ETHICAL ISSUES IN EXECUTIVE COMPENSATION

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State Bar of Texas
EXECUTIVE COMPENSATION COURSE
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CHAPTER 7
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**Areas of Practice**

As a partner in the firm's Labor and Employment Department, Mike's practice primarily consists of defending employers in employment-related litigation and providing counseling to avoid such lawsuits. Mike has represented clients before the state and federal courts in Texas, the federal courts in New Mexico, and before the various administrative agencies in El Paso and the Southwest region. He has successfully tried numerous cases to verdict in employment suits involving alleged discrimination, retaliation and compensation issues. Mike has been a guest lecturer on employment law issues at the University of Texas at El Paso Center for Professional Development and for the UTEP Franchise Center program. He has spoken regularly at the State Bar of Texas Advanced Labor and Employment Law course and has also been a presenter on several occasions at the State Bar's Advanced Civil Trial course. He serves as the Firm's managing partner.

**Professional Affiliations**

- State Bar of Texas (Former Chair, Executive Council, Labor & Employment Law Section)
- American Bar Association (Labor and Employment Law Section)
- El Paso Bar Association
- Society for Human Resource Management
- El Paso Society for Human Resource Management

**Bars & Courts**

- Texas, 1976
- U.S. District Court, Western District of Texas
- U.S. District Court, Southern District of Texas
- U.S. District Court, District of New Mexico
- U.S. Court of Appeals, Fifth Circuit
- U.S. Court of Appeals, Tenth Circuit

**Education**

- Southern Methodist University, B.A., 1973
- University of Texas School of Law, J.D., *cum laude*, 1976 (Order of the Coif)

**Professional and Civic Involvement**

Mike is a former Chair of the Executive Council of the State Bar of Texas Labor and Employment Law Section. He was named Outstanding Young Lawyer of El Paso in 1983 and is listed in the Best Lawyers in America. Mike was named one of the 16 "Go To Labor and Employment Attorneys" in the State of Texas by The Texas Lawyer and in 2003 - 2007 has been recognized as a "Texas Super Lawyer" by the publishers of Texas Monthly and Law & Politics. Mike was recently named the 2007 Professional of the Year by the El Paso Society for Human Resource Management. He is on the Boards of Directors of the El Paso Downtown Management District, the El Paso Central Business Association, and the Greater El Paso YMCA, and serves as President of El Paso Pro-Musica which brings the world of Chamber Music to the border region. A decent golfer, he serves as General Counsel of the El Paso Country Club.

**Certifications**

- Board Certified, Labor and Employment Law -Texas Board of Legal Specialization
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ETHICAL ISSUES IN EXECUTIVE COMPENSATION

In negotiating executive compensation, where both the executive and the employer are represented by their own counsel, the possibility for a conflict of interest on either attorney’s part is virtually eliminated, at least with regard to negotiation of the agreement. Where one side or the other is not represented, however, the potential for conflicts of interest, both with regard to the agreement and to future representation may come into play. This paper examines some of the situations in which one party claimed an attorney representing the other side breached ethical duties or was disqualified from representing them in a future dispute because the lawyer inadvertently created an attorney-client relationship with or other duty owing to that party.

I. WHO IS THE CLIENT?

While the answer to this question would normally appear very obvious, in the context of dealing with executives, the line can sometimes become blurred because an entity like a corporation can only act through the people it engages as directors, officers, employees and agents. This is particularly true in the context of small, closely held businesses. The fact pattern described in the Oregon Supreme Court’s opinion in In Re Banks, 584 P.2d 284 (Ore. 1978) arises more often than might be suspected. Banks was a disciplinary action against two partners in a law firm, one a business lawyer and the other a litigator. The company involved was a family owned business whose shareholders, in equal percentages, were the patriarch of the family, his wife and their two daughters. For all intents and purposes, however, the business was operated as the alter ego of its founder, the patriarch. The business lawyer had prepared an employment agreement for the patriarch as president and did trust and estate work for him and the family. Under the agreement, the profits of the business essentially flowed to the patriarch in the form of bonuses. No dividends were declared for the other shareholders. When the business fell on hard times (and the patriarch apparently became physically abusive in addition to running the company as if it were his own), the patriarch’s family revolted and created a voting trust which elected a new, non-family board of directors. The new board put the patriarch on leave of absence. The two attorneys continued to represent the company and the litigator counseled the new board that certain conduct by the patriarch was a violation of the employment agreement his partner had previously drafted (at the instructions of the patriarch). The court issued a reprimand to the attorneys, concluding that during the time when no conflict existed, they had represented the patriarch as an individual as well as representing the corporation. Consequently, they should not have continued to represent the corporation regarding issues arising out of an agreement which a member of their firm had prepared on behalf of both clients. The court noted, as discussed later in this paper, the principle that a law firm representing a corporation does not represent its officers, directors or shareholders individually, but concluded that, in this particular set of circumstances, the firm had represented both the corporation and the patriarch.

