Current Issues in Internal Corporate Investigations

Concern over the liability exposure of directors and officers has never been higher.

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INTRODUCTION

Concern over the liability exposure of directors and officers has never been higher. Sarbanes-Oxley has increased the responsibilities of a company's board of directors, and ensured a level of board independence that has significantly increased the frequency of internal corporate investigations designed to identify and correct misconduct and fend off regulators, including the SEC.

In 2004 alone, the SEC brought more than 600 new enforcement actions against issuers, and their directors and officers. That extraordinary number is, of course, in addition to the numerous ongoing SEC formal and informal investigations. There is an ongoing debate as to whether the SEC's relatively new aggressiveness will be beneficial to issuers and their investors in the long-term. What is clear now, however, is that the current SEC enforcement environment, combined with the new Sarbanes obligations of boards, as well as company counsel, has put more emphasis than ever on the internal corporate investigation.

This article attempts to cover in some detail many facets of the internal investigation, from its commencement, through the preparation of a report to the board, to the use of the report to eliminate or reduce regulatory exposure. It also covers many aspects of the Sarbanes regime—with particular emphasis on the new policing role of company counsel—and concludes with a summary of recent SEC settlements and an in-depth examination of the extent to which those settlements were influenced, one way or another, by the provision of the internal investigative report to the SEC.

INITIATING AN INTERNAL INVESTIGATION

Why conduct an investigation at all?

If some material impropriety is suspected, whether as a result of internal investigations at the company, or as a result of the commencement of a government investigation or private action, conducting an internal investigation is more often than not the advisable course of action. See Brad D. Brian and Barry F. McNeil, INTERNAL CORPORATE INVESTIGATIONS 6-7 (2d Ed. 2003) (hereinafter "Brian & McNeil").

Events commonly leading to an internal investigation

- Discovery of inaccurate financial statements
- Service of a government subpoena
- Service of a civil complaint
- A whistleblower
- 10A notice by external auditor
- Advice by outside counsel that it is invoking its up-the-ladder reporting obligations

Duty of the board to exercise due care in managing the company

Members of a corporation's board of directors owe the corporation and its shareholders a duty of care, which refers to "the responsibility of a corporate fiduciary to exercise, in the performance of his tasks, the care that a reasonably prudent person in a similar position would use under similar circumstances". *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984). It is incumbent on the board of directors, then, to conduct an investigation to ensure that it has full knowledge of all issues affecting the company.

If the company, and its Board or its counsel have discovered or even suspect some material impropriety, they may have an affirmative obligation to conduct an investigation.

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") requires an attorney "appearing and practicing before the Commission" to report "evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer." See Implementation of Standards of Professional Conduct for Attorneys, SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003) (enacting Section 307 of the Sarbanes-Oxley Act). Often, in connection with reporting such a violation, counsel will advise the company to commence an internal investigation to ensure an "appropriate response" under the statute.

Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act") requires the company to conduct an internal investigation if the "independent public accountant detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred…." Section10A(b)(1).

Advantages of conducting an internal investigation:

- Identify the improper conduct;
- uncover the identity and role of the persons responsible for that conduct;
- permit the company to make an informed assessment of the legality and propriety of that conduct; and
- provide the company with the opportunity to make an informed and proactive decision regarding whether and how to take corrective action, including whether to self-report to the SEC, or other regulatory agency. *See*, *e.g.*, Deborah J. Edwards, Mark T. Calloway and Brian D. Edwards, *What To Do When the Whistle Blows: Do's and Don'ts of Internal Investigations*, 22 No. 5 ACC Docket 41, 42 (May 2004).

Risks of conducting an internal investigation:

- Inadvertent waiver of privileges;
- creation of an inaccurate or misleading record of events that portrays the company in an unnecessarily negative light or that calls into question the company's motive in undertaking the investigation;
- a public leak of negative information;
- inability to limit the investigation's scope; and
- very expensive.

Different types of internal investigations for different purposes

1) Self-directed—*i.e.*, commenced at the direction of the board of the company's Chief Legal Officer.
2) Investigations conducted in an attempt to cooperate with government regulators (*e.g,* SEC or DOJ) or self-regulating organizations (*e.g.*, NYSE or NASD).
3) Investigations commenced at the insistence of the company's auditors pursuant to Section 10A of the Exchange Act.

Who should direct the investigation?

- The Audit Committee?
- A special committee of independent directors?
- A "Qualified Legal Compliance Committee" under Sarbanes-Oxley?2
- Outside counsel retained specifically to conduct the investigation (i.e., not the company's regular counsel)?

The scope of the investigation

Existence or non-existence of a government investigation or private lawsuit is key in deciding whether to conduct an investigation as well as the scope of the investigation. Brian & McNeil at 6. Counsel conducting the investigation and management should decide on the scope of the investigation and should strictly adhere to the agreed-upon parameters. Brian & McNeil at 6-7. If internal investigation is in response to the commencement of a government investigation, the scope of the internal investigation should mirror that of the government investigation. *Id.* at 6. If internal investigation occurs where allegations of misconduct arise within the company and where no government investigation exists, counsel and management should agree on scope based on purpose of or reason for the investigation. *Id.* at 6-7. If the investigation is being conducted pursuant to Section 10A of the Exchange Act, the company's auditor will want to have input into the scope. Care should be taken to ensure that scope is not broader than necessary. It is appropriate to push back on both the SEC and the company's auditors to limit scope.

Counsel conducting the investigation should confirm in writing, in the form of an engagement letter, the scope of the investigation. The engagement letter should state:

- That counsel has been asked to investigate certain allegations;
- That the investigation is being conducted to enable counsel to advise the company regarding its legal rights, obligations and potential liabilities; and
- That all communications with counsel are protected by the attorney-client privilege and intended to remain confidential. *Id.* at 7.

Document retention

The lawyer's role

The obligation to preserve evidence runs to counsel. Counsel then has a duty to advise and explain to the client its obligations to retain pertinent documents that may be relevant to the litigation. *See Telecom Int'l. Am., Ltd. v. AT&T Corp.*, 189 F.R.D. 76, 81 (S.D.N.Y. 1999). Counsel to the company also may have recurring obligation to monitor the company and its representatives with respect to their continuing obligations with respect to document retention. *See*, *e.g.*, *Zubulake v. UBS Warburg LLC*, No. 02 Civ. 1243 (SAS), 2004 WL 1620866, at *8-*9 (S.D.N.Y. July 20, 2004).

Document retention doctrines

Retention of documents is necessary under the new provisions of Sarbanes-Oxley, as well as pre-Sarbanes-Oxley statutes and case law that had already established it a crime to destroy evidence for the purpose of interfering with government proceedings and investigations. Also, there is a parallel body of state statutes that punishes interference with state investigations and proceedings. Every state and federal jurisdiction recognizes spoliation—the destruction or alteration of evidence relevant to pending or future litigation—as wrongful conduct. Spoliation exposes private litigants to various possible sanctions and evidentiary penalties.

Document retention policy advice for companies

- Establish and implement written retention policies for paper and electronic documents.
- If subject to federal or state regulatory inspection, consider informing regulators of pertinent portions of current policies and seek approval.
- Implement procedures to suspend document destruction and preserve documents when documents may be relevant to pending or anticipated claims.
- Designate a point person as decision-maker to be notified when even potentially relevant documents are slated for destruction.

Reporting lines

Promptly establishing reporting lines throughout the company and from the company to counsel to ensure a thorough investigation.

Experts

- Forensic IT
- Forensic Accountants

Auditors must be given the assurances necessary to allow them to rely on the results of the investigation when preparing the company's financial statements. If auditors are included in the actual conduct of the investigation, any privilege applicable to that investigation may be waived. Can the company merely apprise its auditors of the investigations' final conclusions in summary form so as to avoid waiving the privileges?

In most cases, outside counsel, rather than the client, should retain the expert to ensure that all communications involving the expert are protected by the attorney-client privilege and that all documents created by the expert are considered work product.

What role, if any, should be given to the company's outside auditors in conducting the investigation?

The role of outside auditors should generally be limited in order to narrow the scope of the investigation, and ensure the maximum application of the attorney-client privilege and the work product doctrine to the investigation.

ATTORNEY/CLIENT AND WORK PRODUCT PRIVILEGES

Attorney/client privilege

Attorney-client privilege protects information shared between a lawyer and a client where the information is: (1) a communication, (2) made in confidence, (3) between a person who is, or is about to become, a client, (4) a lawyer, and (5) for the purpose of obtaining legal advice or assistance. *In re Richard Roe, Inc*., 68 F.3d 38, 39-40 (2d Cir. 1995)

Work product doctrine

Documents and other materials prepared in anticipation of litigation or for trial are protected from discovery unless the party seeking discovery has a "substantial need" for the materials in the preparation of the party's case and the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. If the party seeking discovery makes the required showing, the court can order discovery, but in doing so, shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation. Fed. R. Civ. P. 26(b)(3).

The *Upjohn* decision

In *Upjohn Co. v. United States*, the Court held that counsel's communications with company employees will be protected by the company's attorney-client privilege under certain circumstances. 449 U.S. 383 (1981). The Court set forth guidelines, as opposed to a bright-line test, for determining when the company's privilege applies to corporate employees. These guidelines include: (1) whether the communications were made by corporate employees at the direction of superiors for the purpose of obtaining legal advice; (2) whether the communications contained information necessary for counsel; (3) whether the matters communicated were within the scope of the employee's corporate duties; (4) whether the employee knew that the communications were for the purpose of the corporation obtaining legal advice; and (5) whether the communications were ordered to be kept confidential by superiors. *Id.* at 394-96. Note, however, that this privilege always belongs to the company, not its employees. As discussed below, it is, therefore, always the company's privilege to waive.

