Analysis of Investigative Techniques Performed On the Business Operations of Organizations

Introduction

It is late on a Friday afternoon. The Chief Executive Officer, or the General Counsel, of XYZ Corp. receives a telephone call advising that the local FBI, United States Attorney, or Regional Office of the SEC, is investigating serious charges of wrongdoing alleged to have been committed by Ms. A, the Company's Chief Operating Officer and governmental liaison, in connection with a number of government procurements. A search warrant, or an all-inclusive subpoena, has been, or shortly will be, issued for all documents relating to Ms. A and the government contracts she has helped procure. The Company's cooperation is sought.

Governmental civil and criminal investigations are a fixture of our corporate landscape. Senior managers and, ultimately, corporate directors have to assess the need to be responsive to various governmental pressures, while at the same time giving true meaning to the presumption of innocence upon which all of us rely. When events of this nature arise, reliance on clichs, unthinking adherence to laudatory principles and guidelines, and a failure to assess the particular situation, can lead many corporations down a path they will soon rue.

The current environment imposes a responsibility on companies to ferret out employee misconduct and to deal with any known or suspected instances of misconduct with efficient and decisive measures. What is lacking are prescribed guidelines for directors to whom these difficult questions are referred. This essay seeks to fill that void.

The Current Ambient Circumstances

At a minimum, at least five specific factors should influence how corporations, and their officers and directors, respond to indications of possible illegality on the part of one or more senior employees of the Company.

First, the Doctrine of Accountability suggests that officers and directors aware of potentially illegal conduct by senior employees may be liable for any recurrence of similar misconduct, and may have an obligation to halt and cure any continuing effects of the initial misconduct. In two cases - In re Gutfreund1 and In re Cooper Companies2 - the SEC publicly criticized corporate officers and directors for failing to take measures that precluded misconduct from recurring (even though, in the latter case, the directors were not certain any misconduct occurred).

Second, the Corporate Sentencing Guidelines provide stiff penalties for corporations that fail to take voluntary action to redress apparent misconduct by senior employees.3 Since corporations can only act through individuals, the violation of any law by any corporate officer or senior employee immediately creates the possibility that criminal action can be brought against the corporation itself.4

Third, most prosecutors will give - or at least say they will give - special consideration to companies that take effective action in the face of suspected wrongdoing by senior employees, officers or directors.5 While leniency, as such, is a thing of the past in this, the Decade of Retribution,6 the disparity between the harshness meted out to companies that voluntarily take measures to deal with their own problems and those that fail to do so cannot be gainsaid.7

Fourth, the Private Securities Litigation Reform Act of 1995 now requires, as a matter of statute, that independent auditors look for, and assess, management's response to indications of potential illegality.8 Where a corporation does not have a proven track record of responding to indications of potential illegality, the auditors may not be able to reach a conclusion that the company took appropriate and prompt action in response to indications of possible illegal actions. The tidal wave of drastic consequences flowing from that conclusion will create significant problems for any corporation, whether it is a regulated entity or not.

Fifth, recently, the Delaware Court of Chancery in In re Caremark International Inc. Derivative Litigation, in the context of approving a settlement of a derivative action, offered its view that a director's duty of care includes a duty to attempt in good faith to assure that corporate information and reporting systems exist. These systems must be reasonably designed to provide to senior management and the Board timely, accurate information, which would permit them to reach informed judgments concerning the corporation's compliance with law and its business performance.9

Practical Considerations

Directors of public companies should take as a given that, at some point, a valued corporate officer will become the focus of a governmental inquiry. Board members can draw little comfort from facts that restrict the wrongdoing to employees in a remote location. If the allegations have any merit (or form the basis of government action), one of the questions that will be asked, with the benefit of perfect hindsight, is "Where were the directors"?10

Boards can prepare for that inevitable moment by viewing their obligations in three parts. The first relates to preventive steps every company should take to allow management to avoid or mitigate allegations relating to improper conduct. Second, there are a number of considerations that should guide the Board's deliberations as the investigative process plays itself out. Finally, at the end of the process, the Board should ensure that company practices are adjusted to reflect lessons learned over the course of the investigation.

Preventive Steps

Directors can ensure that the Company fosters a tone of corporate respect for legal obligations from the top of the corporation on down. The most efficacious way to avoid problems is to instill in all corporate citizens an understanding that unlawful conduct is not encouraged, will not be condoned or ignored and will lead to serious adverse consequences. There is no single prescribed method for communicating this message, but there are several components to it that should be considered:

In words and in actions, corporate managers should demonstrate their respect for legal obligations imposed upon the company, and their intention to enforce those obligations fully.

Corporations should develop and update codes of conduct applicable to all employees, setting forth the standards of behavior employees are expected to achieve.

Periodically, companies should provide training and education to employees, advising and reminding them of applicable normative standards of behavior, and teaching them how to avoid conduct that may be illegal or improper or unethical.

