NORTH CAROLINA BAR ASSOCIATION
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NOTES BEARING INTEREST

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Inside This Issue:

North Carolina Has Rewritten Its Warpy Law of Unincorporated Associations

By Ed Winslow

Unincorporated associations are groups that may be loosely or tightly organized, but that are not incorporated under applicable laws. They are merely bodies of individuals who are acting together with a common purpose and using some practices of incorporated entities in their governance.

Examples include sports teams, civic clubs, Sunday School classes and churches, homeowners associations, neighborhood and political groups, youth groups, and informal charities of all kinds. These are merely examples. They also may include unions, trade associations, cooperatives and pressure groups—and, brotherhoods, sects, fringe groups and terrorist organizations—maybe, also, cooperatives, collectives and online communities. There's no end to them: groups with common purposes that are not incorporated.

We are told that our very genes impel us to form cooperative alliances of this sort; and authors ranging from Baron de Tocqueville to Alvin Toffler and Tom Friedman maintain that they are foundational to American democracy, and that new kinds of them will be the building blocks of the global economy in the digital future.

The common law never knew exactly what to make of them—especially the nonprofit ones. Common law knew natural persons, and it knew entities. It saw no other choices. With this in mind, Justice Sam Ervin opined that unincorporated associations do not exist under North Carolina law. For legal purposes, he said, "an unincorporated association [is] an 'airy nothing,' or a 'non-existent legal ghost,' no matter how powerful it may be in reality."

The Problems with Them

Denying that they exist only encouraged them. Now, there are more than ever. They range from the aforementioned cooperatives, funds, and groups to the likes of the Atlantic Coast Conference and—until 1992—the American Bar Association. As might be expected, "non-existent ghosts" that are nonetheless "powerful in reality" create a host of troublesome legal questions.

These include:

- What is an unincorporated association: an entity, a partnership, some sort of joint or common tenancy? Is it enough to say that they don't exist, when there are so many of them?
- Can an unincorporated group own or hold property (say, a bank account or real estate) in its own name?
- Can an unincorporated group enter into a contract? Who is bound?
- Can an unincorporated group sue or be sued in the name of the group?
- Who is liable for torts committed by members of a group in the furtherance of its common purposes?
- Where a group has become inactive or dissolved, who owns any property that may have been held in the group's name (say, a dormant bank account)?
- How can a third person know (1) the prop-

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The Chair's Comments


Mark Davidson

Meet Milan Pham. Now a Durham resident, Milan graduated from the School of Law at the University of North Carolina in Chapel Hill in 1999, after having received a bachelor of arts in sociology in 1996 from North Carolina State University.

Since graduating law school, Milan has split her time between managing civil rights discrimination cases and running her own business law private practice. As of this writing, Milan is serving as the director of the Orange County Human Rights and Relations Department.

Thanks to the Business Law Section, the Corporate Counsel Section, the Board of Governors, the North Carolina Bar Association staff, the North Carolina Bar Association Foundation, and many firm and corporate donors, Milan soon will be starting a new full-time job as the inaugural director of the North Carolina Lawyers for Entrepreneurs Assistance Program (NC LEAP). Thanks to the generosity of the same folks, funding for Milan's position has been pledged for three years. Having quickly met the $250,000 goal for funding three years, the Fundraising Committee, chaired by Marion Cowell, is

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Comments *from page 1*

now seeking funds for a fourth year.

If the sentiments of the Director Search Committee toward Milan could be summed up in a word, it would be "terrific." With her background and talents, Milan appears to be perfectly suited to launch NC LEAP. But don't take our word for it; invite Milan in for a visit to discuss how your firm can provide pro bono business law services through LEAP, and see for yourself.

With Milan NC LEAP has created its first job. With Milan's leadership and your support, NC LEAP will help others create many more jobs in the years to come. ❒

Law *from page 1*

er name of an unincorporated group? or (2) who has authority to act on behalf of the group? or (3) the address or location of the group? or (4) how disputes among group members (e.g., the right to funds on deposit) will be decided?

In short, Sam Ervin's answer to these questions was to say that an unincorporated association was not an "entity"; it had no separate existence. So, for Justice Ervin, to say that anything was done by an unincorporated group was only to say that the individual members had done it, acting together. The group was not different from the members, one by one.