Issues of waiver

Ordinarily, courts will find that disclosure of the written report of the investigation constitutes a waiver of both the attorney-client and work product privileges. *See, e.g., In re The Leslie Fay Companies, Inc. Sec. Litig.,* 161 F.R.D. 274, 283 (S.D.N.Y. 1995) (holding that production of audit committee's report to the SEC waived attorney-client privilege, not only for the report itself, but for documents underlying the report). *In re Sealed Case*, 676 F.2d 793, 824 (D.C. Cir. 1982) (rejecting claim of privilege after disclosing to SEC). *In re Steinhardt Partners*, L.P., 9 F.3d 230, 234 (2d Cir. 1993) (voluntary submission of legal memorandum waived work product privilege).

Can the company selectively waive the privilege?

Can the company disclose the report to government regulators without risking a waiver of the privilege's application to the report with respect to potential third party litigants? Some courts have upheld the concept of selective or "limited" waiver in the context of voluntary corporate disclosures of internal investigative findings to government agencies:

> *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978) (finding limited waiver of the attorney-client privilege where company disclosed privileged material to the SEC pursuant to an agency subpoena in a separate, nonpublic SEC investigation);
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> *In re LTV Sec. Litig.*, 89 F.R.D. 595, 620-21 (N.D. Tex. 1981) ("the voluntary disclosure of information to an agency, as part of an agency enforcement proceeding, often is viewed as only a partial waiver of the attorney-client privilege");
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> *Byrnes v. IDS Realty Trust*, 85 F.R.D. 679, 687-89 (S.D.N.Y. 1985) (endorsing the limited waiver theory outlined in Diversified Industries).

Other courts have rejected the concept of a limited waiver:

> *United States v. Mass. Inst. of Tech.*, 129 F.3d 681, 686 (1st Cir. 1997) (finding waiver of both the attorney-client and work product privileges by disclosure to the Defense Contract Audit Agency pursuant to contracts between MIT and the Department of Defense);
>
> *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2d Cir. 1993) (finding waiver of work product through voluntary disclosure to the SEC);
>
> *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1431 (3d Cir. 1991) (finding waiver of both attorney-client and work product privileges due to disclosure to the SEC and Department of Justice of internal investigation for purposes of cooperation);
>
> *In re Martin Marietta Corp.*, 856 F.2d 619, 623-24 (4th Cir. 1988), cert. denied, 490 U.S. 1011 (1989) (finding that, where privileged material had been disclosed to the U.S. Attorney and Department of Defense, all related attorney-client material and all related non-opinion work product material would be discoverable).

There is also authority for the proposition that a limited disclosure of the report's findings and conclusions will not waive the protection afforded to the report by the privilege.

> *In re Dayco Corp. Derivative Secs. Litig.*, 99 F.R.D. 616, 619 (S.D. Ohio 1983) (The Dayco court stated that since, "the press release did not summarize evidence found in the report, nor did it purport to combine those findings with those of the Directors," it had not effected a waiver of the privilege.)
>
> *In re Witham Mem'l Hosp.*, 706 N.E.2d 1087 (Ct. App. Ind. 1999) (holding that because the press release did not "compromise the confidentiality of the report itself, the communications between the attorneys and the investigator during the investigation, or the analysis contained in the report," the privilege was not waived.)

If the government agrees to enter into a confidentiality agreement and promises to keep any privileged materials confidential, will that protect the privilege?

The SEC endorses the practice of using confidentiality agreements to preserve the company's privileges as to third party private litigants in related civil actions:

> "[A]llowing issuers to produce internal reports to the Commission…without waiving otherwise applicable privileges serves the public interest…[and] that preserving the privilege or protection for internal reports shared with the Commission does not harm private litigants or put them at any kind of strategic disadvantage." *See* Implementation of Standards of Professional Conduct for Attorneys, SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003).
>
> "For these reasons, the Commission will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection." *Id.*

Some courts have suggested that production pursuant to a valid confidentiality agreement preserves the privilege and does not amount to a waiver as to third parties:

> *Dellwood Farms, Inc. v. Cargill, Inc.*, 128 F.3d 1122, 1127 (7th Cir. 1997) (suggesting that privilege would not have been waived had the possessor of the privilege "been more careful, as by obtaining an agreement by the person to whom they made the disclosure not to spread it further");
>
> *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1375 (D.C. Cir. 1984) (to protect the privilege, "the company can insist on a promise of confidentiality before disclosure to the SEC");
>
> *In re Natural Gas Commodity Litig.*, No. 03 Civ. 6186 (VM) (AJP), 2005 U.S. Dist. Lexis 11950, at *39 (S.D.N.Y. June 21, 2005) (holding that party had not waived protection of work product doctrine where production to CFTC was made pursuant to a written confidentiality agreement);

Maruzen Co., Ltd. v. HSBC USA, Inc., No. 00 Civ. 1079 (RO), 2002 WL 1628782, at *1 (S.D.N.Y. July 23, 2002) (finding no waiver of work product protection where defendants had explicit confidentiality agreement with the U.S. Attorney's Office);

In re M & L Business Mach. Co., 161 B.R. 689, 696 (D. Colo. 1993) (stating that allowing limited confidentiality agreements "strives to balance the policy goal of encouraging cooperation with the government…with the strict requirement of confidentiality").

Other courts have held that confidentiality agreements cannot prevent waiver of disclosed material:

Westinghouse Elec. Corp. v. Republic of Philippines, 951 F.2d 1414, 1427 (3d Cir. 1991) ("Even though the DOJ apparently agreed not to disclose the information, under traditional waiver doctrine a voluntary disclosure to a third party waives the attorney-client privilege even if the third party agrees not to disclose the communications to anyone else.").

In re Columbia/HCA Healthcare Corp., 293 F.3d 289, 302 (6th Cir. 2002) (rejecting "any form of selective waiver, even that which stems from a confidentiality agreement…").

Self-critical privilege

In general, the self-critical analysis privilege may apply to protect self-evaluating documents or documents created during a company's internal investigation into allegations of misconduct when the following three criteria are met:

- The information results from self-critical analysis undertaken by the party seeking protection;
- The public has a strong interest in preserving the free flow of the type of information sought; and
- The information is of the type whose flow would be curtailed if discovery were allowed. Note, *The Privilege of Self-Critical Analysis*, 96 Harv. L. Rev. 1083, 1086 (1983).

"A privilege of self-critical analysis or a self-evaluative privilege serves the public interest by encouraging self-improvement through uninhibited self-analysis and evaluation." *In re Health Mgmt., Inc.*, No. CV 96-0889 (ADS), 1999 WL 33594132, at *7 (E.D.N.Y. Sept. 25, 1999). Cases upholding the application of the self-critical privilege as a general principle include:

In re Health Mgmt., Inc., No. CV 96-0889(ADS), 1999 WL 33594132 at *7, (E.D.N.Y. Sept. 25, 1999);

Lasky v. ABC, Inc., No. 83 Civ. 7438 (JMW), 1986 WL 9223, at *2-3 (S.D.N.Y. Aug. 13, 1986) (holding that certain documents in question were protected by the self-critical privilege);

New York Stock Exch. v. Sloan, No. 71CV2912, 1976 WL 169086, at *4-5 (S.D.N.Y. Oct. 21, 1976) (recognizing self-critical privilege in securities law context).

Cases declining to apply the self-critical privilege, generally:

In re Ashanti Goldfields Sec. Litig., 213 F.R.D. 102, 105 (E.D.N.Y. 2003);

Robinson v. U.S., 205 F.R.D. 104, 108-109 (W.D.N.Y. 2001) (noting that the self-critical analysis privilege has not been adopted by the Second Circuit Court of Appeals and has been rejected in this district);

Spencer v. Sea-Land Service, Inc., No. 98 CIV 2817, 1999 WL 619637, at *1 (S.D.N.Y. Aug. 16, 1999).

It is not at all clear that the "privilege" will apply to an internal report of this kind. There is no direct authority on this point.

Employee and former employee interviews—the duty to warn of the employer's right to waive the privilege: "I am not your lawyer."

Upjohn warning

We are company counsel; what you say may be privileged; but it is the company's right to waive any privilege that may apply. *See, e.g., In re Grand Jury Subpoena: Under Seal*, 415 F.3d 333, 339-40 (4th Cir. 2005) (holding that company's former employees could not assert attorney-client privilege to protect against disclosure of previous conversations with company's counsel when counsel advised former employees that counsel represented the company and that company reserved the right to waive the privilege).

What does counsel for the company say to employees who ask if they should obtain their own counsel?

You may obtain counsel; we have no opinion on whether you should do so; the company may not pay for it.

In light of *In re Zar*, counsel for the company should also consider "Mirandizing" all employees.

Counsel may explain that employees may be punished by the company as a result of what they say to company counsel. Counsel may explain that the company may divulge what the employee says to the government. Counsel may explain to the employees that if they are untruthful with counsel, and that untruth is repeated to the government, the employee could be prosecuted for obstruction.

Who is the client? The Company, the Board, or the Audit or Special Committee?

Is there a risk of a privilege waiver if the investigative report is shared by the board with management? The likely answer to these questions is that the privilege belongs to the company and would, therefore, not be waived if information is shared with management, but the company needs to be careful, particularly where management is found to have engaged in wrongdoing by the independent investigation.

POTENTIAL EARLY-STAGE CRIMINAL ISSUES

General principles of obstruction, perjury, etc.

Perjury

18 U.S.C. § 1621 (general perjury statute proscribing willfully false testimony given under oath in any case in which a law of the United States authorizes an oath to be administered).

18 U.S.C. § 1623 (applying to false declarations made in proceedings either before or ancillary to any court or grand jury).

Obstruction of justice

This is a category of crimes which involve interference with the public administration of justice. Three of the general obstruction statutes are relevant in the context of interviewing and preparing witnesses during an internal corporate investigation:

18 U.S.C. § 1512 (discussed below)

18 U.S.C. § 1503 (prohibits "corrupt" efforts to interfere with the due administration of justice).

18 U.S.C. § 1505 (prohibits corrupt efforts to interfere with proceedings before department, agencies, and committees).

The *In re Zar* case

The U.S. Attorney's Office in the Eastern District of New York filed a complaint against Ira Zar of Computer Associates, which includes as a cause of action, conspiracy to obstruct justice in violation of 18 U.S.C. § 1512(c)(2).