In the context of executive employment agreements, the attorney drafting the agreement is often the counsel for the employer, but acting at the direction of an executive of the company, perhaps even the executive to be covered by the agreement. The executive either does not perceive the need for independent counsel or, as in the Banks case, is the person who effectively acts on behalf of the employer and has hired the attorney to prepare the agreement for the employer. Due to the individual’s domination of the employer entity, the drafting attorney is effectively looking to the executive employee for the employer perspective on the agreement. Although an argument may be made in such circumstances that the positions of the executive and the entity are aligned, they may later be challenged to be the contrary. When the interests of the executive and the entity become separate and distinct, the ethical dilemma of the attorney placed in such a situation becomes apparent and can subject the attorney to disqualification or disciplinary action. Comment 4 to Rule 1.06 of the Texas Disciplinary Rules of Professional Conduct provides as follows:

There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyers should advise any constituent, whose interest the lawyer finds adverse to that of the organization, of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care should be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged insofar as that individual is concerned. Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

Attorneys bear a “highly fiduciary” duty to their clients. Willis v. Maverick, 760 S.W.2d 642, 645 (Tex. 1988);
A. The Attorney-Client Relationship is Contractual, but the Contract may be Implied


Where both the attorney and the client believe there is an attorney-client relationship, however, one will be found. *In re Epic*, 985 S.W.2d 41, 49 (Tex. 1998). In that case, attorneys in a law firm had, among other things, prepared employment and stock appreciation rights agreements for the chief executive of a newly formed, spin-off company. After the law firm later dissolved, several of those attorneys were members of firms who sued the executive and the company's directors for actions, including excessive compensation, taken to the detriment of the company's shareholders. The Texas Supreme Court found that the admission by the executive and the attorney that the attorney was representing the executive as well as the company in the preparation of such agreements justified the disqualification of the attorneys' new firms.

B. Payment of Fees is Not Determinative

Although the implied contract necessarily must include an agreement that the attorney will receive compensation for his or her work, an attorney-client relationship is not dependent on the payment of a fee. *Simpson v. James*, 903 F.2d 372, 376 (5th Cir. 1990) (citing *State v. Lemon*, 603 S.W.2d 313, 318 (Tex.App. - Beaumont 1980, no writ) and *Prigmore v. Hardware Mut. Ins. Co.*, 225 S.W.2d 897, 899 (Tex.App. - Amarillo 1949, no writ). Nor does the non-payment of a fee or the payment of such fees by a third party conclusively determine the absence or existence of an attorney-client relationship. *In re Epic*, supra.

In *Perez v. Carrigan*, 822 S.W.2d 261, 265 (Tex.App. - Corpus Christi 1991, writ denied), the attorneys were hired and paid by an insurance company, but told Perez they represented him as well as his employer. The court held that an attorney-client relationship could exist even if the services were rendered gratuitously. On the other hand, even where the purported client actually paid the attorney, the relationship might not be found to exist, as in *SMWNPF Holdings, Inc. v. DeVore*, 165 F.3d 360, 367 (5th Cir. 1999), where the Court held as follows:

[i]he fact that Holdings paid the fees is irrelevant to a determination whether Holdings was represented by [the attorneys]. The agreement was for Holdings to pay the attorneys' fees, just as a borrower often pays a lender's fees; in neither case does a presumption arise that the party paying the fees is a client of the attorney's.

C. Question of Fact for the Fact Finder

Ultimately, unless conclusively established one way or the other, the existence of an attorney-client relationship will be a decision made by the finder of fact. *Tanox, Inc. v. Akin, Gump, Strauss, Hauer & Feld*, 105 S.W.3d 244, 254 (Tex.App. - Houston [14th Dist.] 2003, pet. denied); *Lemaire v. Davis*, 79 S.W.3d 592, 600 (Tex.App. - Amarillo 2002, pet. denied) (reviewing instructions accompanying submission of the question to the jury).

Clearly, the preferred course for counsel drafting executive employment or compensation agreements would be to have the executive obtain separate and independent representation. In the absence of such representation, however, counsel for the employer should notify the executive, in writing, exactly who counsel represents in preparing the agreement. Rule 1.12 of the Texas Disciplinary Rules of Professional Conduct provides, in pertinent part, as follows:

(a) A lawyer employed or retained by an organization represents the entity....
(e) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing or when explanation appears necessary to avoid misunderstanding on their part.