In North Carolina then, applicable rules were: Property of a group is owned by all members, as tenants in common. A contract with a group is actually a contract with each of the members. Liabilities belong to members individually. An association cannot be dissolved without the unanimous consent of its members. Any lawsuits must be prosecuted in the separate names of all of the members of the group. The group has no legal standing to speak for any of its members. Any name that a group may adopt is merely an assumed name, used as a proxy for the separate names of all the members.

This produced unsatisfactory outcomes of all sorts. For example,

♦Should funds donated to an unincorporated charity fund belong to the last member, after other members move on?

♦Should all the members of a team be vicariously liable if one of its members has an automobile accident on a team trip?

♦What sense does it make to require every member of a group to be named in a deed, or listed as owners of a bank account?

♦How many members of clubs and teams and neighborhood associations and political action groups would join, if they understand that they might be liable for the group's contracts and commitments?

And there are other problems. Suppose a member of a team or class stops attending activities, perhaps having moved to another state. Is that person still a member? Where a group has no formal name, no officers, and no address, how do you know when you are dealing with one person and when with the group?

Piecemeal and Inconsistent Answers

Armed only with the theory that these associations do not exist, courts and legislatures stumbled to a variety of piecemeal and often inconsistent responses to these problems. Like most other states, North Carolina adopted scattered statutes that dealt with some issues in some contexts. They included:

♦*Churches.* As might have been expected, North Carolina has special rules for churches, Chapter 61 of the General Statutes. Chapter 61 anticipates common issues that unincorporated religious groups might face. It is limited to ecclesiastical bodies, churches, denominations, societies, congregations and sects (none of which are defined).

♦*Real estate.* Chapter 39, Article 4 ironed out the most common real estate title issues for "associations of individuals organized for charitable, fraternal, religious, social or patriotic purposes when organized for the purposes which are not prohibited by law." At the end though, it did not really say exactly who owns property held in the name of such a group.

♦*Lawsuits.* N.C.G.S. Section 1-69.1 authorized unincorporated associations, whether organized for profit or not, to sue and be sued under "the name by which they are commonly known" without naming the individual members. In that case, judgments would attach to an association's assets "as if it were incorporated." Chapter 1 conflicted with Chapter 66. One said that an association must record its name under the assumed name statute in order to file a lawsuit; the other said not. Ultimately, the Court of Appeals resolved the conflict. (Doesn't matter how any longer. See discussion below.)

On balance, the law of unincorporated associations is a warp or gap in the seamless web. The common law denies their existence. Legislatures patched over pressing practical problems, but did no more than that. And any group with the competence or resources to care, soon got itself into some other form: trust, partnership, for-profit or nonprofit entity. This left the informal, the unsophisticated, the unresourced and the underground groups in the gap.

The law remained—messy.

The Uniform Unincorporated Nonprofit Associations Act

Into the breach stepped the National Conference of Commissioners on Uniform State Laws. In the early 1990s NCCUSL resolved to bring order where the common law had failed.

NCCUSL failed too. That is, it drafted a model statute, the Uniform Unincorporated Nonprofit Associations Act. And, the draft does bring clarity in three areas: (1) authority to acquire, hold, and transfer property, especially real property; (2) authority to sue and be sued as an entity; and (3) contract and tort liability of officers and members of associations. But, the drafters bowed to defeat in other areas, including governance, corporate names and defining what is arguably the central concept of the new law: what is a "nonprofit" association? (The model Act leaves the question of for-profit associations to the side.) *www.law.upenn.edu/bll/ulc/unincorx/unincorx.htm*

The perfect did not thwart the good, however. In 1996, NCCUSL promulgated an Act. It does solve many problems, just not all of them. Twelve states have adopted it.

In 1998, the North Carolina General Statutes Commission took up the NCCUSL model. By 2005 though, it still had done nothing. Then, prompted by the interest of some large associations, the General Assembly intervened. It told the painstaking and very deliberate Commission to get busy. Thus provoked, the Commission—with comments from the Business Law Section and others—proposed an Act which the General Assembly enacted in 2006 as Chapter 59B of the General Statutes.

The North Carolina Act was effective on Jan. 1, 2007. It is not identical with NCCUSL's version, but it is close. It is accompanied by both Official Comments and North Carolina Comments.

