Securities fraud investigations, securities class actions and derivative litigation: Suggestions for cost-effective management

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Received (in revised form): 23rd April, 2010

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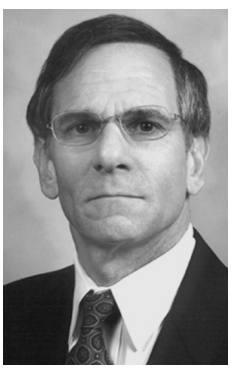

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Journal of Securities Law, Regulation & Compliance
Vol. 3 No. 3, pp. 218–231

ABSTRACT

Securities fraud related investigations by governmental agencies, which are often accompanied by civil litigation, pose substantial risk to public companies. Such risks include not only potential substantive liability but the substantial expenses that may be incurred in investigating and defending allegations of wrongdoing, even if they prove to be meritless. The authors suggest appropriate means of controlling legal expense consistent with providing a vigorous, effective defence. In particular, they suggest how experienced counsel can help implement a well-organised strategy that imposes appropriate cost controls, while avoiding false economies that risk a worse outcome at higher ultimate overall cost.

Keywords: cost-effective, defence, government, investigation, litigation, securities fraud

INTRODUCTION

It is said that bad news comes in threes. With respect to securities enforcement and litigation matters, that is typically an

understatement. All too often, a company that has announced bad news — such as a restatement of previously issued financial statements, or that sales or earnings are significantly less than expected, or that finds itself the subject of adverse press reports — rapidly finds itself under scrutiny or attack on many fronts. It may face investigation by the US Securities and Exchange Commission (SEC), the US Department of Justice (DOJ), state law enforcement and self-regulatory organisations. Shareholders may file class action securities fraud lawsuits. Other shareholders may file derivative lawsuits asserting claims against corporate directors and officers in the name of the corporation.

Addressing these investigations and lawsuits will require the corporation to retain defence counsel, who in turn, will need to retain ancillary professionals, including forensic electronic discovery consultants and perhaps accountants or other experts. Moreover, in significant matters it is likely that the company or committees of its board of directors will have to retain additional counsel and their consultants. Depending on the significance of the issues, the corporation's board of directors may well conclude that it needs to conduct an independent investigation, both to fulfil its fiduciary duties and, potentially, to gain cooperation credit from the SEC and the DOJ for corporate self-investigation and self-remediation of potential violations.[1] Also, in response to a subsequent shareholder derivative demand, the Board may conclude that it is appropriate to appoint a special litigation committee of independent directors who will retain independent counsel to help them investigate and evaluate the claims asserted in the demand to determine what, if any, action the corporation should take in response to the demand.[2]

In addition to its retained defence and independent counsel, in any significant matter a corporation is also likely to face the cost of counsel retained by individual officers, directors and employees. Most Delaware corporations have bylaws providing for indemnification and the advancement of legal fees of their directors and at least their most senior officers, and many have policies authorising indemnification and advancement for other employees.[3] Such individuals are likely to require or seek separate counsel for several reasons. First, individuals who are interviewed by company counsel (including not only defence counsel but also counsel conducting an internal investigation or counsel for a special litigation committee) should receive *Upjohn* warnings making clear that:

- counsel represents the company, not the individual;
- the interview is subject to the company's attorney-client privilege and should not be disclosed to, or discussed with, anyone else;
- the company may unilaterally decide to waive the privilege without the interviewee's consent; and
- information provided by the individual will be shared with the company, and may, if the company waives privilege, be shared with others, including government enforcement agencies, without the interviewee's consent.[4]

Individuals who receive such warnings may conclude that they wish to seek the advice of counsel before proceeding with the interview. Secondly, the SEC's recently announced policy regarding cooperation credit for individuals may lead some individuals to conclude that it is in their interest to consult with counsel early in the investigation process.[5]

Given this potential plethora of proceedings and counsel, the notion of managing the process for 'cost-effectiveness'

may sound fanciful. It is certainly true that, in any serious matter, the legal fees and expenses inevitably will be substantial. Moreover, given the stakes, the primary focus must be on the quality and substantive effectiveness of the representation.

The authors believe, however, that there is no conflict between substantively effective representation and cost-effective representation. To the contrary, thoughtful management can help to achieve both goals. Some suggestions in this regard are offered below.

