The Hazards of Board Memberships

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Legal malpractice underwriters have always exercised caution when reviewing the applications of firms that have one or more attorneys sitting on the boards of for-profit and non-profit corporations, community service organizations, and closely held corporations. The corporate world continues to see significant activity in scrutiny and regulation and legal disputes abound. Corporate legal issues continue to grow in complexity as even small businesses seek out global markets and/or develop a substantial online presence. Legal news headlines of law firms facing fallout due to a corporate client's poor financial performance are commonplace. Taken together, one can begin to understand why someone charged with evaluating the level of risk that any given law firm represents might exhibit serious caution when there are attorney board memberships mixed into the equation.

When it comes to insurance underwriting, the skill is in trying to set an accurate price for the product today that will fully cover the unknown losses that will develop several years down the road. Insurance companies that do this well will remain in business and continue to grow. Those that do not will falter and sometimes fail. A good underwriter understands that she or he is responsible for trying to forecast the future. The goal is to underwrite business that will lead to predictable, or perhaps reasonable, losses. In the insurance world large unexpected losses are a bad thing. Insurance companies don't like surprises and board memberships represent one potential source of large unexpected losses. Why is this? It is primarily due to conflict of interest concerns. Juries have had field days with conflict claims because the issues are so easily presented in the context of law firm or attorney making greedy self-serving decisions at the financial expense of the corporation. Even the appearance of impropriety can be disastrous. Board memberships compound the conflict issues and it is as simple as that.

Be aware that claims involving attorneys on client corporate boards exist in both the for-profit and non-profit arenas. Claims have also arisen from situations where attorneys were acting as both legal adviser and board member in closely held corporations. A problem with that particular situation is that coverage disputes can and do occur. Most malpractice policies only provide coverage for claims that arise from work done on behalf of firm clients and often the closely held corporation was never a client of the firm. In reality the attorney was acting independently, providing legal advice off the clock in furtherance of family financial interests. This can be a serious problem when it arises. In fact, some policies specifically exclude coverage for any work done on behalf of any closely held corporation in which a firm attorney served as a board member and/or held a financial interest in.

Board participation can be particularly concerning for an underwriter when the attorney is sitting on the board of a hospital or a financial institution. Regulatory oversight and the potential for significant losses drive extra underwriting scrutiny here. Worse yet is when the attorney/board member takes a financial interest of 5% or more in any client organization. A meaningful ownership interest coupled with board membership on a client organization creates conflict concerns that are now at a level where an underwriter is going to be extremely cautious and, in some instances, will make a determination that the risk is unacceptable.

In spite of the conflict concerns associated with board memberships, there will be attorneys who will continue to become involved on the boards of client organizations in one fashion or another. Should you decide to do so, carefully think through the conflict of interest issues before making any commitment to serve. Always disclose and document the conflict issues to the client organization and consider whether it would be prudent to obtain a written waiver. If a waiver is called for, remember that this document must be more than a signed acknowledgement of the existence of a conflict of interest. It must document informed consent if it is to be effective. Informed consent is perhaps best described as obtaining client agreement to proceed after the client has been advised of all possible ramifications that the potential or actual conflicts represent to the client as well as advising the client to seek independent counsel about the advisability of agreeing to move forward given the existence of the actual or potential conflicts.

In certain situations, setting forth all possible ramifications will be a tall order. If trying to do so does prove difficult, perhaps that is a warning worth listening to. If it is too difficult to write this document in a way that any layperson could understand, then the better choice might be to keep it clean. Either decide to sit on the board and ensure that no one at the firm does any legal work for the corporation or keep the client and say no to an offer of board membership. Truth be told, particularly with non-profit boards, the entity is often asking an attorney to sit on the board as one way to obtain legal advice at little to no cost. You do not need to sit on a board in order to provide legal advice. Again, keep it clean. Agree that the entity will be a firm client so that malpractice coverage is in play and donate your time to the entity as outside counsel.

Are there additional exposure concerns beyond the conflict of interest issue? In short, yes. Here are a few other significant issues worth considering before deciding whether to sit on a corporate board.