18 U.S.C. § 1512 is primarily a witness protection statute; however it was recently amended, and arguably broadened by section 1102 of the Sarbanes-Oxley Act of 2002. Pursuant to the amendment, there is a new provision in 18 U.S.C. § 1512, which imposes a fine or imprisonment on one who "corruptly (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or (2) otherwise obstructs, influences or impedes any official proceeding, or attempts to do so. *See* 18 U.S.C. § 1512(c) (emphasis added).

The complaint against Zar alleges that he and other Computer Associates executives gave false information about the company's accounting practices to the company's counsel and to counsel for its Audit Committee. The obstruction of justice claim (under 18 U.S.C. § 1512(c)(2)) is based on the allegation that Zar and other executives made these misrepresentations to the company's law firm and to the Audit Committee's law firm with the knowledge and intent that this information would be conveyed to the US Attorney's office, the SEC and the FBI, thereby obstructing and impeding government investigations. *See* Complaint at ¶¶16-17, *United States v. Zar*, No. 04-331 (ILG) (E.D.N.Y. 2004).

THE INVESTIGATION AND REPORT

The scope of the investigation

Who determines scope?

Witnesses. Counsel conducting the investigation should, to the fullest extent possible, be given unlimited access to those witnesses with information relevant to the investigation.

Documents. Counsel should also be given unlimited access to all relevant documents.

Electronic discovery

Document retention is a crucial factor both prior to and during litigation. The so-called doctrine of spoliation dictates that a company has an obligation to preserve potentially relevant documents in the face of actual or potential litigation. Potential violations of the catch-all obstruction statute, 18 U.S.C. § 1503, and the Sarbanes-Oxley Act, are heightened because of the complexity surrounding electronic discovery. Possible sanctions for failing to preserve e-mails and other electronic evidence in civil cases include multimillion dollar fines, adverse-inference jury instructions, preclusion sanctions, default judgments and costs and attorneys' fees. Public relations problems might also arise from the mere accusation of destroying electronic evidence. Lower stock prices, shrinking customer and supplier bases, diminished company morale, alienating potential employees, and defending against shareholder litigations are all possible consequences.

Cases involving electronic discovery are really about document management, usually involving documents sent to and received from dozens to hundreds of individuals and information from various corporate locations and systems.

The retention of an expert is an important first step. The expert should be conversant in all types of media and operating systems, including e-mail packages, and be able to explain the complexities of the various systems to the court and parties. Examples of areas where an expert can give the court and parties guidance include: searching data by keywords, eliminating duplicate documents, limiting searches by relevant time period, and suggesting how confidential information can be protected.

Certification of completeness of document production

It is not clear if officers or directors must certify the written report. Sarbanes-Oxley rules require the CEO and CFO to review and certify the material accuracy and completeness of quarterly and annual reports. Sarbanes-Oxley, however, does not appear to address one-time reports such as those written pursuant to an internal investigation. CEOs and CFOs, as well as members of the disclosure committee (should one exist), may want to certify the written report for accuracy and completeness to raise the level of veracity surrounding the report. Such a certificate by the company may be required by the SEC as part of a settlement.

Communications with the client; to whom should counsel report?

An initial goal in determining to whom counsel should report is to identify an individual or group who possesses certain characteristics:

- Has appropriate authority to act upon the results of the investigation;
- Is independent of the alleged wrongdoing and wrongdoers; and
- Will be perceived by those outside the company as independent.

To the extent the management team does not meet these characteristics, they may need to be excluded from the investigation. Some common individuals or groups that meet these characteristics may include: in-house counsel, the corporate compliance officer, the board of directors, the audit committee, or a special committee comprised of the independent members of the board of directors.

To write a report or not

Caution must be exercised in considering both benefits and costs before preparing a written report that summarizes or details the contents and results of an internal investigation.

Benefits

The written report can be a valuable tool for management in planning the company's response to the allegations of misconduct. The report also creates a documented record of the scope and findings of the investigation that may be valuable to the company in future litigation or investigations. Further, a written report may be more credible to the SEC/DOJ.

Costs

A written report may discuss potentially illegal or unethical conduct by company employees. If the existence of such a report becomes known, prosecutors or government investigators will likely pressure the company to waive any applicable privilege and to disclose the report. Civil litigants will seek the production of the report during discovery as it may provide a helpful roadmap to be used when attempting to prove their case. It is much harder to deal with a written document in defending a case, in contrast to an oral report. In addition, the potential for a leak must be considered.

How detailed should the report be?

The amount of detail necessary depends on the report's intended purpose. If a primary purpose of the investigation is to convince the government that the corporation is adequately policing itself and that government enforcement action is not warranted, the report should contain considerable factual detail. If government agencies have already commenced their own investigations into the alleged misconduct, less detail may be more appropriate. A more detailed report will provide a specific road map to the government and civil litigants in its prosecution of the company and management, and may be treated as an admission of wrongdoing by the company or its management.

Generally, written reports summarize the circumstances that led to the investigation; detail the investigative steps that were taken; summarize the facts revealed by the investigation; and identify internal policies, procedures or practices relevant to the events. Depending on the purpose of the investigation, the report also may analyze the applicable law; develop arguments for or against prosecution, sanctions or liabilities; identify steps which the corporation may take to prevent future violations; and recommend appropriate remedial actions, such as product recalls or restitution. If the corporation intends to disclose the report to the government, it should be drafted with careful attention to scope.

When a corporation has determined that it will make information available to the government, it must decide the extent of the information which it will disclose. For instance, it may decide to make the entire report available to the government but try to maintain the confidentiality of the witness interview memoranda and other materials on which the report is based. If the corporation's disclosures are too limited, the government may seek additional disclosures. On the other hand, the greater the degree of disclosure, the more likely it is that any privilege over other information may be waived. Cautionary and balanced language should be used in the report regardless of whether the report will be disclosed to ensure that it cannot later be used against the company.

Purpose? Internal vs. External

An internally-used report allows the company and management to determine what went wrong. If the report is only for internal use, counsel preparing the report can be more frank and more critical as the report will generally be privileged. If the report is publicized, it may help to address concerns raised by investors and regulators as it shows that the company is seriously addressing the improper conduct. If the report is written for this purpose, it should contain more cautionary language as it could be considered an admission by the company in litigation.

To whom should the report be provided?

The report should be provided to the individual or committee that requested the report. Obviously, there are also other possible recipients such as the government, auditors, or the marketplace.

REPRESENTING THE SPECIAL LITIGATION COMMITTEE (SLC)

The need for an SLC in response to a derivative claim

It has been said that the development of SLCs has had a chilling effect on derivative claims. If demand must be made on the board and the board refuses to sue, one view holds that the only recourse for the shareholder is then to sue the directors for wrongful refusal. But if the existing board, or the committee to which the matter was referred, was not involved in the challenged transaction, the decision not to sue would be protected by the business judgment rule which insulates directors against an adverse ruling. If demand need not be made and suit is filed, as will generally be the case when the directors who were involved in the challenged decision still sit on the board, the typical response in recent years has been for the directors to appoint to the board two or three independent directors who constitute a special litigation committee with the task of determining whether the litigation against their fellow directors should go forward. Invariably, the committee moves to dismiss the litigation. *See, e.g., Charles W. Murdock, Corporate Governance—The Role of*

Special Litigation Committees, 68 Wash. L. Rev. 79 (Jan. 1993); Thomas R. Mulroy, *The Internal Corporate Investigation*, 1 DePaul Bus. & Com. L.J. 49 (Fall 2002) (hereinafter "Mulroy").

Another important aspect of the SLC is that, "[t]o the extent a corporation affirmatively relies on the committee's report, courts may deem the attorney-client privilege waived and order the report disclosed." *See* Mulroy at *67. *See also* Mulroy at 67 n.115, citing:

> *Joy v. North*, 692 F.2d 880, 893-94 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) (holding report and supporting documentation must be disclosed to shareholders);
>
> *In re Perrigo Co.*, 128 F.3d 430 (6th Cir. 1997) (committee report ordered disclosed to derivative plaintiffs but not to public);
>
> *In re Cont'l Illinois Sec. Litig.*, 732 F.2d 1302, 1314 (7th Cir. 1984) (report ordered disclosed to a newspaper reporting on the litigation).

When creating an SLC, the company must make every effort to ensure that the SLC's members are independent and have no interest in the issues in dispute. Otherwise, the court may reject any action, such as the filing of a motion to dismiss taken by the SLC.

> *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 948 (Del Ch. 2003) (denying SLC's motion to dismiss because ties among SLC members, the university where they were tenured professors, and CEO and directors were so substantial that they caused reasonable doubt about members' independence).
>
> *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart*, 833 A.2d 961, 980 n. 63 (Del Ch. 2003) (stating that plaintiffs may have been able to establish lack of independence of SLC, and therefore challenge its ability to consider and reject a demand, had plaintiffs used proper discovery procedure).

As with any internal report, extreme care must be given by the SLC and its counsel to consideration of scope and privilege issues.

THE SARBANES-OXLEY REGIME

New requirements for public companies

Certification of financial reports

Significant risks of increased litigation are inherent in the increased certification requirements. Such requirements may translate into benchmarks against which scienter and breach of fiduciary duty will be measured. Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, SK027 ALI-ABA 241, 314 (Aug. 2004). Increased certification requirements will inevitably lead to greater disclosure regarding the certification process. *Id.* These requirements will likely translate into greater liability exposure for the CEOs, CFOs and possibly others involved in the certification process. *Id.*

Corporate responsibility for financial reports

Section 302 of the Sarbanes-Oxley Act imposes certification requirements for chief financial officers (“CFOs”) and chief executive officers (“CEOs”) applicable to each annual or quarterly report issued that attests:

- the signing officer has reviewed the report;
- the report does not contain any untrue statement of material fact; and
- the information fairly presents the financial condition and results of operations of the issuer.