Companies should encourage employees to raise questions - either about their own conduct, or the conduct of others - through a non-retributive vehicle, such as a corporate ombudsman, and provide anonymity for those seeking assistance.

Particularly in regulated industries, the Board should be acquainted with laws and regulations applicable to the industry and business and on a periodic basis should discuss material changes in such laws and regulations and their effect on the Company's business.

In their review of corporate internal controls, the Board (and, in particular, the Audit Committee) can oversee the operation of these preventive steps.11

There should exist a mechanism to ensure that directors learn sooner (rather than later) about allegations of significant illegality by corporate officers or directors. Not every claim or complaint must, or should, be channeled immediately to the company's directors. There comes a point, however, at which a certain threshold of seriousness has been passed (such as, for example, when outside counsel has been retained to address the problem). There should exist a mechanism to provide outside directors with a confidential assessment of the problem and the steps being taken to consider the issue. While not time consuming, this step allows the Board to monitor an evolving situation closely. It also avoids the potentially perilous situation in which an outside director first learns of the problem in a telephone call from a savvy reporter or securities analyst.

One way to monitor claims or complaints is to set up a special Board committee. Part of the Caremark settlement of the derivative suit was for Caremark's Board to establish a Compliance and Ethics Committee consisting of four directors, including two independent directors. The Committee was required to meet at least four times a year to monitor business segment compliance with certain government regulations, and to report on compliance to the Board twice a year. In addition, the settlement required Caremark's officers responsible for business segments to serve as compliance officers and report twice a year to the Board's Compliance and Ethics Committee.

The Board should review and, where appropriate, revise its corporate code of conduct to ensure that any employee, officer or director who may, in the future, be accused or suspected of improper conduct is required to cooperate with any internal inquiries by the company into the events in question. The absence of such cooperation was stressed in the SEC's Cooper Companies release. The Commission noted that both Gary and Steven Singer, respectively the company's Co-Chairman and its Chief Administrative Officer, asserted their Fifth Amendment privilege in response to government inquiries and declined to be interviewed by independent counsel retained by the company's Board of Directors.12 The Commission stressed that the informational vacuum created by an officer's assertion of the constitutional privilege "does not negate a public company's disclosure obligations under the federal securities laws. Indeed, it is under these circumstances that the need for the Board to safeguard investor interests may be most compelling."13

In mandating cooperation with internal inquiries, a company should maintain some flexibility in its approach. For example, over the course of a criminal inquiry, it is commonplace for the target of the inquiry to assert his or her Fifth Amendment privilege in response to the government's inquiries. Even when an individual employee, on the advice of counsel, has adopted that posture, there remain opportunities for the company to satisfy its need for information (such as exchanges through counsel and subject to a joint defense agreement).14

One way for a company to encourage cooperation with internal inquiries is to link such cooperation with indemnification issues. This will certainly catch the eye of corporate officials. Paragraph 8 below explores this idea.

The Investigative Process

This article is written because preventive measures are not always sufficient. Every Board faces the prospect that there will come a point at which some arm of the government will examine the conduct of a key employee. When such examinations become intensive, the brunt of the Board's response often rests with outside directors who - unlike "inside" directors and the company's counsel - will not have regular contact with the government, the target and relevant documents. There are several steps that directors should consider as the investigation unfolds.

All indications of significant wrongdoing should be followed up on behalf of the Board. Some sense of proportionality must be applied to this requirement since a certain level of litigation often is a cost of doing business. While the Board should be updated about litigation generally, the regimen recommended here is reserved to instances in which, typically, the government (and possibly private litigants) are probing alleged misconduct by company employees. Particularly when that misconduct relates to senior management, and the issues raised are undoubtedly significant, the Board should consider its own internal inquiry into the salient facts.

Upon notice of a significant wrongdoing, the company should immediately review and assure the proper functioning of its compliance program. In some cases, it may be necessary to take measures in response to the alleged wrongdoing. For example, in the Caremark case, after the government investigations were underway, the Ethics Committee of Caremark's Board adopted a new internal audit charter requiring a comprehensive review of compliance policies and the compilation and dissemination of an employee handbook concerning such policies. Furthermore, the company instituted employee training sessions concerning legal compliance and changed business procedures to increase management supervision.

The Board should consider whether restrictions should be imposed on the activities of those suspected of improper conduct, at least until the status of such persons is resolved. This is one of the core messages from the Gutfreund release. The Commission alleged that three of the top officers at Salomon Brothers Inc. were informed in April 1991 that Paul Mozer, a Managing Director in charge of Salomon's Government Trading Desk, had submitted a false bid in an auction for government treasury securities. Armed with such information, the Commission stressed that the firm's top officers were under an obligation to "increase supervision of Mozer and to place appropriate limitations on his activities."15 In the absence of such action, Mozer was alleged to have submitted two subsequent unauthorized bids.16

In general, the Gutfreund release, of course, is a product of the statutory supervisory responsibilities imposed upon broker-dealers and the unique context of the market for government securities. This aspect of the release, however, addresses a point relevant to the Board of a company in any industry. While immersed in the heat of discerning what, in fact, did take place, the Board should ensure that some thought has been given to increased oversight and restrictions on the individuals involved pending the outcome of the internal inquiry.