The North Carolina Uniform Unincorporated Nonprofit Associations Act

After Jan. 1, 2007, North Carolina's nonprofit associations are no longer airy nothings. They exist. Chapter 59B firmly establishes nonprofit associations as entities (sort of). No one is required to do anything, or to change any procedures. Instead, the Act unilaterally awards the status of "entity" and creates new, entirely voluntary, possibilities for interested nonprofit groups. There are no registration or filing requirements, no fees to pay, and no mandatory form of organization or rules about how to operate.

In a nutshell,

- *Property.* Nonprofit associations can, if they wish to, receive, hold and transfer real and personal property in their own names and separately from their members.
- *Liability.* Members and agents of nonprofit associations are not automatically or vicariously liable for actions or legal obligations of the group.
- *Lawsuits.* Nonprofit associations can sue and be sued as associations, in their own names.
- *Inactive groups.* A procedure is provided for disposing of property of inactive associations.
- *Agent for service of process.* Associations that elect to do so may designate an agent for service of process.

The Act addresses only "external" relationships of nonprofit associations: property, legal obligations and lawsuits. It does not address internal matters: governance, control or rights among members.

Issues and Provisions of the Act

The Act presents the following issues for nonprofit associations, their members and those who deal with them.

What is an "unincorporated nonprofit association"?

The essence of the Act is that it gives to certain groups some of the attributes of corporations, even though they are not incorporated or registered with the State. Qualifying groups are treated as entities.

Groups that qualify for this treatment are referred to in the statute as "nonprofit associations." A "nonprofit association" is defined as

> an unincorporated organization, other than one created by a trust and other than a limited liability company, consisting of two or more members joined by mutual consent for a common, nonprofit purpose.

The group must be "unincorporated," but in some fashion must be an "organization." This is to say that in some rudimentary way, a group must act like an entity in order to be treated like one. Joint tenancies, tenancies in common, and tenancies by the entireties are not by themselves nonprofit associations, even if the co-owners share use of property for nonprofit purposes.

Many unincorporated associations elect to have trappings of incorporated entities: charters, bylaws, agreed rules of governance, official names, various officers and agents. None of these is required by the Act, however. There is no requirement that anything must be in writing, or that the association have a name, or that its purpose must be stated anywhere or by any particular means.

All that is required is that at least two persons must agree to (or, at least go along with) some manner of "organization" for a common nonprofit purpose. This broad definition is intended to extend the benefits of the Act to the smallest, most informal and most temporary of groups, clubs, teams and classes.

N.C.G.S. Section 59B-2(2) and Official Comments 7 and 8.

What is a "nonprofit" association?

To say that the Act applies to "nonprofit associations" begs a significant question: what is a "nonprofit" association?" Surprisingly, the term is not defined in the Act. The statute applies only to "nonprofit associations" but does not say what "nonprofit" means.

The Official Comments observe that a common definition of "nonprofit" would provide that net gains do not inure to the benefit of members of a nonprofit association and that there could be no distributions to members; but this Act is intended to apply to some groups that might well distribute gains to members, such as unincorporated consumer cooperatives, or perhaps athletic conferences.

General legal authorities say that not-for-profit associations include voluntary organizations formed for moral, benevolent, social, patriotic, civic or political non-commercial purposes. Nonprofits organizations are commonly classified as public benefit, mutual benefit, or religious.

Without doubt, the Act applies to more than just charities. But exactly when, say, a mutual benefit association which makes distributions to its members ceases to be a nonprofit association and becomes a for-profit association, or partnership, is left for case-by-case determinations.

N.C.G.S. Section 59B-2(2) and Official Comments 7, 8 and 9.

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Who is a "member" of a nonprofit association?

In informal groups, membership may not be well defined.

The Act is concerned with determining membership of nonprofit associations, but only for purposes of external relations, such as liabilities to third persons. With that in mind, the term "member" as used in the Act is defined to mean

> A person who, under the rules or practices of a nonprofit association, may participate in the selection of persons authorized to manage the affairs of the nonprofit association or in the development of policy of the nonprofit association.

This definition extends the protections of the Act (i.e., insulation from personal liability) to virtually anyone who might otherwise be liable for obligations of nonprofit associations.