Engaging experienced, pragmatic, diplomatic counsel

Sophisticated clients have long understood that, given the speed and complexity of government investigations, and the possibility of multiple, parallel proceedings, it is essential to hire counsel who has extensive experience in handling such matters. Not only will their experience make them more efficient generally and avoid potentially costly mistakes, it will also help them identify potential risks early and develop an effective, flexible strategy that can anticipate and adapt to the inevitable new developments that will occur as the investigation progresses.

Experience alone, however, is not enough. The most effective counsel is also pragmatic. Every investigation inevitably involves constraints of time pressure and less than infinite financial and human resources. Companies vary enormously in size, structure, geography and culture, and in their ability to tolerate the reputational risk that may be posed by an investigation or related litigation. This means that a mechanical, 'one size fits all' approach will almost certainly be wasteful and ineffective. Counsel needs to be able to draw on their experience to think creatively about how to develop an approach that is practically achievable and effectively addresses not only the legal risks facing the company but also business and reputational risk.

Diplomatic skills are no less essential, but their importance is frequently underestimated. Company counsel will need to negotiate with agency investigative counsel, possible internal investigation counsel, counsel for individuals, and litigation adversaries. Clients are entitled to zealous representation throughout this process. But needless friction and fights will be expensive, ineffective and counterproductive, particularly in a regulatory investigation or an internal investigation.

For example, while SEC demands for information are not self-enforcing, forcing the issue to court will almost certainly be counterproductive even in the event the respondent prevails and the court narrows the request — an outcome that is far from certain.[6] The relationship with enforcement staff will inevitably become more adversarial and the investigation process more burdensome and expensive. More importantly, a confrontational approach is likely to result in a worse substantive outcome. Agency counsel is not generally inclined to exercise its prosecutorial discretion favourably with respect to companies or other respondents perceived as recalcitrant. In particular, a respondent that takes an adversarial approach will forfeit the opportunity to receive credit for cooperation, which both the SEC's Enforcement Manual and the Justice Department's Filip Memorandum recognise as a basis for the enforcement authority to exercise its discretion to seek a lesser sanction than it otherwise might.[7] In short, any procedural 'victory' is almost certain to be Pyrrhic.

Thus, the most cost-effective and substantively effective approach is, typically, good faith negotiation and persuasion. Having made clear the client's recognition

of the legitimacy and importance of the agency's enforcement mission, and the company's commitment to cooperate and comply in good faith, counsel can then clearly and accurately explain the practical logistical impediments to providing all of the requested information within the time requested, or why certain requests are likely to be extremely burdensome and expensive to the client but yield little useful non-duplicative information. Counsel and the enforcement staff (or independent counsel) can then engage in a constructive dialogue about how to provide the information the requester needs within an expeditious but reasonable timeframe — perhaps by prioritising some items, by rolling production, by scheduling testimony to accommodate important commitments or by other means. Except in rare cases, this approach will achieve the best result.

This same pragmatic, problem-solving approach may offer opportunities to reduce duplicative cost and burden in matters with parallel proceedings. For example, where multiple, largely overlapping requests for documents and information have been received from the SEC, the DOJ, a state attorney general and/or a self-regulatory organisation, it may be possible to reach agreement for production to all of them of the same documents (or specific subsets) on the same time schedule. Obviously, such a decision requires a careful analysis that considers the scope and degree of congruence of the various requests and whether such an approach is truly more efficient and in the company's best interest. But the potential for efficiencies, and avoidance of disputes that may arise from discrepancies in production, should be considered. And, in any event, decisions regarding responses to document requests always should be made with an eye toward the overall universe of such requests.

HANDLING DOCUMENTS PROPERLY

Securities cases are notoriously document intensive. Enforcement agencies and courts expect companies to identify, preserve, collect, and review potentially relevant documents.[8] Failure to do so properly can lead to serious sanctions, including, potentially, criminal prosecution,[9] and will undermine any claim of cooperation for which the corporation wants to receive credit.[10] It may also lead to duplication of effort and expense when the work must be re-performed properly. Moreover, it is in the company's interest to identify and review key relevant documents promptly so that counsel can make a preliminary risk assessment and help the company formulate an appropriate strategy.

A comprehensive discussion of compliance with document preservation and production obligations is beyond the scope of this paper; below are only a few considerations that can facilitate compliance in the most cost-effective way possible.