Although the preparation of an executive employment or compensation agreement may not lend itself to characterization as “adverse,” it can certainly become a situation where explanation would appear necessary to avoid misunderstanding on the part of the executive regarding whom the attorney represents in preparing the agreement. A simple letter or memo to the executive from counsel at the outset of the process will go a long way to alleviating the types of situations occurring in the cases previously cited.

II. DUTIES TO NON-CLIENT

Even if the attorney preparing the executive employment or compensation agreement has made it clear to the executive that he represents only the entity, he may find he still owes a duty to the executive or may be prevented from representing the entity in matters relating to the agreement.

A. The “Mere Scrivener"

Occasions may arise where the attorney is engaged to prepare documentation where his or her role may appear to be, or is represented by the parties to be, simply putting an agreement independently negotiated by two parties on paper, without representing either side. An attorney-client relationship is not created when an attorney is hired in a non-legal capacity. Certainly no attorney-client relationship would be involved where an attorney contracted to drive someone's car as a chauffeur, for example, even though he possessed a license to practice law. Nor would a person engaged to write a biography be considered to have created an attorney-client relationship by developing or drafting the manuscript. Where an attorney is engaged simply to draft an instrument, but is not asked to provide advice regarding that instrument, at least one court has suggested no attorney-client relationship is established and that the attorney can indeed be a “mere scrivener.” In re Bivins, 162 S.W.3d 415, 419-420 (Tex.App. - Waco 2005, no pet.).

In Bivins, the attorney, Pettigrew, was engaged to prepared a deed conveying certain property from his client to the client's son. Although the son paid the legal fees, he did not contest that Pettigrew only represented the father when preparing the deed. Nevertheless, when the community or separate nature of the property which was the subject of the deed became a contested issue between the son and his wife in a divorce proceeding, the court disqualified Pettigrew from representing the son's wife. After recognizing the possibility of an attorney serving as a mere scrivener, the Court of Appeals nevertheless upheld the disqualification, noting that although Pettigrew may have been engaged to be a mere scrivener, because the character of the property conveyed (as separate or community) was a contested issue in the divorce proceeding and the son testified he had confidential communications with Pettigrew during the deed transaction, Pettigrew was disqualified from representing the son's wife against the son in the divorce under Rule 1.05 and 1.09(a)(2) and (3). The communication of confidential information in the context of the preparation of the deed effectively created an attorney-client relationship and a duty owed by Pettigrew to the son, even though he had originally been engaged only to memorialize an already completed deal.

A similar argument was made by a party in the unreported case of In re McCormick, 2002 WL 31076557 (Tex.App. - Tyler 2002). There, the owner of an insurance agency had terminated the relationship of an independent sales agent for placing policies with carriers who the agency did not represent. The owner told the agent he would rehire him if they could agree on a means of preserving the owner's right to share in renewal premiums from those policies. They negotiated an agreement between themselves, without the assistance of counsel on either side. The owner then asked his attorney to prepare a written contract incorporating the terms of that agreement, including a non-competition clause, which he did. Several years later, the agent opened his own business and the agency owner's attorney sued for breach of the agreement. The suit was filed by the same attorney who prepared the agreement. The agent moved for disqualification, arguing that the attorney had been involved in a dual representation when preparing the agreement. The Court of Appeals found that the evidence on that issue was sufficiently conflicting that the trial court had not abused its discretion in denying disqualification. Although the facts are not detailed in this non-published opinion, there was apparently no argument made that the attorney had done anything more than prepare the document.

In the context of an executive employment or compensation agreement, the lesson of Bivins and McCormick is that counsel must be careful to avoid creation of an attorney-client relationship with the other party, even when he is told by his client that he is merely to reduce the agreement reached by the parties to writing. Any type of communication with the other party during the process of finalizing the agreement, either regarding the terms of the agreement itself or the factual situation underlying the agreement may later be alleged by that
party to have been a confidential communication or the 
 provision of advice regarding the agreement, thereby 
 creating an attorney-client relationship and preventing 
 the lawyer from a representation adverse to that party.

B. Preparation of Documents for a Third Party

Closely akin to the mere scrivener is the attorney 
 who, on behalf of a client, prepares documents for third 
 parties. One obvious example of this would be a lawyer 
 engaged by a financial institution to prepare or review 
 loan documentation between the institution and its 
 customer/borrower.