Section 906’s additional certification requirements, subject to the imposition of criminal penalty where the person “knows” that the report does not comply with these requirements.

Public company Audit Committees

Section 301 of the Act makes Audit Committee members directly responsible for oversight of work done in conjunction with an audit. Section 301 mandates the establishment of audit committees for any public company. Their responsibilities are to:

- Appoint and oversee auditors
- Resolve audit disagreements between management and auditors
- Manage compensation issues for auditors and advisors

An audit committee must:

- Be comprised of independent directors
- Have grievance procedures in place
- Have authority and funding to preserve independence

Real time disclosure

Section 409 amends section 13 of the Securities Exchange Act. The amendment applies to issuers reporting under section 13(a) or 15(d) of the Securities Exchange Act. The amendment requires such issuers to “disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.” *See* 15 U.S.C. 78m(l).

Management assessment of internal controls

Section 404 of the Act requires the SEC to prescribe applicable rules regarding the responsibilities CEOs and CFOs have, as signing officers, for issues regarding internal controls and disclosure. Annual reports of all issuers are to contain internal control reports. These reports must state management responsibility for internal controls and management’s assessment of the effectiveness of the controls.

Disclosure of all material correcting adjustments, off-balance sheet, and pro forma financial information

Section 401 of the Act enhances the type and degree of disclosures in periodic reports filed with the Commission Every financial report that contains financial statements prepared in accordance with GAAP must reflect all material correcting adjustments identified by the accountant. *See* 15 U.S.C. 78m(i). Each annual or quarterly report must disclose all off-balance sheet transactions with "unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses." *See* 15 U.S.C. 78m(j). Pro forma financial information included in any periodic report or in any other public disclosure must be presented in a manner that is both "not misleading" and in conformance with GAAP.

Code of ethics

Under the act, "code of ethics" is defined as "such standards as are reasonably necessary to promote" three goals:

1) "honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;"
2) "full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer;" and
3) "compliance with applicable governmental rules and regulations."

Section 406 implements new disclosure rules related to code of ethics policies of the issuer. Each issuer is required to disclose in its periodic reports whether or not (and if not, why not) the issuer has adopted a code of ethics for senior financial officers. Any change or waiver of the code of ethics for senior financial officers must be disclosed in the 8-K.

Prohibition on loans to directors and officers

- **Enhanced conflict of interest provisions.** Section 402 prohibits any reporting company to lend money or extend credit to any director or officer. Personal loans are banned. *See* 15 U.S.C. 78m(k). How are advances for the purpose of litigation defense to be treated?
- **Disclosures of transactions involving management and principal stockholders.** Section 403 of the Act amends Section 16 of the Exchange Act to provide that changes in beneficial ownership must be reported to the SEC within two business days following the date of the transaction. *See* 15 U.S.C. 78p.

Pension fund blackout periods

A "blackout period" refers to periods of more than three consecutive business days during which employee participants are prohibited from such transactions, subject to certain exceptions. Section 306 creates a new derivative action against directors and officers who trade in their company's stock during a blackout period (*i.e.,* when participants in the company's benefits plan may not trade). Any profits made in violation of this provision are recoverable by the reporting company.

Forfeiture of bonuses

Section 304 creates a reimbursement rule for CEOs and CFOs who are given additional compensation prior to noncompliance with SEC reporting requirements. If an issuer is required to prepare an accounting restatement due to a material noncompliance with any reporting requirement, as a result of misconduct, the CEO and CFO must reimburse the issuer for certain funds paid as additional compensation. The CEO and CFO must pay back "any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement." The CEO and CFO must also pay back "any profits realized from the sale of securities of the issuer during that 12-month period." The Commission has the authority to exempt any person from these requirements.

Auditor independence

Section 201 of Sarbanes-Oxley amended section 10A of the Securities Exchange Act by adding a new subsection prohibiting public accounting firms from providing, contemporaneous with an audit, any non-audit service. *See* 15 U.S.C. 78j-1(g).

Prohibited non-audit services include:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service that the Board determines by regulation is impermissible.

A registered accounting firm can engage in any non-audit service not described above only if it is approved in advance by the audit committee of a company as provided in section 202 of Sarbanes-Oxley.

Section 202 of the Act also amended the Exchange Act to require pre-approval by the audit committee of the issuer for all auditing services (including providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies under state law) and non-audit services not listed in section 201. *See* 15 U.S.C. 78j-1(i). The pre-approval requirement is waived with respect to non-audit services (but not audit services) if the following certain requirements are met.

- The aggregates of all non-audit services are not more than 5 percent of the total amount of revenues paid by the company to its auditor during the fiscal year in which the non-audit services are provided;
- such services were not recognized by the issuer at the time of the engagement to be non-audit services; and

- such services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

Employment restriction on accountants

Sarbanes-Oxley also enhances conflict of interest rules for accountants. Section 206 makes it "unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity of that issuer during the 1-year period preceding the date of the initiation of the audit."

Audit partner rotation

Section 203 of the Act amends Section 10A of the Securities Exchange Act to prohibit an issuer from using the same auditor for a period of more than five consecutive years.

> "It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."

Audit record retention

Section 802 of the Act requires "any accountant who conducts an audit of an issuer of securities to which Section 10A of the Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies, shall maintain audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded." A willful violation of this requirement may be punished by a fine and imprisonment of up to ten years.

Auditor reports to audit committees

Section 204 of the Act amends the Exchange Act to require any registered public accounting firm that performs an audit to timely report to the audit committee of the issuer certain details of the audit. *See* 15 U.S.C. 78j-1(k)(1)-(k)(3). Specifically, the auditor must report:

- "All critical accounting policies and practices to be used;"
- "All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm;"
- "Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences."

Increased authority for the SEC

Increased frequency of SEC review

Section 408 provides for "regular and systematic" review of disclosures by issuers (including those on Form 10-K) for the "protection of investors." The Commission will schedule such reviews according to certain factors:

- Issuers that have issued material restatements of financial results;
- issuers that experience significant volatility in their stock price as compared to other issuers;
- issuers with the largest market capitalization;
- emerging companies with disparities in price to earnings ratios;
- issuers whose operations significantly affect any material sector of the economy; and
- any other factors that the Commission may consider relevant.

Bars on officers and directors

Section 1105 empowers the SEC, through its own administrative proceedings, to bar persons from serving as officers or directors if they have violated Section 10(b) or Section 17(a)(1), and such conduct demonstrates "unfitness" to serve as a director or officer. Section 305 changes old standard of "substantial unfitness" to "unfitness."

New forms of equitable relief available to the SEC

The change from "substantial unfitness" to "unfitness" for those director and officer bars obtained through court injunction.

Standards of professional conduct for attorneys

Section 307 of the Act called for rules setting forth "minimum standards of professional conduct for attorneys appearing and practicing before the commission." The Act states that the new rules are "in the public interest and for the protection of investors." One specific rule required by the Act requires an attorney "to report evidence of a material violation of securities law or breach of fiduciary duty…by the company…to the chief legal counsel or the chief executive officer…." If the counsel or officer does not properly respond (*i.e.,* adopt appropriate remedial measures or sanctions), counsel must report the violation to the audit committee of the board of directors, another committee of the board "comprised solely of directors not employed directly or indirectly by the issuer," or to the full board.

SEC ATTORNEY PROFESSIONAL RESPONSIBILITY RULES

Section 307 of Sarbanes-Oxley and the rules promulgated thereunder by the SEC (17 CFR Part 205) require an attorney representing an issuer to report to the company any evidence the lawyer uncovers of a material violation of the securities laws.

How do Section 307's reporting obligations work?

The lawyer must first report evidence of the material violation to the company's "Chief Legal Officer" ("CLO"). The attorney may also report the alleged violation to the company's CFO. As part of the lawyer's reporting of the alleged violation, the lawyer must demand that the CLO provide the lawyer with an appropriate response.

Upon receiving the "report" from the lawyer, 17 CFR § 205.2 requires that the CLO do one of two things:

- The CLO must investigate the evidence of the material violation presented by the lawyer and either provide an appropriate response or assure the lawyer that no material violation has occurred; or
- The CLO may refer the report to a Qualified Legal Compliance Committee if one has already been put in place by the company.

The SEC has defined (in 17 CFR § 205.2(k)) a Qualified Legal Compliance Committee ("QLLC") as a committee of an issuer (which also may be an audit or other committee of the issuer) that:

- Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));
- has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;
- has been duly established by the issuer's board of directors, with the authority and responsibility:
    - To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));
    - To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

        i) Notify the audit committee or the full board of directors;

        ii) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by the outside attorneys; and

        iii) Retain such additional expert personnel as the committee deems necessary; and
    - At the conclusion of any such investigation, to:

        i) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

        ii) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

iii) Acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in material respects to implement an appropriate response that the qualified legal compliance committee has recommended the issuer take.

Unless counsel has received an appropriate response from the company's CLO, 17 CFR § 205.3(b)(3) requires that he or she report the evidence of the material violation to:

- The audit committee;
- another committee that consists solely of independent directors; or
- the board of directors as a whole if there is no committee consisting solely of independent directors.

If counsel believes it would be futile to report the alleged evidence of a material violation to the company's CLO and CFO, he or she may proceed directly to the committee level of reporting. 17 CFR § 205.3(b)(4). Once counsel has received what he or she believes is an appropriate response, he or she has no further reporting obligation. 17 CFR § 205.3(b)(8). If counsel has not received what he or she believes to be an appropriate response, he or she must explain the reasons supporting his or her belief to the CLO and the directors to whom the alleged violation was reported. 17 CFR § 205.3(b)(9).