At the same time, many groups themselves award "membership" liberally, and label as "members" anyone who donates funds to the association perhaps, or signs a list or roster. Mere labeling does not make a person a "member" for purposes of the Act, however.

N.C.G.S. Section 59B-2(1) and Official Comments 1, 2 and 3.

Entities can be members of nonprofit associations

Nonprofit associations may have as members individuals, corporations and all manner of other public and private legal entities.

N.C.G.S. Sections 59B-2(1) and 59B-2(3) and Official Comment 4.

Governance of nonprofit associations not covered

The Act seeks only to address external relations of nonprofit associations. It does not prescribe rules of governance or internal procedures of any kind. It says nothing about how decisions are made, how agents or officers are selected, who members may be, or what the association does. Most groups address those matters somehow: either with explicit agreements such as bylaws, or by consent of the members. Whether they do or not, questions about these matters must be resolved by general principles of law and equity because the Act does not address them.

N.C.G.S. Section 59B-3 and Official Comment.

Holding and transferring property

No longer are nonprofit associations ghosts. Under the Act, they exist. (At least, they exist to the extent that any legal entity exists, which is to say mostly in the minds of lawyers.) Nonprofit associations are legal entities for purposes of acquiring, holding and transferring real and personal property.

They can be beneficiaries, legatees and devisees. Judgments and executions can be entered against them and visited upon them like any other entity. They can own land and automobiles, have bank accounts and trade stock. This is true even for associations that have no connection to North Carolina, except holding property here.

The Act's new provisions replace, and are consistent with similar provisions formerly set out in Chapter 39 of the General Statutes.

A new provision enables nonprofit associations to record in the offices of registers of deeds affidavits that authorize identified persons to transfer real property on their behalf.

N.C.G.S. Sections 59B-4, 59B-5, 59B-6 and Official Comments.

Liability of members and others

Just as nonprofit association are made legal entities for purposes of holding property, they are also entities separate from their members for purposes of determining and enforcing legal rights, duties and liabilities. This means that members and persons who participate in the management of associations, like shareholders and officers of corporations, are not liable, either directly or vicariously, for the associations' obligations merely by reason of their membership or participation in management. Also, consistently with the separation between associations and members, members may sue associations, and associations may sue their members.

N.C.G.S. Section 59B-7.

Lawsuits, proceedings, judgments, service of process, venue, standing, diversity of citizenship

Nonprofit associations can sue and be sued in their own names. Judgments or orders against associations do not automatically apply to members. Associations can appoint and file in the office of the Secretary of State a statement identifying an agent to receive service of process. Venue is proper in counties where associations have offices or places of operation, or where any officer resides if the association has no office or place of operation.

Importantly for many types of associations, associations have standing to assert claims on behalf of their members and persons it refers to as members, if the rights asserted are germane to the association's purposes.

There is an extensive body of federal decisions about the status of unincorporated associations for venue and diversity purposes. Whether past rules will hold in the future will await future decisions of the federal courts.

N.C.G.S. Sections 59B-8, 59B-9, 59B-11, 59B-13; 73 Tul. L. Rev. 699 (1998); 4 Stan. L. Rev. 160 (1951).

Personal property of inactive associations

Where an association has been inactive for three years or more, a person in possession or control of personal property belonging to the association may transfer custody of the property to a person specified for that purpose in the association's documents, or if no person is specified, then either to a nonprofit entity pursuing broadly similar purposes, or to a government agency. The association's document may specify a period different than three years.

The term "inactive" is not defined. There is no requirement that an association must be dissolved. "Inactive" is understood merely to indicate that the association has stopped operating.

The provision for transferring property of inactive associations applies only to personal property, not real estate. It authorizes transfer of "custody," not title. Upon transfer, the property remains dedicated to the purpose for which the defunct association held it.

N.C.G.S. Section 59B-10 and Official Comment.

Names of associations

Under the Act, nonprofit associations are "entities." This means that they can hold property, make contracts, and sue-and-be-sued "in their own names." The nature of many informal groups though is that they have no names. The Act requires no names and provides no place to record one. (In the past, associations were covered by the assumed name statute G.S. Section 66-68, but Chapter 59B removed nonprofit associations from Section 66-68, which is itself obsolete in several respects.) This leaves a modest gap. It can be managed readily enough by careful legal practitioners but it may confound the unwary from time to time.