In Clarke v. Ruffino, 819 S.W.2d 947 (Tex. App. - 
 Houston [14th Dist.] 1991, writ dism’d w.o.j.), Lehtonen, 
 one of the parties to a lawsuit over interests in a piece of 
 property, sought to refinance the property. Legal 
 services connected with the refinancing were performed 
 by attorney Watson, who was apparently engaged to 
 prepare the paper work by the financial institution. The 
 borrower had no contact with Watson until the closing of 
 the refinance transaction, but at the closing Watson 
 reviewed the documents and transaction with him and 
 presented a bill for his services which Lehtonen paid.

Some time after that closing, the other party to the 
 lawsuit engaged Watson’s partner to prosecute the case 
 against Lehtonen. In upholding the disqualification of 
 Watson’s firm from handling the case, the court noted the 
 following:

Even if this was merely an accommodation or a 
 pro forma relationship, the disciplinary rules 
 do not permit a mere pro forma representation 
 of a client. 819 S.W.2d at 949-950, citing 
 Insurance Company of North America v. 
 Westergren, 749 S.w.2d 812, 815 (Tex. App. - 
 Corpus Christi 1990, mandamus overruled).

Unfortunately, counsel preparing executive employment 
 agreements or executive compensation agreements may 
 often find themselves in a comparable situation. For 
 example, the attorney might be asked by a client 
 company to prepare the employment or compensation 
 agreement for an executive employed by one of the client 
 company’s subsidiaries. Presented with a completed term 
 sheet and being told to present a bill, a lawyer in that 
 situation might well feel he is preparing the documents 
 merely as an accommodation to the client company, not 
 as the attorney for the executive. If, however, that 
 lawyer reviews and discusses the terms and effects of the 
 agreement with the executive, perhaps even without 
 being paid, an attorney-client relationship may be argued 
 to have been formed.

C. Negligent Misrepresentation

In McCamish, Martin, Brown & Loeffler v. F. E. 
 Appling Interests, 991 S.W.2d 787 (Tex. 1999), the 
 Texas Supreme Court held that Section 552 of the 
 Restatement (Second) of Torts, regarding negligent 
 misrepresentation could apply to an attorney and his 
 representations to a non-client. In that case, the law firm 
 had represented a savings & loan institution which settled 
 a lender liability claim with a borrower. Because the 
 savings & loan was on the brink of receivership, the 
 borrower was concerned that the settlement agreement 
 must be enforceable against the FSLIC. The borrower 
 insisted that the savings & loan's attorneys affirm that the 
 settlement agreement complied with the statutory 
 requirements for enforceability against the FSLIC. The 
 settlement agreement reflected that the savings & loan 
 “and its counsel” represented that the steps had been 
 taken to insure it could be enforced against the FSLIC, 
 setting forth each of those steps, including approval of 
 the settlement by the institution’s Board of Directors. As 
 it turned out, however, the savings & loan's Board of 
 Directors, which included a partner in the law firm, but 
 not the one working on the settlement, had ceded its final 
 authority over settlements several days before the 
 settlement agreement was signed. Consequently, the 
 FSLIC was able to successfully set aside the settlement.

The borrower sued the law firm for negligent 
 misrepresentation. The law firm defended on the 
 grounds that it owed no duty to the borrower because it 
 was not in privity with it, but only owed a duty to its 
 client, the savings & loan. It argued the privity 
 requirement extended to all negligence based causes of 
 action relating to legal work, whether characterized as 
 legal malpractice or as negligent misrepresentation.

The Texas Supreme Court decided to the contrary, 
 holding a non-client could sue an attorney under Section 
 552, even in the absence of an attorney-client 
 relationship. The Court opined that liability under the 
 negligent misrepresentation cause of action is based on 
 “an independent duty to the nonclient based on the 
 professional's manifest awareness of the nonclient's 
 reliance on the misrepresentation and the professional's 
 intention that the nonclient so rely. 991 S.W.2d at 792. 
 As part of its opinion, the Court did take pains to 
 distinguish an attorney's statements communicating a 
 client’s negotiating positions from statements of material 
 fact upon which suit might be brought.

The Court also noted that the third party’s reliance 
 would not be justified if the representation took place “in 
 an adversarial context.” 991 S.W.2d at 795. In doing so, 
 however, it cited Feinman, 31 Tort & Ins. L.J. at 750, for 
 the proposition that the characterization of the 
 relationship as adversarial or non-adversarial should turn, 
 at least in part, on “the extent to which the interest of the 
 client and the third party are consistent with each other.” 
 Id.

Since the preparation of executive employment and 
 compensation agreements does not generally take place 
 in an adversarial setting, but one in which the interest of
material facts (e.g., either party may be inclined to make representations of misrepresentation may exist in that context). Counsel for the employer and the executive are presumed to be consistent, the opportunity for a claim of negligent misrepresentation may exist in that context. Counsel for either party may be inclined to make representations of material facts (e.g., “the company is committed to staying in this community” or “the executive is in perfect health”) upon which they expect the other side to rely in reaching a final agreement.