Counsel may, but is not obligated to, reveal evidence of the material violation to the SEC if counsel believes it reasonably necessary to:

- Prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors (17 CFR § 205.3(d)(2)(i));
- prevent the issuer, in a Commission investigation or administrative proceeding, from committing perjury, proscribed in 18 U.S.C. § 1621; suborning perjury, proscribed in 18 U.S.C. § 1622; or committing any act proscribed in 18 U.S.C. § 1001 that is likely to perpetrate a fraud upon the Commission (17 CFR § 205.3(d)(2)(ii)); or
- rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used (17 CFR § 205.3(d)(2)(iii)).

Note that pursuant to 17 CFR § 205.3(b)(6), these reporting obligations may not apply to:

- Lawyers retained to investigate evidence of a material violation; or
- lawyers retained to assert a colorable defense on behalf of the company in any investigation or judicial or administrative proceeding regarding the alleged material violation.

What is an appropriate response?

The SEC defines an appropriate response (in 17 CFR § 205.2(b)) as a response by a representative of the issuer to the attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

- That no material violation, as defined in paragraph (i) [of § 205.2], has occurred, is ongoing, or is about to occur;

- that the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or
- that the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:
  - Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or
  - Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

In reality, what does this mean? It is hard to say given that we know of only one case involving a Section 307 withdrawal. *See S.E.C. v. TV Azteca, S.A. de C.V., et al.*, No. 1:05-CV-00004 (EGS) (D.D.C.). In *TV Azteca*, for example, the Issuer has responded to allegations concerning a material violation of securities laws and the results obtained from an internal investigation by adopting a number of corporate governance reforms.

CURRENT ISSUES IN CRIMINAL LAW AFTER SARBANES

Sarbanes-Oxley's criminal provisions

Improper influence on conduct of audits

Section 303 of the Act makes it unlawful for officers and directors of an issuer to "take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading." The SEC has exclusive authority to enforce this section.

Retaliation against whistleblowers

Broad protections for whistleblowers are provided by the Act. These protections may encourage employees to come forward, as well as have a chilling effect on employer/employee relations. *See generally*, Terry F. Moritz, David E. Morrison, Katharine E. Burdic, *Recent Developments in the Interpretation of the Sarbanes-Oxley Act Whistleblower Provisions,* 1465 PLI/Corp 447 (Jan. 2005).

Protection for employees of publicly traded companies who provide evidence of fraud is found in Sections 806 and 1107. Section 806 creates a civil remedy for whistleblowers who suffer retaliation (*see* 18 U.S.C. §1514A):

- Provides a civil cause of action;
- Protects employees who are discharged or suffer other discrimination due to any whistleblowing activities;
- Applies to all reporting companies; and is
- Limited to whistleblowing regarding federal securities law violations.

Section 1107 creates criminal sanctions against those who "knowingly, with the intent to retaliate" act against whistleblowers:

- Includes both fines and up to ten years of imprisonment; and
- Applies to all reporting companies.

Document destruction

18 U.S.C. § 1512(c), as amended by Section 1102 of Sarbanes-Oxley, provides that whoever corruptly alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding shall be fined under this title or imprisoned for up to 20 years or both. As used in 18 U.S.C. § 1512(c), "corruptly" is likely to require that the defendant possess a "specific intent" to obstruct justice, which can be shown by knowingly engaging in acts which have the natural and probable (that is foreseeable) result of obstructing justice. This is true of 18 U.S.C. § 1503, which prohibits "corruptly tampering with a witness in a civil or criminal proceeding." Courts have held that a conviction under § 1503 requires the "specific intent" to impede the administration of justice.) *See, e.g., U.S. v. Moon*, 718 F.2d 1210, 1236 (2d Cir. 1983).

18 U.S.C. § 1519 provides criminal liability of a fine and/or maximum imprisonment of 20 years for whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence any federal investigation. Congress intended that 18 U.S.C. § 1519 be applied broadly to any act to destroy or fabricate physical evidence so long as the act is done with the intent to obstruct, impede or influence the investigation or proper administration of any federal matter. 148 Cong. Rec. S7418-01, *S7419 (daily ed. July 26, 2002).

This provision was so broadly drafted "that it arguably could be applied to a company's destruction of documents years before even a civil inquiry by an agency begins as long as that company's activities were 'administered' by that agency and the company's intent was to cover its wrongdoing or hamper a then-only potential future investigation." Abbe David Lowell & Kathryn C. Arnold, *Corporate Crime after 2000: A New Law Enforcement Challenge or Déjà vu?*, 40 Am. Crim. L. Rev. 219, 225 (2003).

18 U.S.C. § 1519 differs significantly from 18 U.S.C. § 1505, its predecessor. Unlike 18 U.S.C. § 1505, 18 U.S.C. § 1519 does not require a willful or corrupt state of mind, which allows the government to prosecute individuals who carry out these acts without knowledge of a law or legal duty. *Id.* Moreover, 18 U.S.C. § 1519 does not require an actual investigation to be ongoing because it includes unsuccessful attempts at violating this prohibition. *Id.*

New securities fraud statutes and penalties

Section 807 of Sarbanes-Oxley, 18 U.S.C. § 1348, creates a new federal felony for securities fraud subject to fines and/or imprisonment of up to 25 years for those who *knowingly* execute or attempt to execute a scheme or artifice to (1) defraud any person in connection with securities of an issuer, or (2) obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of securities of an issuer.

To date, no federal court has been asked to construe or apply this provision. The net effect of 18 U.S.C. § 1348, however, is to make prosecution of securities fraud cases much easier for federal prosecutors because it:

- Omits the requirement of willfulness found in the criminal provisions of the Securities Act and the Exchange Act, and substitutes for it only a knowing intent to defraud, which deprives an accused of the argument that no matter how improper his conduct may have been, he did not intentionally violate a known legal duty;
- eliminates the mailing and interstate wire requirement found in 18 U.S.C. §§ 1341 and 1343; and
- omits the requirement that the fraud occur "in connection with the purchase or sale" of a security—it merely requires that the scheme occurred in connection with a security.

18 U.S.C. § 1349 provides for the prosecution of those individuals who attempt or conspire to commit securities fraud, and is important in three respects:

- *First*, it does not contain an overt act requirement. Thus, there is one fewer element of proof than required by a conspiracy charge under 18 U.S.C. § 371.
- *Second*, conspiracies charged under 18 U.S.C. § 1349 carry the maximum penalty for the underlying substantive offense, rather than the five-year maximum contained in 18 U.S.C. § 371. Thus, conspiracies charged under 18 U.S.C. § 1349 now carry a twenty-five-year maximum sentence if they are based on securities fraud violations under 18 U.S.C. § 1348.
- *Third*, 18 U.S.C. § 1349 does not displace 18 U.S.C. § 371.

The decision to prosecute

The Holder and Thompson Memoranda

On January 20, 2003, the Justice Department released a memorandum by Deputy Attorney General Larry D. Thompson, entitled "Principles of Federal Prosecution of Business Organizations" (the "Thompson Memorandum"). The Thompson Memorandum updates an earlier memorandum on the same subject issued by former Deputy Attorney General Eric H. Holder Jr., dated June 16, 1999 (the "Holder Memorandum"), and stresses that any actions taken by a corporation that result in wrongdoing not being uncovered fully, completely and quickly will weigh in favor of prosecution. *See* Introduction to Thompson Memorandum.

In general, the Thompson Memorandum outlines the nine principles that federal prosecutors are expected to consider in determining whether to bring charges against a corporation. Thompson Memorandum, at Section II.A.

- **Nature and Seriousness of Offense (Section II.A.1. and Section III).** This principle is cited as a primary concern. Independent of the other factors, the seriousness of a crime alone may warrant prosecution. However, it is also noted that even if the crime is very severe, it may not warrant prosecution if committed by one rogue employee. Prosecutors are told to look to other divisions within the Justice Department, such as the Environmental, Tax, Antitrust and Criminal divisions, to see if they have policies that point toward or away from prosecution for certain industries or practices.
- **Pervasiveness of Wrongdoing Within A Corporation (Section II.A.2 and Section IV).** Prosecutors are advised to look toward the pervasiveness of a violation to decide whether to prosecute. Thus, even if a violation is relatively minor, if it is perpetuated by several employees, officers and/or directors of a corporation, the principles would support prosecution. The memorandum particularly emphasizes acts of wrongdoing that are condoned by a company's upper management. The involvement of management in wrongdoing is the most important issue in determining pervasiveness. Managers are often the leaders that establish a corporation's culture. As such, a violation perpetrated by several management-level employees, as opposed to low-level employees, could weigh strongly in favor of prosecution.

The guidelines tie the first two principles closely together and make them interdependent to a greater extent than the other principles. Thus, if a crime is only moderately serious but very pervasive, the first two principles would support a prosecution.

- **The Corporation's Prior History (Section II.A.3 and Section V).** Prosecutors are instructed that a corporation, like a natural person, is expected to learn from its mistakes. A history of similar conduct may be probative of a corporate culture that encouraged, or at least condoned, such conduct, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and yet it either did not take adequate action to prevent future unlawful conduct or continued to engage in the conduct in spite of the warnings or enforcement actions taken against it. In making this determination, the corporate structure itself, *e.g.*, subsidiaries or operating divisions, should be ignored, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates should be considered.
- **Cooperation and Voluntary Disclosure (Section II.A.4 and Section VI).** Prosecutors are asked to examine four factors to evaluate whether a corporation is cooperating:
  - The corporation's willingness to identify the culprit(s) (including senior executives);
  - produce witnesses;
  - disclose the results of internal investigations; and
  - waive the attorney-client privilege.

  One of the most controversial aspects of the new principles is the focus on waiving attorney-client privilege and work-product protection. Although waiving privilege is not "an absolute requirement," "prosecutors should consider the willingness of a corporation to waive such protection when necessary to provide timely and complete information."

  Another controversial aspect of this principle is the examination of a corporation's cooperation through factors such as whether the corporation is protecting culpable employees by advancing attorneys' fees, continuing to employ the employees without sanction, providing information about the government's investigation pursuant to a joint defense agreement or attempting to shield culpable officers by having the corporation plead guilty.

While the memorandum allows for indemnification mandated by law, it makes no similar allowance for indemnification that is contractual or part of a company's by-laws.