Effect of Act on existing relationships

The Act does not affect rights accrued before the new statutes become effective.

Deeds executed before the effective date in conformity with Sections 39-24 and 39-25 are declared to be sufficient to pass title to real estate. The Act does not affect conveyances of land by trustees of churches under Chapter 61 where the land is conveyed to and held by the trustees.

N.C.G.S. Section 59B-15; 2005 Sess. L. 2006-226, Section 2(b).

New Entity in Town

New Chapter 59B makes a new place for nonprofit associations in the continuum of legal persons—even if the statute does not say exactly what a nonprofit association is, and even though it does not tie up every loose end.

Its rules will bring clarity to the external relations of groups that often have no sense of themselves as legal persons at all. And it creates a choice—an "entity" or "quasi entity," at least—for groups that either cannot afford to incorporate, or have no appetite for the rules associated with incorporating, or do not want to make their existence a matter of public record.

Cultural gurus predict many such groups to come in the flat, interconnected world of the future. ❐

WINSLOW PRACTICES WITH BROOKS, PIERCE, MCLENDON, HUMPHREY & LEONARD, LLP IN GREENSBORO.

Thank You for NC LEAP Contributions

North Carolina Lawyers for Entrepreneurs Assistance Program

The following groups have contributed gifts to NC LEAP:

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- Annual dues contributions from 1,500 members of the Business Law Section
- Business Law Section budget contribution
- Two grants from NCBA Foundation Endowment
- NCBA Foundation budgetary funds

(As of Feb. 15, 2007)

An initial fund-raising goal of $250,000 has been set to fund NC LEAP through 2008-09. The NCBA and NCBA Foundation have also made commitments for in-kind administrative and operational support of NC LEAP.

N.C. Bar Center Welcomes Founding Director of NC LEAP

The N.C. Bar Center welcomes Milan Pham as the new director of the North Carolina Lawyers for Entrepreneurs Assistance Program (NC LEAP).

A 1999 graduate of the University of North Carolina School of Law, Pham holds a bachelor of arts degree in sociology from N.C. State University.

Pham most recently served as director of the Orange County Human Rights and Relations Department. Her experience includes managing civil rights discrimination cases and running her own business law private practice.

NC LEAP is a pro bono project of the North Carolina Bar Association Foundation in conjunction with the NCBA Business Law and Corporate Counsel sections. The program links volunteer attorneys with low wealth, rural and minority entrepreneurs in need of legal assistance. ❐

M&A Purchase Price Adjustment Clauses: Buyer Beware?

By Skip Smart and Kent Workman

Editor's Note: Article originally appeared in the October 2006 issue of Business Lawyer, *the newsletter published by the North Carolina Bar Association's Corporate Counsel Section. Reprinted with permission.*

A Delaware court's recent decision may have cost the buyer of a business more than $10 million in potential damages arising from the target's allegedly misstated financial statements. **OSI Systems, Inc. v. Instrumentarium Corp.**, 892 A.2d 1086 (Del. Ch. 2006) illustrates some of the difficulties that can arise under garden-variety post-closing purchase price adjustment clauses. The case also serves as a reminder that buyers and sellers should carefully consider the intended purpose and effect of such clauses and be certain that the agreement clearly reflects the parties' intent.

The OSI Systems acquisition agreement contained a fairly typical purchase price adjustment provision. The purchase price would be increased (or decreased) if the target's working capital as of the March 19, 2004 closing date ("Final Working Capital") was greater (or less) than the target's June 30, 2003 working capital ("Initial Working Capital"). Final Working Capital would contain at least the same line items as Initial Working Capital and be calculated in accordance with the Transaction Accounting Principles (defined generally as compliant with U.S. GAAP), "applied consistently with their application in connection with the preparation of [Initial Working Capital]. . . ." The parties would close the transaction on the basis of the seller's estimate of Final Working Capital and, after closing, the buyer would have the opportunity to prepare its own calculation of Final Working Capital. To the extent the parties disagreed on Final Working Capital, they were to submit their differences to a mutually acceptable independent accounting firm for resolution.