The solution to avoiding possible liability under Section 552 may be as simple as insertion of a clause in the agreement disclaiming reliance by either party on representations made by the other party or its counsel which are not contained in the agreement. However, if the agreement does contain factual recitals, counsel must engage in some form of due diligence to insure they are accurate or at a minimum avoid any statement or inference that counsel is the one making the factual representation, rather than the party.

III. JOINT REPRESENTATION

Sometimes, rather than fighting the issue, counsel may simply want to acknowledge that his role in the preparation of an executive employment or compensation agreement effectively involves dual representation of both parties. This may be particularly true when the executive is the primary actor for the entity and they are perceived as being one and the same within and without the organization.

In Aguirre v. Reyna, et al., 2004 WL 53471 (Tex.App. - Corpus Christi 2004), an unreported case, the attorney involved, Talbert, represented both the seller and buyer of a piece of property. The seller and his family sued the purchaser and Talbert alleging a variety of torts, including fraud and negligence. The court upheld the granting of summary judgment in Talbert's favor against the seller's family, finding he owed them no duty since he had not represented them. The court noted the general rule that a lawyer’s professional duty does not extend to non-clients, even if they are the intended beneficiaries of the lawyer’s work, citing Barcelo v. Elliott, 923 S.W.2d 575, 579 (Tex. 1996). In the absence of any statements by Talbert that he was acting as their attorney or any reliance on him as their attorney by the family members, the court found the general rule applied. With regard to the seller himself, the court found that he had acquiesced in the dual representation by signing a dual representation agreement which essentially tracked the requirements of Disciplinary Rule 1.06(c) and provided, in part, as follows:

...Although it is not common for a lawyer to represent two (or more) parties in a transaction, a dual representation is permitted by professional ethics guidelines as long as two conditions are met. First, the lawyer must conclude, after a good faith self-evaluation, that he can adequately represent the interests of each client. The multiple representation should not adversely affect the lawyer’s independent professional judgment on behalf of any client. Second, all clients must consent to the dual representation after full disclosure by the lawyer.

In this transaction I have concluded that the first condition has been satisfied because I do believe that I can provide competent services to each of you (although I hope you will understand that we must reserve the right to withdraw from this dual representation if later events cause me in good faith to reach a different conclusion). This letter is intended to satisfy the second condition, that of disclosure and consent. Accordingly, I will confirm some of the possible effects that dual representation may have on you.

Conflicts of Interest. If I determine that, because of differences between the parties, I can no longer represent each of you impartially I will inform you of the conflict, and I must then withdraw from representation. If this occurs, I will no longer be able to represent any party to the dispute...

Scope of Employment. I am being hired solely to advise you on and document this real estate transaction. As part of this multiple representation, I am not responsible for and will not advise you on other transactions, nor will give either of you any kind of tax advice with respect to this transaction...[although I will] try to act as fairly as possible in judgment-call matters, it is certainly possible that one of you may not concur with my judgment...

...Of course, I would have declined the dual representation before now and thus would not even be giving you this disclosure if I had not already concluded that I can adequately represent both of you in this transaction; however, I also understand that you may feel differently. Therefore, I would appreciate your giving careful thought to the matters discussed in this letter [before signing it].

In light of the seller's signature on the dual representation agreement, the court upheld summary judgment for Talbert.

Use of a similar dual representation agreement may allow counsel to avoid any potential violation of
Disciplinary Rule 1.06. However, in the situation where counsel is obtaining the dual representation consent from an executive and the entity, the executive involved cannot be the one who consents on behalf of the entity, even if he is the one directing that the agreement be prepared on the entity’s behalf. Consent must be given by another appropriate official or the shareholders. Texas Disciplinary Rules of Professional Conduct 1.12, comment 5 provides as follows:

A lawyer representing an organization may, of course, also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.06. If the organization’s consent to the dual representation is required by Rule 1.06, the consent of the organization should be given by the appropriate official or officials of the organization other than the individual who is to be represented or by the shareholders.

IV. BRINGING IN A “STRAW LAWYER”

In order to avoid the potential conflict of interests between the entity and the executive, one might consider engaging a “straw lawyer” to nominally represent the other party (usually the executive). In doing so, however, the “straw lawyer” needs to be cognizant of his duties to the client or he will end up in an ethical dilemma himself.