Likewise, the Board should consider whether restrictions should be imposed on the company's activities that are the subject of investigation. In the Caremark case, in determining whether the settlement was fair, the court found no substantial evidentiary support in the record for a breach of the directors' duty of care for failing to take steps to prevent or remedy the alleged violations of law. The Caremark Board had taken numerous steps to restrict the company's business activities in the wake of government investigations and indictments into such business, including terminating all financial relationships with physicians in certain business segments and instituting restrictive policies on its contractual relationships with physicians.

The Board should consider whether any disclosure, either to investors or to outside auditors, is necessary or appropriate under the circumstances. The disclosure question will be a "moving target." As such, it is a question that must be revisited as the company's understanding of the relevant facts evolves.

The federal securities laws do not compel the disclosure of government investigations. It is telling that, in proposing revised rules regarding the disclosure of legal proceedings in late 1994, the Commission did not address this specific question.17 Indeed, public disclosure of a government investigation that has little substantive merit may make it more difficult for the government agency to close the investigation. As a result, investigations centering on public companies often are concluded with neither formal proceedings nor a whisper to the outside world.

At a certain point, however, public disclosure of the investigation must be considered. Item 103 of Regulation S-K, which governs annual SEC Forms 10-K and quarterly forms 10-Q, requires disclosure of "material pending proceedings" against the company. The item also adds a requirement to "[i]nclude similar information as to any such proceedings known to be contemplated by governmental authorities."18 Once the company's counsel determines that a government enforcement action is likely, serious consideration must be given to public disclosure of at least this information.

At the same time, the company must consider whether to disclose the existence of the investigation to the company's independent auditors. Recent Congressional amendments to the Exchange Act have placed auditors under a statutory duty to develop systems reasonably designed to detect illegal acts and to make appropriate disclosure to management and, under certain circumstances, to the Board of Directors when illegal acts are detected.19 Whether or not the investigation is expected to have a material impact on the company's financial statements, the Board should consider disclosure - at least on an informal basis - to the company's auditors.

In the face of possible misconduct by senior officers, consideration should be given to imposing restraints upon trading in company securities by the company and those with knowledge of the facts. The difficulties that mire disclosure considerations also affect the assessment of whether corporate insiders should be restricted from trading the company's securities. As a purely legal matter, the same materiality standard applies. If information is immaterial for disclosure purposes, that same information is immaterial with respect to potential insider trading claims.20 When a potentially material government investigation is in an active phase, it may be prudent to curtail trading by insiders.21 At some point, the need for such restrictions dissipates. No hard and fast rules can be applied since many investigations "close" without a word from the government agency involved.

The Board should consider carefully whether corporate officers and employees should be represented by company counsel, by separate counsel, or jointly by company and separate counsel, and who should bear the costs of such representation. This point is driven by a practical consideration. Few entities are better suited for a legal war of attrition than the federal government and its various agencies. Although the SEC's subpoena authority affords it considerable leeway for discovery during the investigative phase, the Commission asserts, successfully in some cases,22 its right to seek a new round of discovery when an action is filed in federal courts. Few corporate officers (or organizations, for that matter) have the resources for that approach.

There are advantages to joint representation of the company and employees, including the savings on legal fees, the maintenance of control over the investigation, the sharing of information, and the benefits of the joint defense privilege. The disadvantages are the myriad of conflicts that can plague the company over the planning and execution of the defense strategy.

These are the realities that make questions of indemnification and, in particular the advancement of expenses, critically important to the individuals involved. Companies need to review the indemnification provisions in their charter and by-laws, as well as any indemnification agreements that may exist. Indemnification agreements may provide more generous indemnification and alter the statutory standards for mandatory and discretionary indemnification. Generally, companies are required to indemnify when the individual is successful on the merits or in defense of any claim. Companies have the discretion to indemnify in other cases. However, there is typically a standard of care that must be satisfied. In Delaware, for example, a company can authorize indemnification if the officer or employee "acted in good faith, in a manner he reasonably believed to be in or not opposed to the best interest of the corporation, and, with respect to a criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful."23 Disinterested directors, independent counsel or stockholders make this determination on a case-by-case basis.24

Delaware, like many states, provides the Board with broad discretion to advance expenses.