The buyer's post-closing calculation of Final Working Capital was dramatically lower than the seller's estimate, and would have reduced the purchase price by $25.3 million, or approximately 54 percent of the total purchase price. Most of the reduction resulted from the buyer's use of different accounting principles than those employed by the seller to calculate both Initial Working Capital and its estimate of Final Working Capital. The buyer argued that it was justified in using different accounting principles because those used by the seller were not GAAP-compliant and, therefore, did not meet the definition of "Transaction Accounting Principles" that the agreement required be used in calculating Final Working Capital.

When the buyer attempted to submit the dispute to the accountants for resolution, the seller refused to participate on the grounds that the buyer's claim was outside the scope of the purchase price adjustment procedures. According to the seller, the buyer's position amounted to a claim that Initial Working Capital and the financial statements from which it was derived were not prepared in compliance with GAAP, a claim which if true would constitute a breach of the seller's representations and warranties. The seller alleged that this type of claim was not intended to be resolved by the accountants, but rather under the separate dispute resolution procedures applicable to breaches of the agreement and other contractual indemnity claims.

The parties' arguments over the characterization of the buyer's claims held significant financial implications because the agreement included an indemnity cap relating to breaches of representations and warranties set at 25 percent of the purchase price. If the cap applied to the buyer's claim, it would reduce the maximum recoverable amount by more than $10 million.

The court ultimately agreed with the seller, finding that the working capital adjustment provisions were intended solely to handle disputes over the calculation of the change in working capital between the Initial Working Capital date and the closing date, when measured using consistent accounting principles. Although the court based its conclusion on a close reading of the agreement, it appeared to be influenced by the magnitude of the purchase price adjustment sought by the buyer and a perception that the buyer was attempting an "end run" around the indemnity cap. "[The buyer] cannot bypass the contractual indemnification process, . . . and then seek a gigantic Closing Adjustment by attempting to convince the Independent Accounting Firm that [the seller's Initial Working Capital] . . . was materially inaccurate and infected by improper accounting." *Id.* at 1095.

Because working capital adjustment provisions involve a complex web of legal and accounting principles, they can produce outcomes that are unexpected and even counterintuitive. The buyer in OSI Systems, for example, was probably surprised to learn that the seller's alleged systematic misstatements of its working capital could not be remedied under the agreement's working capital adjustment provisions. Many buyers expect to use the adjustment clause to test the quality of the target's working capital, in order to ensure that they are actually getting the working capital for which they bargained.

Most sellers, on the other hand, want to limit the operation of the clause to measuring and compensating for changes over time in the target's working capital. They will often insist on using consistent accounting principles to ensure that an "apples to apples" comparison is made, and will want to leave qualitative issues to the indemnification arena. These disparate intentions can lead to ambiguities in the agreement, which can in turn result in the sort of unhappy surprise experienced by the OSI Systems buyer. It is therefore important for each party to work closely with its legal and accounting advisors to develop a common understanding of how the mechanics of the adjustment calculation should work, and to ensure that this understanding is clearly reflected in the agreement.

OSI Systems also illustrates the more fundamental fact that disputes over these provisions occur frequently. For instance, even in circumstances where the parties agree as to which accounting principles are to be used in the calculation of working capital, the application of such principles is not an exact science. In many cases, management will be required to make estimates and judgments, which may vary among reasonable management teams and may very well lead to irreconcilable differences that resist even the most careful drafting. Accordingly, the prudent party will anticipate a disagreement and ensure that it understands, and has paid adequate attention to, the process to be used to resolve any dispute over the final adjustment calculations. In particular, the agreement should address such issues as access to the other party's workpapers, whether a party can revise its calculations once submitted, any limits on the scope of the accountants' inquiry and responsibility for the costs of the process.

Price adjustment clauses based on changes in working capital are common in M&A transactions, but they are not "boilerplate" that can be lifted straight from a form document. These provisions require the careful attention of the principals as well as their respective accounting and legal advisors. Without such a team effort, they can become a trap for the unwary buyer or seller. ❐

SMART IS A PARTNER AND WORKMAN IS AN ASSOCIATE IN THE CHARLOTTE OFFICE OF PARKER POE ADAMS & BERNSTEIN LLP. SMART HEADS THE FIRM'S BUSINESS LAW PRACTICE GROUP, AND WORKMAN IS A MEMBER OF ITS MERGERS AND ACQUISITIONS TEAM.