Such was the case when Glenn Vickery enlisted fellow attorney, Dianne Richards, to represent his wife in a “friendly” divorce action. Their tale is memorialized in two disciplinary cases, Vickery v. Commission for Lawyer Discipline, 5 S.W.3d 241 (Tex.App. - Houston [14th Dist.] 1999, pet. denied) and Richards v. Commission for Lawyer Discipline, 35 S.W.3d 243 (Tex.App. - Houston [14th Dist.] 2000, no pet.). Basically, Vickery told his wife that they needed a “friendly” (read “sham”) divorce to protect their assets because he was being sued for malpractice for an amount which exceeded his policy limits. He asked Richards to file divorce papers for his wife, which Richards did, without meeting with or discussing the situation with the wife. Vickery had his wife send Richards a retainer. Vickery convinced his wife to sign a final decree, again on the basis of asset protection. A hearing was held at which Vickery appeared for himself and Richards for his wife. The wife was not aware of the hearing. The “friendly” divorce turned unfriendly very quickly, however, when following the final decree, Vickery married one of his wife’s friends and then had the wife evicted from their home. The Commission for Lawyer Discipline brought proceedings against Richards for neglecting a legal matter entrusted to her and for failing to explain the matter sufficiently so her client could make informed decisions regarding the representation. Richards was found to have failed to “reasonably fulfill client expectations for information consistent with the duty to act in the client’s best interests,” in violation of Disciplinary Rule 1.03.

Although this is obviously an extreme case, the principle would still apply to use of a “straw lawyer” to represent the executive in negotiation of an employment or compensation agreement. In order to fulfill his obligations to the executive, the lawyer cannot take a passive role and fail to communicate with or advise the executive without jeopardizing his own position and license.

V. DISQUALIFICATION FROM FUTURE REPRESENTATION

Another consideration when representing either the employer or the executive is the possibility that the attorney may be prevented from representing or suing the other party, due to either an unintended attorney-client relationship or the receipt of the other party’s confidential information.

If the lawyer for the entity is found to have entered into an attorney-client relationship with the executive in the preparation and execution of the agreement, he (and his firm) may be prevented from representing the employer in any action arising out of the agreement, such as enforcement of a confidentiality agreement or covenant not to compete. In re Roseland Oil & Gas, Inc., 68 S.W.3d 784, 787 (Tex.App. - Eastland 2001, no pet.). Rule 1.09(a) provides, in pertinent part:

(a) Without prior consent, a lawyer who personally has formerly represented a client in a matter shall not thereafter represent another person in a matter adverse to the former client:

(3) if it is the same or a substantially related matter.

Clearly, any action for breach of the employment or compensation agreement will be substantially related to the preparation of the same agreement. Comment (i) to Section 132 of the Restatement of the Law Governing Lawyers, however, indicates that counsel in an “accommodation” situation, where the lawyer represents a person as an accommodation to the regular client, may avoid later disqualification in a dispute between the two clients, even if related to the matter involved in the common representation, if the “accommodation” client understood and implicitly consented to the lawyer continuing to represent the regular client in the matter. In order to avail oneself in the argument provided by this section of the Restatement, an attorney should make the understanding of the “accommodation” client explicit by putting it in writing.

The risk of potential disqualification apply only to the lawyer representing the employer. In National
Medical Enterprises, Inc. v. Godbey, 924 S.W.2d 123 (Tex. 1996), the employer, NME, retained an attorney, Tomko, to represent a former regional administrator in connection with investigations into NME’s activities. When Tomko was hired to represent these individuals, he was a member of a law firm. During the representation, he left his original firm to join Baker & Botts. Tomko advised the administrator regarding criminal investigations into such activities and in responding to discovery in related civil suits. Tomko did not represent the administrator in any civil suit, however. Tomko also represented one of NME’s medical directors, also at NME expense. When representing the administrator and the medical director, Tomko and his clients were covered by a joint defense agreement with NME.

Tomko eventually withdrew from representation of the administrator and the medical director. Approximately seventeen months later, other lawyers at Baker & Botts, who had not worked with Tomko or the administrator or medical director, filed suit against NME on behalf of a large number of former patients. NME moved to disqualify the firm and the Supreme Court held that the firm must be disqualified, finding the patient lawsuits were substantially related to the investigations and actions involving the administrator. Even though Tomko had not actually represented NME (which would have immediately disqualified his firm), he had obtained confidential information of NME which he had agreed not to disclose under the joint defense agreement.