Prosecutors are also told to examine "whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction)." This revision to the original articulation of this principle in the Holder Memorandum underscores that for corporations to receive "credit" for cooperating, they must continue to cooperate fully throughout an investigation and do nothing that would appear duplicitous to the government.

- **Corporate Compliance Programs (Section II.A.5 and Section VIII).** Prosecutors are instructed to scrutinize compliance programs closely to ensure that corporations have put effective programs in place. However, having a compliance program that appears adequate is no longer enough. Prosecutors are now directed to determine whether a compliance program is truly effective or whether it is merely a "paper program"—*i.e.,* a program that looks good on paper but is actually ineffective in practice. Factors that point to a satisfactory compliance program include:
  - The promptness of reporting wrongdoing by the company to the government;
  - the company's subsequent cooperation in the investigation;
  - whether directors exercise independent review over proposed corporate actions;
  - whether directors receive enough information to exercise independent judgment;
  - whether internal audit functions allow for independent and accurate audits; and
  - whether there is an adequate information and reporting system that enables directors to receive the information they need.
- **Restitution and Remediation (Section II.A.6 and Section VIII).** Under the guidelines, prosecutors are compelled to examine three factors in determining whether to credit the claim that appropriate restitution and remediation have taken place:
  - Employee discipline;
  - monetary restitution; and
  - reform of corporate practices and compliance programs.

  A corporation's response to wrongdoing is taken as indicative of its willingness to curtail future wrongdoing. Any action by the corporation that suggests it is attempting to protect employees who have engaged in malfeasance will generally lead federal prosecutors to conclude that a corporation, and more specifically its management, condones such behavior and that wrongdoing has become part of the corporate culture. Any such action bespeaks pervasiveness and will strongly point towards the appropriateness of prosecution.
- **Collateral Consequences (Section II.A.7 and Section IX).** Prosecutors are told to examine the consequences of the proposed prosecution on officers, directors, employees and shareholders of the cor-

poration. As with the prosecution of a natural person, any prosecution of a corporation will have unwanted collateral consequences and, according to the Justice Department, such a consideration alone should not stop a prosecution. Prosecutors should balance the consequences of prosecution against the pervasiveness of the conduct at issue, as well as the effectiveness of a company's compliance program.

- **The Adequacy of the Prosecution of Individuals Responsible for the Corporation's Malfeasance (Section II.A.8).** While the Thompson Memorandum does not elaborate on this factor, prosecutors are likely to prosecute a company where, for whatever reason, the individuals responsible for a company's criminal conduct have not been (or cannot be) prosecuted to the fullest extent of the law. For example, where the individuals responsible for the alleged criminal conduct are outside the jurisdiction of federal prosecutors, the company may well be prosecuted more aggressively than the criminal conduct would otherwise warrant.
- **Non-Criminal Alternatives (Section II.A.9 and Section X).** Prosecutors are instructed to consider whether non-criminal alternatives would adequately deter, punish, and rehabilitate a corporation that has engaged in wrongful conduct. In evaluating the adequacy of non-criminal alternatives to prosecution, *e.g.*, civil or regulatory enforcement actions, prosecutors may consider all relevant factors, including:
  - The sanctions available under the alternative means of disposition;
  - the likelihood that an effective sanction will be imposed; and
  - the effect of non-criminal disposition on federal law enforcement interests.

  Such an alternative is inappropriate, however, where the violation is egregious, there is a pattern of wrongdoing, or there exists a corporate history of violations. Thus, non-criminal alternatives appear to be adequate for small or first-time violations and play into the analysis under earlier principles such as compliance programs, severity, pervasiveness, and past corporate history.

  Over the last 16 years, the charging decisions by the United States Attorney's Office for the Southern District of New York (the "U.S. Attorney's Office"), as reflected in press releases issued by that office, illustrate which principles generally tend to be given the most weight by federal prosecutors. Cases brought before the Holder and Thompson Memoranda demonstrate that full and complete cooperation by a corporation will almost always benefit a corporation, although it will not always ensure that a prosecution will not be brought. On the other hand, a lack of cooperation, or even worse, the obstruction of an investigation, will almost always tip the scale in favor of prosecution.

  In press releases from June 1987 through March 1998, the major reasons given for not prosecuting a corporation were:
  - The corporation's full cooperation with the government;
  - entry into a consent agreement or judgment with the SEC, government, or both;
  - dtructural and management changes made by the corporation; and
  - the collateral effect of the prosecution.

Comments on Adelphia, Martha Stewart, Quattrone and other recent cases of interest

Adelphia

On July 9, 2004, John Rigas, the founder of Adelphia Communications Corp., and his son, Timothy Rigas, the former chief financial officer, were convicted of eighteen counts of securities fraud, bank fraud, and conspiracy. On June 20, 2005 John Rigas was sentenced to fifteen years in prison, and his son, Timothy, received a sentence of twenty years. On July 10, 2004, the trial of Michael Rigas, the former Operations Chief, ended in a mistrial with the jury deadlocked on seventeen accounts against him. A retrial is currently scheduled to take place during the Fall of 2005.

Martha Stewart

On March 5, 2004, Martha Stewart was found guilty of four counts of obstruction of justice and lying to investigators and was subsequently sentenced to five months in prison, two years' probation, five months of home confinement after release, and a fine of $30,000. Her appeal is pending.

Frank Quattrone

On May 3, 2004, Frank Quattrone, the ex-head of Credit Suisse First Boston's ("CSFB") technology banking business, was convicted on three charges of obstructing justice and witness tampering. He was convicted on charges of trying to hinder a government investigation into whether CSFB sold shares of hot IPOs to favored clients in exchange for inflated commissions. Quattrone was subsequently sentenced to eighteen months in prison and two years probation. Currently, Quattrone is free on bail pending an appeal of his convictions.

Bernard Ebbers

On March 16, former WorldCom CEO, Bernard Ebbers, was convicted of committing a massive financial fraud at WorldCom, which would eventually cause the company to file for bankruptcy. On July 13, 2005, Ebbers was sentenced to twenty-five years in prison. Ebbers is currently free on bail pending an appeal of his convictions.

Richard Scrushy

On June 28, 2005, former HealthSouth CEO, Richard Scrushy, was acquitted on thirty-six counts of conspiracy, false reporting, fraud and money laundering. Avoiding criminal liability, Scrushy blamed HealthSouth's $2.7 billion earnings overstatement on fifteen former HealthSouth employees who pleaded guilty.

Tyco International Ltd.

On June 17, 2005, former Tyco CEO, L. Dennis Kozlowski, and former CEO, Mark H. Swartz, were convicted on twenty-two of twenty-three counts of grand larceny, conspiracy, securities fraud and falsifying business records. On September 19, 2005, Kozlowski and Swartz were each sentenced to up to twenty-five years in prison.

THE AUDITORS

The Section 10A investigation

Section 10A of the Securities Exchange Act of 1934 ("Exchange Act") delineates the steps auditors must take in carrying out an investigation. Section 10A of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), imposes both audit and reporting requirements on public auditors and requires that if a public auditor in the course of conducting its audit "detects or otherwise becomes aware" of information that an illegal act, regardless of its materiality, has or may occur, then it is required "to determine whether it is likely that an illegal act has occurred." If the auditor determines that an illegal act has "likely" occurred, then he must determine what possible effect the illegal act could have on the company's financial statements. This analysis requires the auditor to look at any "contingent monetary effects, such as fines, penalties, and damages." Accordingly, unless the auditor determines that the illegal act is "clearly inconsequential" it must "as soon as practicable" inform the appropriate level of management.

Once the auditor has reported the illegal act to the company's management, Section 10A(b) requires "timely and appropriate remedial action with respect to the illegal act." If the management fails to take remedial action, then the auditor must determine whether the illegal act will have a "material effect" on the company's financial statements. If the auditor determines that the illegal act will materially affect the company's financial statements and that the act can be reasonably expected to warrant the auditor's resignation or deviance from its standard audit procedures, then the auditor must report its conclusions to the company's board of directors. If at the end of the next business day the company has failed to notify the SEC as to the auditor's conclusions, Section 10A provides the auditor with two options:

- First, the auditor can continue its engagement as the company's auditor, but it must provide the SEC with a copy of the report made to the board of directors or documentation of an oral report within one additional business day, or
- Second, the auditor can resign, but must still provide the SEC with the report or proof of an oral report within one business day from the date the company was supposed to inform the SEC.

Should the report, or its substance, be provided to the auditors?

Disclosure of the report or its substance may waive the company's attorney-client privilege. A limited balanced disclosure of the report's findings and conclusions may not waive the company's privilege.

> *In re Dayco Corp. Derivative Secs. Litig.*, 99 F.R.D. 616 (S.D. OH 1983) (The Dayco court stated, that since, "the press release did not summarize evidence found in the report, nor did it purport to combine those findings with those of the Directors it had not effected a waiver of the privilege).
>
> *In re Witham Memorial Hospital*, 706 N.E.2d 1087 (Ct. App. Ind. 1999) (The Court held that because the press release did not "compromise the confidentiality of the report itself,

the communications between the attorneys and the investigator during the investigation, or the analysis contained in the report," privilege was not waived.)

Thus, it is possible that a summary discussion of the report to the auditors might not waive the privilege.

Cooperation between the auditors and regulators

To what extent should it be encouraged/permitted? The company may not have much of a choice as the SEC usually requests to interview the auditors.

REPRESENTING DIRECTORS AND OFFICERS AFTER SARBANES-OXLEY

Audit committees and outside directors

Composition of the board

Section 10A(m)(3)(A) of the Exchange Act requires that "[e]ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer and shall otherwise be independent."

Independence rules under the Exchange Act

Section 10A(m)(3)(A) of the Exchange Act states that to be considered an independent director, "a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof."

Section 10A(m)(3)(C) of the Exchange Act provides the SEC with the authority to exempt audit committee members from the Exchange Act's independence requirements, as it "determines appropriate in light of the circumstances."