- **Identify key custodians and thoroughly document efforts to identify, collect and preserve relevant documents, including but not limited to the prompt issuance of document preservation directives and suspension of any routine document destruction processes.** In the event of disputes, contemporaneous documentation is essential to demonstrate diligence and good faith.[11]
- **With respect to electronic documents, counsel should engage professional forensic document experts to assist in collection, preservation and processing.** These experts, who are trained in computer architecture and software, can provide invaluable assistance in reviewing company computer system documentation and interviewing client information technology staff to understand the com-

pany's computer architecture and the potential location of potentially responsive documents, including documents that may be located outside the system on personal computers, smart phones, Blackberries, etc. They can forensically collect such documents using specialised software that preserves metadata, and can appropriately document the collection process and the chain of custody of the data. Informal collection through e-mailing or simply copying electronic documents risks altering metadata or other information, is a false economy and, indeed, a prescription for disaster.[12] In the event of a dispute concerning electronic data collection, retention of an experienced, qualified expert who complied with industry standards will be strong evidence of a good-faith effort to comply with preservation obligations. The e-discovery industry has become increasingly mature and competitive; while e-discovery costs still will be substantial, it is increasingly possible to negotiate favourable rates.

- **Use electronic tools to identify a subset of the most likely relevant documents and reduce review time.** The use of filtering terms, relational analysis or other statistical tools to identify the most likely relevant documents is widely accepted. Discussing proposed filters with agency investigative staff in an effort to reach consensus will demonstrate cooperation and potentially avoid later disputes over the adequacy of the document review and production. Forensic document experts can help not only identify and apply the tools but also facilitate the negotiations by quantifying the likely impact of using additional search terms. If complete agreement cannot be achieved, it may be possible to reach agreement on a phased approach, starting with an initial set of search terms and with the agency reserving the right to require the use of broader filters after reviewing the initial productions.
- **Use a document review platform that can provide multiple sets of lawyers with access to the document database, while providing them with a separate secured portion that reflects their substantive review and legal analysis while preserving work-product protection for each legal team.** To the extent the matter requires an internal investigation, this can save duplication and expense.

PERFORMING AN INITIAL ASSESSMENT

Not all government investigations are created equal. Some involve discrete, limited issues and are highly unlikely to raise issues of potential financial statement restatements, or deficiencies in corporate governance or senior management integrity. Others obviously raise some or all of these issues, so that an internal investigation by independent counsel likely will be required and securities and derivative litigation is inevitable. An intensive initial investigation and preliminary assessment by defence counsel to assess which type of position is presented will help the company determine the scope of the issues presented and formulate an efficient, cost-effective strategy that anticipates and is tailored to the potential risks.

MANAGING THE LAWYERS APPROPRIATELY

Contrary to what one might assume, the existence of multiple lawyers in a complex securities enforcement and litigation matter — for the company, for an independent investigation and/or special litiga-

tion committee, and for individuals — actually offers the promise of a resolution of an investigation and ancillary proceedings that, overall, is more efficient and cost-effective. For example, to the extent a company's board concludes that an independent internal investigation is appropriate, agency enforcement staff frequently can be persuaded to defer depositions or other aspects of their investigation pending the outcome of that investigation. Litigation also may be stayed pending the results of such an investigation.[13] In addition to avoiding potentially needless duplication of effort, this process may benefit the corporation in other ways. It can streamline the fact-gathering process. Similarly, it can achieve an orderly process in which the board is presented with a report setting forth the relevant facts found and, if appropriate, identifying potential remedial measures for consideration. In this scenario, the company is then positioned to make a presentation to the enforcement agency setting forth the relevant facts and remedial measures that may have been adopted in response to the investigation. While the agency is of course not obligated to accept the results of the independent investigation, to the extent it concludes that the investigation has been appropriately thorough and its results are credible, that may facilitate a resolution both more promptly and on more reasonable terms.

Moreover, in such circumstances it should be possible to manage the process in a way that avoids substantial duplication of effort by defence counsel and independent investigation counsel. Defence counsel can, and should, provide independent counsel with factual information in its possession and may also provide a preliminary analysis of issues warranting investigation. Much of the work performed thereafter by independent counsel (eg, including interviews and analysis) is work that, absent an independent investigation, would be done by defence counsel. While any judgment must take account of the particular circumstances, in many cases defence counsel may appropriately be able (or indeed, be required) to defer or limit certain fact-gathering and analysis tasks until independent counsel has substantially completed its factual investigation; at that point, defence counsel will then be in a position to review the conclusions of, or otherwise build on, the work of the independent counsel.