Importantly for the context under consideration in this paper, the Texas Supreme Court referenced Judge Posner’s opinion in Analytica, Inc. v. NPD Research, Inc., 708 F.2d 1263 (7th Cir. 1983). In that case, a lawyer who represented an employee in the structuring of a stock transaction between the employee and his corporate employer was disqualified from later suing the corporation. The disqualification was not based on the fact that the corporation had paid the lawyer’s fees for the employee or on any contention that the lawyer had developed an attorney-client relationship with the company. Instead, it was based on the fact that the corporation had furnished confidential financial, sales and management information to the lawyer during his representation of the employee for the stock transaction. The Seventh Circuit held the corporation “had a right not to see [the attorney] on the opposite side of a litigation to which that data [which it had previously shared with him in confidence] might be highly pertinent.” Id at 1269.

The Texas Supreme Court, in quoting this language, noted that the disqualification was not based on a former attorney-client relationship with the opposing party, but “on the attorney’s duty to the party to preserve its confidences.” 924 S.W.2d at 131.

The Texas Supreme Court had reached a contrary conclusion previously, where such confidential information was no longer confidential, in Metropolitan Life Insurance Company v. Syntek Finance Corporation, 881 S.W.2d 319 (Tex. 1994). There, a law firm had represented the principal of Syntek in a divorce proceeding and preparation of a pre-nuptial agreement which involved detailed knowledge of his personal financial status, including his various companies, one of which was Syntek. The same firm later defended Metropolitan against a suit by Syntek concerning a hotel which Syntek had purchased. During discovery, counsel for Metropolitan discovered that Syntek’s principal had stopped the loan payments at issue to Metropolitan and added allegations concerning the principal’s actions. Syntek then moved to disqualify the firm. The Supreme Court found the trial court had not abused its discretion in denying disqualification under Rule 1.09 (representation adverse to a former client in the same or a substantially related matter). Applying the test originally set forth in NCNB Tex. Nat’l Bank v. Coker, 765 S.W.2d 398, 400 (Tex. 1989), the Court held that the availability of the information at issue was in the public domain and had been provided to Metropolitan in discovery and also available in a bankruptcy examiner’s report against another company. Under these circumstances, the Court found no substantial relation between the divorce/pre-nuptial representation and the hotel suit which would reveal confidences (as it would later find in the NME case) and held the trial court had properly denied the motion to disqualify.

These cases illustrate that counsel engaged by an executive to represent him in the negotiation of an employment or compensation agreement must be cognizant that the more confidential financial information he obtains from the executive’s employer (or prospective employer for that matter), the more likely he and his firm may be disqualified from pursuing an action against the employer on behalf of others. Neither the NME opinion nor the Analytica court addressed whether disqualification would be necessary if the attorney involved was suing the employer on behalf of the employee who he had represented when obtaining the confidential information, although the logic underlying the holdings in those cases would seem to dictate that result.

VI. CONCERNS UNDER SARBANES-OXLEY

The Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7210 et seq., was passed in the wake of several corporate scandals to promote public confidence in publicly held corporations by requiring such entities to adopt and enforce codes of ethical conduct, protecting corporate whistleblowers and requiring that high level corporate executives take an active and accountable role in assuring the entity does not engage in illegal or unethical conduct. The Securities and Exchange Commission has issued rules which address the conduct of attorneys representing entities under SEC jurisdiction. A comprehensive review
of those rules is beyond the scope of this paper which will address only the possible impact of Sarbanes-Oxley on attorneys preparing executive compensation agreements.

A. Who is the Client?

At the outset, Sarbanes-Oxley makes it clear that the attorney representing the entity owes its duties to the entity and not to constituents such as officers, directors or employees. However, it is also clear that such entities may only act through such constituents. The generally accepted definition of the constituents who may speak on behalf of an entity, developed in the context of the prohibition of counsel against direct communications with someone represented by other counsel, is set forth in Texas Disciplinary Rule of Professional Conduct 4.02(c), as follows:

(c) For the purpose of this rule, “organization or entity of government” includes:

(1) those persons presently having a managerial responsibility with an organization or entity of government that relates to the subject of the representation, or (2) those persons presently employed by such organization or entity whose act or omission in connection with the subject of representation may make the organization or entity of government vicariously liable for such act or omission.

An expansion of this definition is found in Section 100 of the Restatement of the Law Governing Lawyers, identifying the following individuals as constituents whose communications are deemed to be the communications of the entity to include a current employee or agent:

a. if the employee or other agent supervises, directs or regularly consults with the lawyer concerning the matter or if the agent has power to compromise or settle the matter;
b. if the acts or omissions of the employee or other agent may be imputed to the organization for purposes of civil or criminal liability in the matter; or
c. if a statement of the employee or other agent, under applicable rules of evidence, would have the effect of binding the organization with respect to proof of the matter.