Independence rules under the NYSE Corporate Governance Rules, codified in Section 303A of the NYSE's Listed Company Manual

- Listed companies must have a majority of independent directors.
- A director cannot qualify as independent unless the Board "affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).
- A director who is an employee, or whose immediate family member is an executive officer, of the company is not "independent" until three years after the end of such employment relationship.
- A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation not contingent in any way on continued service, is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

- A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not "independent" until three years after the end of the affiliation or the employment or auditing relationship.
- A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not "independent" until three years after the end of such service or the employment relationship.
- A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not "independent" until three years after falling below such threshold.

Financial experts

Section 407 of the Sarbanes-Oxley Act requires that the SEC issue rules requiring that each issuer disclose in its periodic reports whether or not, and if not, why, the audit committee does not have at least one member who is a financial expert. The SEC, pursuant to Section 407 of the Sarbanes-Oxley Act, amended Item 401 of Regulations S-K and S-B to require issuers to make those disclosures in their annual report. *See* Securities Act Release No. 33-8177, *Disclosures Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002* (Mar. 3, 2003). Regulation S-K defines an "Audit Committee Financial Expert" as a person who has all of the following:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

In addition, Regulation S-K (17 C.F.R. § 229.401(g)(2)(2003)), requires that such person shall have acquired such attributes through one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- Other relevant experience.

Increased liability

Section 407 of Sarbanes-Oxley does not appear to have been adopted to increase the duties, obligations or liability of any audit committee member, including the audit committee financial expert. The SEC, in its final rules, affirmatively provided a safe harbor that asserts that a person who is determined to be an audit committee financial expert is not an "expert" for any purpose, including Section 11 of the Securities Act of 1933 and that such person does not have any greater duties, obligations or liability than those of any other member of the audit committee and board of directors in the absence of such designation. *See* SEC Release No. 33-8177, *supra*. Recent developments in both the SEC and class action context do, however, suggest that the enactment of Sarbanes-Oxley will result in greater penalties for directors accused of wrongdoing:

- ***Nortel***. On January 11, 2005, Nortel announced that a number of its executives would repay $8.6 million in bonuses that they had received from the Company. Nortel made the announcement in connection with its release of its audited financial statements for fiscal years 2001 through 2003. The audited financial statements showed that Nortel's earnings were not as high as previously expected and believed. Presumably, in an attempt to avoid SEC action, Nortel's executives agreed to repay these bonuses which were tied to the previously expected higher results.
- ***Enron***. On January 7, 2005, ten former directors agreed to pay $13 million of their own funds to settle a class action litigation brought by shareholders.
- ***WorldCom***. On January 5, 2005, ten of WorldCom's former outside directors agreed to settle their portion of a class action lawsuit brought by bondholders and shareholders for $54 million. Of this amount, the former directors agreed to pay a total of $18 million from their own personal funds, or about 20% of their combined personal net worth.

Separate counsel for outside directors

Given the current regulatory climate, outside directors may want separate counsel. Often the outside directors may have defenses not available to management. Even if outside directors are not implicated in the alleged misconduct, they may want separate counsel to advise on their Sarbanes obligations.

COOPERATION WITH THE SEC

Significance

In 2001, in the wake of the Enron scandal, companies became increasingly exposed to liability from the SEC's enforcement practice when Harvey Pitt, as SEC Chairman, introduced a "real-time enforcement" program into the SEC's enforcement practice. Stephen Cutler has defined the "real-time enforcement program [as] one that seeks to respond quickly, effectively, and efficiently to wrongdoing" and stated that a vital element of this program includes "rewarding meaningful cooperation –

because doing so will enable [the SEC] to bring more cases faster." For example, the SEC has already initiated 639 civil or administrative enforcement actions in 2004.

Accordingly, on October 23, 2001, the SEC issued a Report of Investigations Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions ("Seaboard Report"). The Seaboard Report's purpose was to set forth "a framework for evaluating a company's cooperation in determining whether and how to charge violations of the federal securities laws." The Seaboard Report's framework is comprised of four broad measures:

- Self-policing;
- self-reporting;
- remediation; and
- cooperation.

Stephen Cutler, the SEC's director of enforcement, has made the following statements:

> "[C]redit for cooperative behavior may range from taking no enforcement action at all to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents the SEC uses to announce and resolve enforcement cases." *SEC Seaboard Report Explains How Companies Might Win Leniency In Probes*, 33 SEC. Reg & L. Rep. 1529 (Oct. 29, 2001).
>
> There may be instances where a company's "conduct is so egregious, and harm so great, that no amount of cooperation or other mitigating conduct can justify a decision not to bring any enforcement action at all." SEC Release No. 44969, *Report of Investigations Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions* (Oct. 23, 2001).
>
> The SEC "is placing a greater emphasis than ever before on assessing [and] weighing cooperation when making, charging, and sanctions decisions." Remarks of Stephen M. Cutler, former Director of Enforcement, U.S. Securities and Exchange Commission (Feb. 11, 2004). [Hereinafter, "Cutler, February 2004 Speech."]

To cooperate, or not? How to cooperate? Does it have to be all or nothing?

Cooperation means implementing the Seaboard Report's four measures: self-policing, self-reporting, remediation, and cooperation.

Self-Policing. Generally, means implementing appropriate compliance and supervision policies and procedures to ensure that misconduct is prevented or detected as soon as it occurs. Cutler has stated that the SEC looks "to the company's actions both *before* and *after* discovery of misconduct, including the rigor of its compliance and/or internal audit program and the tone set by senior management." Stephen M. Cutler, *Speech by SEC Staff: Remarks Before the Investment Company Institute*, *Securities Law Developments*

Conference (Dec. 6, 2001). This sentiment is best conveyed by Cutler's statement: "If you start thinking about the [Seaboard] Report only after you receive a subpoena, you're too late." *Id.*

Self-Reporting. The company must "conduct[ ] a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely, and effectively disclos[e] the misconduct to the public, to regulators, and to self-regulators."

These measures include:

- Stopping the misconduct;
- having independent counsel conduct an internal investigation; and
- disclosing the misconduct as soon as possible.

Remediation. Includes "dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected."

Cooperation. Generally refers to cooperation "with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts."

The SEC's current approach is to measure a company's cooperation at every point of the process, rather than looking at it as a whole. In fact, Cutler has publicly stated that not only has he "directed the staff to keep an ongoing log recording parties' cooperation, or lack thereof," but that the SEC "is using a more graduated scale when it assesses cooperation." Cutler, February 2004 Speech. As explained by Cutler, the reality of this practice is that if a company's initial cooperation with the SEC is not adequate, the SEC will take this into consideration "even if the conduct of the [company] was later exemplary." *Id.*

The decision to cooperate

Can cooperation be a two-way street with the SEC? Can the company selectively provide more information to the SEC in exchange for concrete steps by the SEC toward settlement?

What constitutes cooperation?

Remedial actions

Terminate employees. In Seaboard, the company terminated Leon-Meredith, its former controller, within 12 days of learning of misconduct and two employees responsible for supervising Leon-Meredith were also terminated.

In *Sec. Exch. Comm'n v. Ahold* (October 13, 2004), "[t]he Commission [ ] did not seek a penalty from Ahold, among other reasons, because of the company's extensive cooperation with the Commission's investigation…including, but not limited to,…terminating employees responsible for the wrongdoing."

Enact new controls. In Seaboard, the company implemented several new controls. It strengthened its financial reporting processes to prevent a recurrence of such misconduct in the future. These steps included:

- The development of a detailed closing process for the subsidiaries' accounting personnel;
- Consolidating the subsidiaries' accounting functions under a Seaboard CPA;
- Hiring additional qualified employees responsible for preparing the subsidiaries' financial statements;
- Changing the subsidiaries' annual audit requirements; and
- Vesting Seaboard's controller with supervisory responsibilities over the subsidiaries' reporting processes.

No indemnification

When, if ever, is indemnification permitted? In regards to *In Re Lucent* (May 17, 2004), Associate Enforcement Director Paul Berger stated that "[a]nyone who settles with us is going to agree not to be indemnified" and that the commission "may well ask [a company] not to indemnify an individual" employee who has incurred costs and penalties. Phyllis Diamond, *SEC Demand for Cooperation Seen Raising Due Process Concerns*, 36 SEC. Reg. & L. Rep. (BNA) 1070 (June 14, 2004). The basis for prohibiting indemnification is twofold:

- The cost of indemnification is borne by the shareholders. *Id.*
- Employees who are indemnified by their companies have a greater incentive to repeat the corporation's version of events, and less incentive to cooperate with federal investigators. *Id.*

It is not yet clear if the SEC will view as uncooperative the indemnification of a company's employee that is explicitly authorized under the company's by-laws.

Self-Reporting

In *Seaboard*, the SEC found significant the speed and candor in disclosing the wrongdoing. The audit committee and full board were notified in a timely fashion, and the company disclosed to both the SEC and the public that its financial statements would have to be restated. In *Ahold*, before the company disclosed the misconduct and that it was going to restate its financial statements, it gave the SEC advanced notice of the content of its announcement.

Privilege waiver

The SEC expects companies to waive all privileges if it desires to obtain cooperation credit. In *Seaboard*, the SEC found it significant that Seaboard did not invoke the attorney-client privilege, work product protection, or other privileges or protection with respect to any information uncovered in the investigation. In *Ahold*, the company explicitly stated that the company was cooperative because it "promptly provided the staff with the internal investigative reports and the supporting information and waived the attorney-client privilege and work product protection with respect to its internal investigations."

Joint defense privilege

Even if a common interest does exist between the company and management on certain issues, the SEC may frown on use of the joint defense privilege as it may encourage defendants to present a unified front and collaborate to present a "uniform" version of events.

Providing counsel to employees

In *In Re Lucent* (May 17, 2004), the SEC warned corporations that paying its employees' legal fees while an SEC investigation is ongoing could be deemed uncooperative.