Changes in DOJ Corporate Waiver Policy Still Raising Concerns

BY R. DEKE FALLS

Editor's Note: Article originally appeared in the February 2007 issue of The True Bill, *the newsletter published by the North Carolina Bar Association's Criminal Justice Section. Reprinted with permission.*

Republican Sen. Arlen Specter of Pennsylvania has reintroduced a bill aimed at protecting the attorney-client privilege in corporate investigations. The bill seeks to legislatively supersede a key provision of the Thompson Memorandum and the McNulty Memorandum,[1] the two memos that have guided federal prosecutors since 2003 in determining when to indict corporations.

The Thompson Memorandum, titled "Principles of Federal Prosecution of Business Organizations," was drafted in 2003 by then-Deputy Attorney General Larry D. Thompson. It set forth nine factors for federal prosecutors to consider when deciding whether to seek criminal charges against corporations and other business entities.

Most of the factors in the Memorandum reflected DOJ policies that were already in effect. However, the Memorandum provided a new emphasis on the corporation's role in providing legal counsel to employees, and the corporation's willingness to waive the attorney-client privilege. Under the Memorandum, prosecutors were to consider a corporation's voluntary disclosure of wrongdoing and willingness to cooperate in the government's investigation. In making this evaluation, prosecutors could consider whether the corporation had waived the attorney-client privilege and work product protections, both with respect to the corporation's internal investigation and with respect to communications between specific officers, directors, employees and counsel. Prosecutors could also consider whether the corporation advanced legal fees for key employees, retained employees without sanction for their misconduct, or provided information to employees through joint defense agreements.

The effect of this provision was that, in some cases, prosecutors threatened to indict the corporation unless the corporation waived all attorney-client protections and cut off funding for the legal defense of employees. Not surprisingly, this tactic soon drew criticism from business leaders, attorneys, civil rights organizations and, recently, the federal bench.

Last summer, in **United States v. Stein,** U.S. District Court Judge Lewis Kaplan in the Southern District of New York handed down two withering opinions of the Thompson Memorandum and prosecutors' insistence that the corporation stop paying legal fees for employees. The cases arose from the government's investigation of accounting fraud at KPMG.

In Stein I,[2] Judge Kaplan found that the provision of the Thompson Memorandum treating payment of employees' attorney fees as lack of cooperation on the part of a corporation, when consideration was being given to indicting that corporation, was a violation of the substantive due process rights of employees. Judge Kaplan ruled that prosecutors had improperly pressured KPMG into terminating attorney payments, which, in turn, violated the employees' Fifth and Sixth Amendment rights. He ordered the government not to consider KPMG's payment of employee legal fees in determining whether KPMG had cooperated with the government, and directed the clerk of court to open a civil docket for KPMG employees to file claims against KPMG for legal fees.

In Stein II,[3] several indicted KPMG employees moved to suppress their statements on the basis that the government, through its pressure on KPMG, forced the employees to waive their constitutional right to silence and right to counsel, or face termination of their employment. Judge Kaplan found insufficient evidence of government coercion with respect to seven employees. However, for two employees, he ruled their statements were coerced, and that the coercion was a result of government action. "[Prosecutors] offered KPMG the hope of avoiding the fate of Arthur Andersen if KPMG could deliver to the USAO employees who would talk, notwithstanding their constitutional right to remain silent, and strip those employees of economic means of defending themselves."[4] Judge Kaplan ultimately suppressed the statements and any fruits of the statements.

Following the Stein cases, on Dec. 7, 2006, Sen. Specter introduced the Attorney-Client Privilege Protection Act of 2006,[5] legislation that would have prohibited federal prosecutors from considering a corporation's refusal to waive valid attorney-client and work product protections as evidence of lack of cooperation. The bill also prohibited prosecutors from conditioning charging decisions on waivers of privileged information.

Less than a week later, current Deputy Attorney General Paul McNulty released a memorandum containing revised guidelines which superseded and replaced the Thompson Memorandum.[6] The McNulty Memorandum, in effect today, establishes new procedures for when and how federal prosecutors can seek privileged information.