Counsel representing an entity in preparing executive employment or compensation agreements may rely on the listed constituents as speaking for the entity and as being the entity, until possible adversity between the constituent and the entity arises. Texas Disciplinary Rules of Professional Conduct 1.12 (a). Once such adversity exists, however, the obligations of the attorney under Sarbanes-Oxley and Rule 1.12 are similar.

B. Reporting illegal and unethical conduct

Rules promulgated by the SEC under Sarbanes-Oxley require an attorney who becomes aware of evidence of a material violation by an issuer or any officer, director, employee or agent of the issuer to report evidence of such violation to the issuer’s chief legal officer (or equivalent) or to both the issuer’s chief legal officer and chief executive officer. If the issuer has a “qualified legal compliance committee,” the attorney may report the evidence of a violation to that body. SEC Rule 205.3(b).

Similarly, Rule 1.12 of the Texas Disciplinary Rules of Professional Conduct, which obviously apply whether the entity is publicly held or not, provides as follows:

(b) A lawyer representing an organization must take reasonable remedial actions whenever the lawyer learns or knows that:

(1) an officer, employee, or other person associated with the organization has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization;
(2) the violation is likely to result in substantial injury to the organization; and
(3) the violation is related to a matter within the scope of the lawyer’s representation of the organization.

The actions which an attorney must take after making the report are likewise set forth in Rule 1.12(c):

(c) Except where prior disclosure to persons outside the organization is required by law or other Rules, a lawyer shall first attempt to resolve a violation by taking measures within the organization. In determining the internal procedures, actions or measures that are reasonably necessary in order to comply with paragraphs (a) and (b), a lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such
matters, and any other relevant considerations. Such procedures, actions and measures may include, but are not limited to, the following:

1. asking reconsideration of the matter;
2. advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
3. referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

The SEC had proposed a rule which would require an attorney representing an issuer who did not receive an appropriate response to a report of a material violation and who believed the violation would result in substantial injury to the issuer or investors was required to withdraw from the representation, notify the SEC of such withdrawal, and disaffirm any submission to the SEC in which the attorney had participated which might be tainted by the violation. This "noisy withdrawal" provision was not included in the final Rule 205.3.

Texas Rule 1.12 does not require an attorney report illegal conduct outside the entity, but it does state that an attorney's obligations following withdrawal from representation will be governed by Rule 1.05. Section (c) of the latter provides, in pertinent part:

(c) A lawyer may reveal confidential information:

(7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.

Rule 1.05 does not appear to require that such information be affirmatively reported outside the organization, at least not in the context of financial misdeeds. Section (e) does impose an obligation to share such information, however, if the criminal or fraudulent act is likely to result in death or substantial bodily harm to a person.

C. Application to Employment or Compensation Agreements

To avoid dual representation allegations in the context of preparation of an executive employment or compensation agreement, counsel for the entity should not take direction on behalf of the entity from the individual who is the subject of the agreement. Often, however, particularly in smaller, closely held organizations, this may not be possible as the executive is the only person who may effectively speak for the entity. In such situations, this is not a Sarbanes-Oxley consideration, but necessary to avoid later disqualification or ethical issues. When this occurs, counsel should follow the dictates of Rule 1.12(e) and inform the executive, preferably in writing, that the lawyer represents only the entity or primarily the entity and that the executive should obtain separate counsel. While the executive is unlikely to do so in such circumstances, he cannot later argue that he misperceived who the attorney represented.

If counsel meets with an executive to review an agreement prior to signature, the lawyer should give the executive something along the lines of an Upjohn warning. This might include the following: that the attorney is representing the company and does not represent the executive; that the purpose of the discussion is to obtain information necessary for the attorney to provide legal services to the company, not to provide any service to the executive; that to the extent the conversation is privileged, the privilege belongs to the company, not the executive; that the company may decide to waive the privilege and disclose the contents of the discussion with a third party.

In an organization subject to Sarbanes-Oxley, an executive's employment or compensation agreement should contain a commitment from the executive to comply with the organization's code of ethics and all applicable laws and regulations. These types of clauses are commonly found in independent contractor agreements and should be carried forward to executive employment agreements. Such a clause should also require the executive to report any violation and to cooperate with any investigation into any violations of the code of ethics or applicable laws or regulations.

The agreement should also specify the role the organization will take if the executive is accused of violating either the code of ethics or applicable laws or regulations, including reservation of the right of the organization to terminate or suspend the executive, with or without pay, during the investigation of such allegations and whether the organization will pay the executive's attorneys fees in such a situation. The agreement should warn the executive that the organization may choose to waive its own attorney client privilege in cooperating with such an investigation.