The risk to the privilege

To obtain full cooperation credit, the SEC expects companies to waive all privileges. If the independent counsel conducting the independent investigation drafts a written report, its disclosure to the SEC or other third party, including the auditors, would waive the company's privilege. In an attempt to protect the privilege nature of the report, the SEC now offers to enter into confidentiality agreements that would prohibit the disclosure of the report to third parties. As discussed above, however, there is currently a split among federal courts as to whether confidentiality agreements can preserve privileges of disclosed materials. One open question is whether the privilege can be preserved by the delivery of an oral proffer of the report.

RECENT SEC SETTLEMENTS AND THE SEC'S STATUTORY POWER TO IMPOSE FINES

Summary of recent major settlements

Tyson Foods. On April 28, 2005, the SEC announced that it had instituted settled enforcement proceedings against Tyson Foods, Inc. ("Tyson Foods") and its former Chairman and CEO Donald Tyson ("Don Tyson"). The SEC alleged that in proxy statements filed with the Commission from 1997 to 2003, Tyson Foods made misleading disclosures of perquisites and personal benefits provided to Don Tyson both prior to and after his retirement as senior chairman in October 2001. The SEC also alleged that the company failed to maintain adequate internal controls over Don Tyson's personal use of company assets. The Commission separately charged Don Tyson with causing and aiding and abetting the company's disclosure violations.

Tyson Foods and Don Tyson agreed to settle the SEC's charges by consenting to the entry of a final judgment in a civil action filed in the U.S. District Court for the District of Columbia ordering Tyson Foods to pay a $1.5 million penalty and Don Tyson to pay a $700,000 penalty. In addition, both parties separately consented to the entry of an SEC Order ordering them to cease and desist from violating the proxy solicitation and periodic reporting provisions of the federal securities laws. The company and Don Tyson agreed to the settlements without admitting or denying the findings or allegations in the SEC's Order and complaint.

Coca-Cola Company. On April 18, 2005, the SEC filed a settled administrative cease-and-desist proceeding against The Coca-Cola Company ("Coke"). The action related to Coke's alleged failure to disclose certain end-of-quarter sales practices in Japan used to meet earnings expectations, and misstatements in a Form 8-K concerning a subsequent inventory reduction.

Without admitting or denying the Commission's allegations, Coke agreed to cease-and-desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

SEC v. Time Warner, Inc. On March 21, 2005, the SEC charged Time Warner Inc. (formerly known as AOL Time Warner) with materially overstating online advertising revenue and the number of its Internet subscribers, and with aiding and abetting three other securities frauds. The Commission also charged that the Company violated a Commission cease-and-desist order issued against America Online, Inc. on May 15, 2000 by artificially inflating its online advertising revenue and the number of AOL subscribers, as well as its failure to consolidate AOL Europe's financial statements.

Without admitting or denying the allegations in the complaint, Time Warner consented to the entry of a judgment that, among other things, ordered it to pay $300 million in civil penalties. The judgment further ordered the company to comply with the Commission's May 15, 2004 cease-and-desist order against AOL; enjoined the company from violaitng antifraud, reporting, books-and-records, and internal control provisions of the federal securities laws; and enjoined the company from aiding and abetting securities fraud. As part of the settlement, Time Warner agreed to restate its historical financial results to reduce its reported online advertising revenues by approximately $500 million (in addition to the $190 million already restated) for the fourth quarter of 2000 through 2002 and to properly reflect the consolidation of AOL Europe in the company's 2000 and 2001 financial statements. The company also agreed to engage an independent examiner to determine whether the company's historical accounting for certain transactions was in conformity with GAAP.

Royal Dutch/Shell Group. The company agreed to a $120 million settlement after violating antifraud provisions by overstating its oil reserves by more than 20%. Under the accord, the world's third-largest publicly traded oil company also agreed to spend $5 million on an internal compliance program. The $120 million civil fine is the third-largest imposed by the SEC for alleged accounting fraud, behind WorldCom Inc.'s agreement to pay investors $500 million in May 2003, and $150 million in a fine and restitution by Bristol-Myers Squibb Co. (discussed below).

Bristol-Myers Squibb. The company reached a final settlement of $150 million with the SEC, concluding an investigation concerning improperly recognizing $1.5 billion in revenue.

Vivendi Universal. Vivendi agreed on December 23, 2003 to pay $50 million to settle accusations by the SEC that it misled investors in its news releases and financial statements. As part of the settlement, the company's former chief executive, Jean-Marie Messier, who transformed the company from a water utility into a media empire but saddled it with huge debts, and its former CFO, Guillaume Hannezo, agreed to pay disgorgements and civil penalties that total over $1 million and to give up any claims to a severance package worth 21 million euros ($26 million) that Hannezo says he negotiated before resigning in July 2002.

i2 Technologies. i2 Technologies agreed to settle its claims with the SEC for $10 million. The SEC alleged that it misstated $1 billion in software-license revenues over five years.

Halliburton. In *Halliburton*, the SEC alleged that Halliburton violated the securities laws by failing to disclose that it had implemented a new set of accounting practices that, while technically proper under GAAP, should have been disclosed because they represented a departure from the practices previously used and previously disclosed by Halliburton. The Staff's settlement with Halliburton and Robert Charles Muchmore, Halliburton's former controller, included:

- A cease and desist order prohibiting future violations of the securities laws;
- a monetary penalty of $7.5 million to be paid by Halliburton; and
- a monetary penalty of $50,000 to be paid by Muchmore.

SEC v. Xerox Corp. In *Xerox*, the SEC charged Xerox with financial fraud and settled the case for a $10 million civil penalty and other relief. The Commission explained in its press release that the penalty, the largest imposed against a public company at the time, reflected the fact that the company's management allowed the fraud to continue for several years and failed to cooperate with law enforcement – specifically that the penalty also reflected in part, a sanction for the company's lack of full cooperation in the investigation.

SEC v. Rite-Aid. In *Rite Aid*, a financial fraud case involving two years of overstated income, and, at the time, the largest restatement of income by a public company, the SEC administrative order noted:

> "Rite-Aid cooperated in the Commission's investigation of this matter, including declining to assert its attorney-client privilege with regard to various matters relevant to the investigation and voluntarily providing the Commission staff with full access to an internal investigation conducted by Rite-Aid's counsel," and "the Commission has considered the value of this cooperation in determining the appropriate resolution of this matter."

The Remedies Act generally

History

Prior to Congress's enactment of the Securities Enforcement Remedies and Penny Stock Reform Act of (1990) ("Remedies Act"), the SEC's ability to impose civil penalties was severely limited. For instance, before the Remedies Act, the SEC's authority to impose monetary penalties stemmed from two regulations. First, Section 32(b) of the Exchange Act permitted the SEC to impose a penalty of $100 per day against issuers that failed to file statutorily required reports. (15 U.S.C. § 78ff(b)). The SEC used this sanction so rarely that as of 1990, it invoked this authority only once.

Second, the Insider Trading Sanctions Act of 1984 granted the SEC the authority to seek significant monetary penalties in civil proceedings involving allegations of insider trading. Consequently, in all other instances, the SEC's enforcement authority was limited to remedial measures.

Therefore, Congress's enactment of the Remedies Act revolutionized the SEC's enforcement authority by significantly broadening the scope of the violations for which the SEC could seek monetary penalties to any violation of any of the major securities statutes. Of equal importance, it provided the SEC with authority to seek significant monetary penalties against companies that range from $120K to $600K per "violation."

Key provisions

Section 21d(3) of the Exchange Act authorizes the SEC to bring a civil action to impose civil penalties and provides three tiers of penalties.

- **First tier.** The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of i) $6,500 for a natural person or $60,000 for any other person, or ii) the gross amount of pecuniary gain to such defendant as a result of the violation.
- **Second Tier.** Notwithstanding clause (i), the amount of penalty for each such violation shall not exceed the greater of i) $60,000 for a natural person or $300,000 for any other person, or ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.
- **Third Tier.** Notwithstanding clauses (i) and (ii), the amount of penalty for each such violation shall not exceed the greater of i) $120,000 for a natural person or $600,000 for any other person, or ii) the gross amount of pecuniary gain to such defendant as a result of a violation, if the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

The future of cooperation with the SEC

The SEC now views its role as a watchdog as more important than ever and its power as stronger than ever. Therefore, the SEC is likely to force companies to cooperate to an even greater extent. Importantly, the SEC does not view its aggressive use of its powers as extreme. Indeed, in a speech recently given by Stephen Cutler, he made clear that he believes the efforts taken by the SEC are moderate in nature:

> "Now before you conclude that we have come down too hard on corporate offices and directors, I wanted to read you a few lines from a recent article about the Chinese government's response to corporate fraud. According to the article:
>
> > China executed four people, including employees of two of its Big Four state banks, fraud totaling $15 million, the Xinhua state news agency said Tuesday, amidst a high-profile campaign financial crime. The executions come after a string of arrests in white-collar crime as China prepares to sell shares in its big banks."
> >
> > *Stephen M. Cutler, Speech by SEC Staff: The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program (Sept. 20, 2004).*

It remains to be seen whether Cutler's successor, Linda Thompson, will continue to pursue this philosophy. Will the pendulum swing back to a more traditional adversarial process in which penalties are more closely limited to the damages the SEC could likely recover under the Remedies Act? The incentive to cooperate will remain high. But the SEC needs to be careful not to overreach given its limited statutory powers to impose fines. Companies will continue to have to see tangible results for this cooperation.

ENDNOTES

1 This article was prepared by Richard A. Spehr (Partner, New York office) with the assistance of Henninger S. Bullock, an associate in the New York office of Mayer, Brown, Rowe & Maw LLP. The views stated by the authors are their own and do not necessarily reflect the views of Mayer, Brown, Rowe & Maw LLP or its clients.

2 As discussed in greater detail below, a Qualified Legal Compliance Committee ("QLCC") is a committee that an issuer may form to consider and, if necessary, investigate allegations of a material violation of the federal securities laws.

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