup> The Memo further explains that reduced sanctions are available to those firms exhibiting "exceptional or extraordinary cooperation."<sup>56</sup> As NYSE Regulation spokesman Scott Peterson commented, the Exchange's policies are "something new" and they are different from the disclosure requirements owed to the SEC.<sup>57</sup> He explained, "We saw a need to highlight those differences, and wanted, at the same time, to be more transparent about our approach to awarding credit for extraordinary cooperation."<sup>58</sup>

Under these twin affirmative duties of cooperation and disclosure, "the Exchange expects those who belong to the Exchange community to provide complete information promptly and in a straightforward manner."<sup>59</sup> Such disclosure of wrongdoing should be "full, accurate, comprehensible[,] and timely," and the Memo cautions members not to interfere with Exchange investigations. The Exchange also expects "active participation without evasion or delay."<sup>60</sup> Moreover, it clarifies that "parties to an investigation are not entitled to dictate the terms or conditions under which it will proceed."<sup>61</sup> In other words, the NYSE requires any member firm under investigation to open its doors to regulators and follow the Exchange's directions. The Memo states in no uncertain terms that failure to fulfill these duties will lead to charges being brought: "Where obligations of disclosure and cooperation are not met . . . Enforcement stands ready to protect the market and the investing public by bringing charges for these violations and seeking the appropriate sanctions."<sup>62</sup>

NYSE Memo 05-65 indicates that credit will be given for "extraordi-

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05-65 (Sept. 14, 2005) ("NYSE Memo 05-65"), available at <http://apps.nyse.com/commdata/PubInfoMemos>.

55. *Id.*

56. *Id.*

57. Kip Betz, *Big Board Memo Says Firms Can Lessen Sanctions Via Cooperation*, Sec. Reg. & L. Rep. (Sept. 19, 2005) (quoting Peterson).

58. *Id.*

59. NYSE Memo 05-65, n.54 above.

60. *Id.*

61. *Id.*

62. *Id.*

nary cooperation.”<sup>63</sup> “Only where a respondent can demonstrate a record of disclosure and cooperation that is *proactive and exceptional* may these serve as mitigating factors.”<sup>64</sup> While the Memo notes that each case is different, it lays out eight factors the Exchange will weigh in considering whether to award extraordinary cooperation credit: (1) prompt, full disclosure of possible misconduct coupled with thorough internal review; (2) candor with the Exchange about the facts; (3) waiver of attorney-client privilege; (4) the breadth, depth, and timeliness of remedial action taken by the firm; (5) cooperative responses to investigative requests; (6) aiding the limited jurisdiction of the Exchange; (7) the presence of a culture of compliance; and (8) partnering with the Exchange to uncover wrongdoing.<sup>65</sup>

Like the SEC and other government agencies, the Exchange rewards cooperation in part to leverage its own limited resources by benefiting from member firms' own internal investigative efforts. But NYSE Memo 05-65 explained that the level of cooperation “is not the only determinant” and that other factors will be considered, such as the type of wrongdoing, customer harm, the length of the violation, and prior problems.<sup>66</sup>

## 2. Sanctions Memo

On October 7, 2005, the NYSE issued a statement on sanctions.<sup>67</sup> Entitled “Factors Considered by the New York Stock Exchange Division of Enforcement in Determining Sanctions,” the statement asserts that the securities industry has “undergone an evolution” in recent years and that the “deterrent effect” of the Exchange’s sanctions was no longer sufficient.<sup>68</sup> This emphasis on enhanced penalties mirrors the trends of the SEC and Justice Department.

To provide guidance to member firms, the NYSE Memo 05-77 sets forth a non-exclusive framework that the NYSE will follow in making punishment decisions. The factors include: (1) the nature of the misconduct; (2) the harm caused by the wrongdoing; (3) the extent of the misconduct; (4) the respondent’s prior disciplinary record; (5) acceptance of responsibil-

63. *Id.* (emphasis added).

64. *Id.* (emphasis added).

65. *Id.*

66. *Id.*

67. See Susan Merrill, Exec. V.P., NYSE’s Div. of Enforcement, NYSE Information Memo 05-77 (Oct. 7, 2005) (“NYSE Memo 05-77”), available at <http://apps.nyse.com/commdata/PubInfoMemos>.

68. *Id.*

ity; (6) the implementation of corrective measures; (7) deceptive conduct; (8) disregarding of "red flags"; (9) the effectiveness of the firms supervisory and compliance programs; (10) the size and resources of the respondent; (11) the training of the respondent; (12) reliance on professional advice; (13) discipline from other regulators; and, last but not least, (14) *extraordinary cooperation*.<sup>69</sup> Hence, the themes of cooperation, disclosure, and compliance that affect charging decisions exist in the sanctioning arena as well.