There is no standard of conduct required to be met. The officer or employee must promise to repay the amounts advanced if it is ultimately determined that he or she should not have been indemnified by the corporation.25 However, the Board can determine the terms and conditions under which the expenses will be advanced.26 This is how the Board can exert some influence over employees. At a minimum, the Board should require cooperation with internal company inquiries into the wrongdoing as a condition to the advancement of expenses. In addition, the Board should consider adding a standard of care as a condition to advancement of expenses. The Delaware standard cited above for discretionary indemnification is one type of standard. These types of provisions could be built into the Company's charter, by-laws and indemnification agreements. They would signal to officers, directors and employees that indemnification and advancement of expenses are not automatic. Thus, the indemnification repertoire could also serve as a deterrent to improper conduct.

While some procedures or standards for indemnification and advancement of expenses may merit exposure in a company's constituent documents, there are others that a corporation may prefer to enact on a case-by-case basis. The point is that a corporation can link certain defense objectives and issues with the economics of indemnification, bearing in mind the ethical constraints of counsel to the accused employee. Strict restrictions on indemnification, however, can have a chilling effect on the recruitment of attractive candidates for directors and senior officers. Of course, the company should maintain flexibility in determining whether to indemnify and how to advance costs.

There are complex and fluid circumstances and potential conflicts of interest that may arise when a company is faced with alleged wrongdoing by its employees. The independent directors, or a special committee formed to consider defense and indemnification issues, should consider and, if appropriate, seek a recommendation, on how these responsibilities should be allocated (and how the allocation serves the best interests of the company and its shareholders). A preliminary evaluation of the alleged wrongdoing may be useful to the Board when making those decisions.

The Board should take steps to guard against the inadvertent waiver of any attorney-client privilege or attorney work product protections. In a crisis setting, there will be two constants for the Board's outside directors. First, its contacts with counsel addressing the problem will be a critical pipeline to both the factual situation and the legal ramifications of those facts. The second constant is that there will be a bevy of third parties - media, government regulators, plaintiffs - who will seek whatever means are available to gain access to those communications.27

It is precisely because the moment is so harried that directors should join with counsel in ensuring that the technical requirements are taken to preserve the protections of the attorney/client privilege and the work product doctrine. The Board should ensure that there is a single document that retains counsel for purposes of advice in connection with the alleged management misconduct. The Board should reinforce that factual information gathered on its behalf is needed for purposes of rendering that legal advice. And directors should assist in preserving the confidentiality of these communications.

For any number of reasons, the Board may decide that the company's long-term interests are served when privileged communications are shared with government counsel (or others). That should be a deliberate decision of the directors rather than one made by default.

The Aftermath

At some point, the crisis passes. For directors, constant involvement in the investigation dissipates to a series of periodic updates. Before settling back into the more familiar routine of regular Board meetings, the Board should ensure that the lessons from the experience are not lost.

In instances of potential wrongdoing by senior managers, the Board should be able to answer three critical questions:

How did the wrongdoing occur?

How did we learn about it?

What assurances do we have that conduct of this type will not recur?

Whatever its outcome, each alleged instance of management or employee misconduct should be viewed as a case study in internal controls. As a preliminary matter, the Board should ascertain whether the problem was detected through the operation of the compliance program (i.e., through a contact from an employee hotline or a referral to the legal department) or whether the information came from another source (such as the federal agency that issued the subpoena).

Beyond that, recidivism is a perilous habit for any corporate entity. Regulators, prosecutors and courts deal particularly harshly with entities that return to their jurisdiction as a "repeat" offender. Consequently, the Board should seek a report from management on the corrective steps that have been taken to prevent a recurrence of the problem.

It is important not only that the Board do the right thing, but that it be able to prove that it did the right thing. As outlined above, corporate Boards often refer their hardest judgments - including those involving officer misconduct - to their part-time, independent members. It is essential that they create a record that supports their ultimate resolution as an informed decision.

Ironically, this process may be most important when counsel for the company and the target(s) of the investigation have been most successful. For lawyers who represent clients through government inquiries, their greatest victories come when the agency decides, after a close examination, to take no formal action. Since these outcomes never see the light of day, they can come under intense scrutiny if problems resurface at a later date. The Board will want to ensure that a record reflects its informed and careful deliberations.

Conclusion

If confronted by alleged wrongdoing by trusted, and significant, corporate officers and directors, there may well be a tendency to "circle the wagons," and defend both the individual and the company against any suggestion or hint of serious difficulties. While corporate directors may be justified in circling the wagons, applying that instinctual approach could presage serious difficulties for the company and ultimately enmesh it, and its directors, in the wrongdoing of officers and directors who, in fact, have breached the company's standards. There are ways to minimize the disruption that may be caused, and to avoid turning the company upside down to deal with the allegations of misconduct, but the Board cannot simply sit by and hope the matter resolves itself, or disappears. Occurrences of this nature call for concerted, but thoughtful, Board action to deal with difficult situations.