Under the new procedures, a prosecutor must first demonstrate a legitimate need for the privileged information. Whether a legitimate need exists depends upon: (1) the likelihood and degree to which the privileged information will benefit the investigation; (2) whether the information can be obtained in a timely and complete fashion by using alternative means that do not require waiver; (3) the completeness of the voluntary disclosure already provided and (4) the collateral consequences to a corporation of a waiver. If a legitimate need exists, prosecutors must seek the least intrusive waiver necessary to conduct a complete and thorough investigation, and should follow a step-by-step approach to obtain the information.

The first step is to request purely factual information related to the underlying misconduct, called "Category I" information. This information may include copies of relevant documents, witness statements, purely factual interview memoranda, organizational charts created by company counsel, factual chronologies, factual summaries or reports containing investigative facts documented by counsel. The prosecutor must obtain written permission from the United States Attorney, who, in turn, must consult with Assistant Attorney General for the Criminal Division. If the request is approved, the United States Attorney must communicate the request in writing to the corporation. A corporation's response to a government request for waiver of privilege for Category I information *can* be considered in determining whether a corporation has cooperated in the government's investigation.

In cases where Category I information provides an incomplete basis to conduct a thorough investigation, prosecutors can then request production of attorney-client communications or non-factual attorney work product. This is known as "Category II" information, and includes legal advice given to the corporation, attorney notes, memoranda, or reports of counsel's mental impressions and con-

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clusions, and legal determinations reached as a result of an internal investigation. Prosecutors are to seek Category II information in rare circumstances only. Requests for Category II information must be authorized in writing by the Deputy Attorney General. If a request is authorized, it must be communicated in writing to the corporation. Unlike Category I information, a corporation's refusal to provide a waiver for Category II information cannot be considered in the prosecutor's charging decision.

Another policy change in the McNulty Memorandum concerns the payment of legal fees by the corporation. Under the Thompson Memorandum, as discussed in the Stein cases, the government could penalize the corporation by threatening prosecution if the corporation continued to pay the legal fees of employees under indictment or investigation. The McNulty Memorandum states that prosecutors generally should not take into account whether a corporation is advancing legal fees, except in the "extremely rare" case where the totality of the circumstances show that the payment of fees is intended to impede the government's investigation.

Despite these changes in DOJ policy, the response to the McNulty Memorandum has been less than positive. Stanton D. Anderson, senior counsel to the U.S. Chamber of Commerce, stated the following in a press release:

> While containing some improvements, this new policy does not adequately protect the right to attorney-client privilege, and unwisely ignores many of the recommendations of former senior Justice Department officials, the American Bar Association, and a massive coalition of some of the nation's most prominent business, legal, and civil rights groups.
>
> We support DOJ's position that eliminates payment or reimbursement of legal fees as a factor of consideration. And although DOJ now says front-line prosecutors cannot *formally* request waivers without first getting approval from the Deputy Attorney General's office (DAG), waiver of privilege can still be considered a sign of cooperation in determining charging decisions. That's not good enough. As long as the DAG can decide whether or not to demand waiver, the privilege is uncertain. An uncertain privilege is no privilege at all.[7]

Sen. Specter was equally unimpressed. On Jan. 4, 2007, he reintroduced his bill in its exact same form, except it is now called "The Attorney Client Privilege Protection Act of 2007." Although Specter's party is no longer the majority in Congress and Specter is no longer the chair of the Senate Judiciary Committee, the incoming chair, Sen. Patrick Leahy, has stated that he remains concerned that prosecutors may still be able to inappropriately consider a corporation's waiver of the privilege in the charging decision. Sen. Specter's bill is pending. ❒

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Endnotes

1. The Thompson Memorandum is available at *www.usdoj.gov/dag/cftf/corporate_guidelines.htm.*
2. *See* **United States v. Stein,** 435 F.Supp.2d 330 (S.D.N.Y. June 26, 2006).
3. *See* **United States v. Stein,** 440 F.Supp.2d 315 (S.D.N.Y. July 25, 2006).
4. *Id.,* at 337-338.
5. The proposed legislative bill can be viewed at *www.acc.com/public/attyclientpriv/thompsonmemoleg.pdf.*
6. The McNulty Memorandum can be viewed at *www.usdoj.gov/dag/speech/2006/mcnulty_mem0.pdf.*
7. Reprinted with permission from the U.S. Chamber of Commerce press release Dec. 12, 2006. The release can be viewed at *www.uschamber.com/press/releases/2006/december.*