### 3. NYSE Corporate Governance Standards

On November 3, 2003, the SEC approved the NYSE's proposed amendments to its corporate governance rules set out in Section 303A of the NYSE Listed Company Manual. Some of these rule changes significantly enhance the role of Audit Committees. While not directly tied to the increasing emphasis on cooperation with government authorities, these amendments reflect the NYSE's commitment to strong corporate governance and compliance and make up a part of the overall regulatory landscape.

The NYSE now requires that a majority of a company's Board of Directors be independent.<sup>70</sup> All listed companies must also have an Audit Committee that satisfies Rule 10A-3 of under the 1934 Act,<sup>71</sup> which Rule states that all Audit Committee members must be independent and that the Committee is responsible for appointing and overseeing the company's outside auditor.<sup>72</sup> All Audit Committee members must be "financially literate . . . or must become financially literate within a reasonable period of time after his or her appointment to the audit committee," and "at least one member . . . must have accounting or related financial management expertise."<sup>73</sup> The Audit Committee is required annually to obtain and review a report from the outside auditors that details, among other things, the company's "internal quality-control procedures," any issues these procedures have raised, as well as any "inquiry or investigation by governmental or professional authorities" within the last five years.<sup>74</sup> Moreover, the committee is charged with discussing the company's risk-assessment

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69. *Id.* (emphasis added).

70. NYSE Listed Company Manual, *Corporate Governance Standards* § 303A.01 (2004).

71. *Id.* at § 303A.06.

72. 17 C.F.R. § 240.10A-3.

73. NYSE Listed Company Manual § 303A.07(a).

74. *Id.* at § 303A.07(c)(iii)(A).

and risk-management policies,<sup>75</sup> meeting with the outside auditors,<sup>76</sup> “review[ing] with the independent auditor any audit problems or difficulties and management’s response,”<sup>77</sup> and meeting with the full Board.<sup>78</sup> In addition, all listed companies are required to disclose and adopt corporate governance guidelines,<sup>79</sup> as well as business conduct and ethics policies.<sup>80</sup> Further “[e]ach listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.”<sup>81</sup>

#### **D. Auditors**

Another important force in play in today’s regulatory and enforcement landscape is the outside auditor. Whereas the federal government and market regulators wield carrots and sticks that encourage companies to cooperate, the independent audit firms have also pushed companies to self-report problems and conduct internal investigations.

Auditors have a statutory duty to report illegal acts to management and the Board, and, if necessary, to the SEC. Section 10A(b) of the 1934 Act establishes a reporting and disclosure framework that outside auditors must follow when they become aware of information indicating possible wrongdoing.<sup>82</sup> When an auditor first discovers evidence of a suspected violation during an audit, it must promptly inform management and the Audit Committee.<sup>83</sup> After informing the Audit Committee, if the auditor determines that (1) the illegal act has a “material effect” on the financial statements, (2) senior management has not taken, or the Board has not caused management to take, “appropriate remedial action,” and (3) “the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement,” then the auditor must apprise the Board of its conclusions.<sup>84</sup>

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75. *Id.* at § 303A.07(c)(iii)(D).

76. *Id.* at § 303A.07(c)(iii)(E).

77. *Id.* at § 303A.07(c)(iii)(F).

78. *Id.* at § 303A.07(c)(iii)(H).

79. *Id.* at § 303A.09.

80. *Id.* at § 303A.10.

81. *Id.* at § 303A.12.

82. 15 U.S.C. § 78j-1.

83. *Id.* at § 78j-1(b)(1).

84. *Id.* at § 78j-1(b)(2).

Within one business day of receiving an auditor's report, the Board must notify the SEC of the problem and provide the auditor with a copy of the notice given to the SEC. If the auditor does not receive this notice within the one-day period, then the auditor is required to either (1) "resign from the engagement," or (2) provide the Commission with a copy of the report it prepared.<sup>85</sup> If the auditor chooses to resign, it still must furnish the SEC with its report.<sup>86</sup>

Although Section 10A imposes an escalating reporting requirement on auditors, it is exceedingly rare that the SEC actually learns of corporate wrongdoing from the auditor because of a company's failure to take remedial action. Rather, the Section 10A reporting-out mechanism exists as a last resort. When an auditor becomes aware of suspected wrongdoing, it will often insist that the company conduct an internal investigation, usually at the direction of the company's Audit Committee. This internal review, in turn, can lead to a company's self-reporting and cooperating with the government. Given the requirements of Section 10A and the regulatory expectations in this area, audit firms have used their ability to withhold or qualify audit opinions to induce companies to conduct investigations, institute remedial measures, and even to alter management. In situations where a Section 10A investigation has been undertaken and evidence of an illegal act has been detected, audit firms often will demand that any potential problems be examined and resolved before they are willing to issue their report on the company's financial statements.

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85. *Id.* at § 78j-1(b)(3).

86. *Id.* at § 78j-1(b)(4).