A) Increased Risk of a Malpractice Claim and Firm Disqualification. Attorney board members face a greater malpractice risk than attorneys who limit themselves to corporate counsel service particularly if the attorney board member is sitting on a client board. The attorney board member often has more power and influence in corporate affairs than do other outside directors. This can make the attorney board member an irresistible target for plaintiffs. Typically, by suing the attorney board member, the plaintiff seeks in part to disqualify the attorney board member and his or her firm from representing the client company. Even if not sued, the attorney board member (and the firm) may be disqualified from representing the company based upon the “lawyer as witness” rule. In other words, the attorney board member often becomes a witness as a consequence of participating in corporate decision-making.

B) Loss of Attorney Client Privilege. When an attorney attempts to wear the two hats of legal counsel and board member, it becomes difficult to determine which hat the attorney is wearing at any given time. Even in situations where the counsel/board member provides strictly legal advice, the

counsel/board member will subsequently be viewed or portrayed as having acted concurrently as a board member. The reality is that when a counsel/board member participates in board conversations the safe play is to assume that all communications lack the attorney client privilege.

C) Inability to Participate in Certain Decisions. Imagine a situation where the board is to consider taking alternative courses of action. One course will result in a significant fee for the attorney board member's firm and the other course will not. From a stockholder's perspective, it is difficult to imagine how an attorney acting as both corporate counsel and board member could give disinterested advice or why the attorney board member should even participate in voting on this matter. In these types of situations, the attorney board member should excuse herself from the discussion and the subsequent vote and ensure that her recusal is properly documented. This is another consequence of an attorney serving in a dual role. There may be times when the client entity is going to be deprived of their attorney board member's advice and perhaps on a critically important issue.

D) Malpractice Resulting From Failure to Warn. If an attorney serves as both corporate counsel and director, she should warn the company's management and the other directors of the above-mentioned hazards (A thru C) and, of course, document such warnings. If she doesn't do so, the failure to warn may be sufficient basis for a malpractice claim if the company incurs significant expense, liability, or other detriment that could have been avoided if the company was appropriately warned of the above.

E) Weakened Defense to a Malpractice Claim. When a corporation's outside legal counsel is sued by stockholder plaintiffs, often he will try to defend his position by stating that the board declined to follow his firm's advice or argue that the board was incompetent. However, if corporate counsel is also serving as a director, this defense is seriously weakened.

F) Inadequate D&O Insurance. Legal malpractice policies typically exclude coverage for director and officer liability (D&O) and sometimes adequate separate D&O coverage can be difficult to obtain. Furthermore, under some D&O policies the coverage applies only if the officer or director was acting "solely" as an officer or director. Thus, an attorney acting as both corporate counsel and board member may not have coverage under the D&O policy. Additionally, for those attorneys who serve as board members for banks and savings and loan associations (regardless of whether they also serve as corporate counsel), some D&O policies exclude coverage for claims made by a regulatory agency such as the FDIC resulting in another insurance coverage gap.

G) Inadequate Indemnification. The corporation's bylaws may contain an indemnification provision, but the provision may not protect the board member for all claims. For example, under the corporate laws of many states, indemnification provisions cannot protect the board member in successful shareholder derivative suits. Also, the indemnification provisions obviously are meaningless if the company is insolvent.

In sum, before you agree to sit on the board of a client entity, remember the risks that come should you decide to try and simultaneously wear the two hats of attorney board member. Often the better decision really may be to either serve as a board member and never give legal advice, or agree to act as corporate counsel without becoming a board member. If you will be acting only as a board member, document this by providing the corporation with a letter stating that you will be acting solely as a board

member and that you will do so in your individual capacity and not as a member or representative of your law firm.

If you will be acting as both corporate counsel and board member, give the corporation's management a written disclosure of hazards A thru C listed above. Emphasize that the attorney client privilege will not apply to any discussion or correspondence made in your capacity as a board member. Make certain that you have adequate D&O coverage and that the corporate bylaws have appropriate indemnification provisions. Review the corporate finances to ensure that the corporation has sufficient resources to survive an adverse claim.

Participation on a corporate board can be a meaningful and fulfilling experience. Just remember that underwriters focus on the ramifications of board memberships for a reason. Make certain that you do too because the decision to serve on a corporate board is a decision that should never be taken lightly.

Risk Management Questions?

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