The retention of separate counsel to represent individuals who require it similarly may facilitate a more cost-effective, orderly resolution. Experienced counsel can provide clients with appropriate guidance as to their legal obligations, as well as a realistic assessment of their legal position. In the authors' experience, this can help the individuals avoid conduct that increases their — and, potentially, the company's — legal exposure, including document destruction and false testimony. Moreover, legal and factual issues may be defined more quickly, facilitating the overall process of the investigation and the development of an overall strategy for handling the investigation and any securities or derivative litigation.

Nevertheless, with multiple teams of lawyers, there is, inevitably, a risk of wasteful or duplicative effort. Clients understandably will want to take steps to limit this risk. Subject to certain limitations, they may reasonably do so with respect not only to defence counsel but also to independent counsel, special litigation committee (SLC) counsel and counsel for individuals for whom the company is advancing defence costs.

For example, the company may require compliance with its general policies governing outside counsel fees and expenses that are designed to avoid needless expense and duplication. Such policies

typically include limitations on the number of lawyers whose attendance at a meeting or deposition may be billed and reimbursed; requirements to use preferred provider vendors with which the company has negotiated favourable rates; and requirements to comply with corporate travel policies. In addition, the company may reasonably require periodic projections or estimates of anticipated fees and expenses with a general description of tasks to be performed so that it can identify in advance and attempt to address with the relevant counsel any concerns about potentially duplicative, wasteful or otherwise unreasonable legal expenses before they are incurred.[14]

It is important to recognise, however, that there are significant constraints on the company's ability to manage costs incurred by independent counsel, SLC counsel or individuals' counsel. For example, for an independent internal investigation to have any value, the investigator must be able to demonstrate that the investigation was adequately thorough and complete and not subject to resource or scope constraints or other interference that precluded a thorough, complete investigation of the relevant issues.[15] Otherwise, the investigation will have no credibility and the time and money spent on it will have been wasted. Indeed, to the extent it may be perceived as an attempted 'whitewash' or cover up, such an investigation is worse than useless — it may even create an additional risk of liability.[16] It is certainly reasonable to expect that an investigator will develop and present an organised work plan, with a timeline and estimated budget. However, it must be understood that these inevitably will evolve as the investigation proceeds and the investigators learn more. What this means is that the best guarantors of cost-effectiveness are the experience and pragmatic judgment of independent investigation counsel and the inevitable time pressure for the investigation to be completed. The most effective thing the company can do to control costs is to require its employees to cooperate fully and take other steps to ensure that the investigators are provided with the required documents and other information as promptly as possible.

Slightly different considerations apply where a company faces derivative litigation in the wake of an SEC investigation and the board of directors concludes that it is appropriate to appoint an SLC of disinterested directors to conduct a separate independent investigation into the claims alleged in the derivative demand or complaint. A separate SLC investigation is required for two reasons. First, it serves a different purpose from the internal independent investigation, focusing particularly on the merits of alleged derivative claims for breach of duty against named corporate directors and officers.[17] Secondly, the board, committee or directors who supervised the internal investigation may not have been 'disinterested' under the stringent standards applicable to derivative claims.[18] This does not mean, however, that the second, SLC investigation must necessarily re-perform all of the work of the first investigation. Rather, the SLC and its counsel and their experts may be able to conclude, after some investigation, that they can reasonably accept and rely upon the previously performed work and conclusions of the first investigation with respect to certain issues and focus their attention on the issues presented in the derivative demand or complaint related to the involvement and potential culpability of the named defendants.

For example, an audit committee may have retained independent counsel to assist it in investigating apparent accounting irregularities. Based on the investigation, the committee may have recommended, and the board may have concluded, that a

restatement of previously issued financial statements was required and that certain additional actions — including enhanced internal controls and personnel actions — should be taken. In performing its separate investigation, the SLC need not assume that, to maintain its independence, it must duplicate all of the steps of the prior investigation, including the entire document collection and analysis process and the accounting analysis that led to the restatement. Rather, the SLC may appropriately seek to determine whether it can build on the work of the prior investigation in these and other areas. It should review and evaluate the prior work to determine whether it appears sufficiently thorough and accurate that the SLC may reasonably rely on it. That may well be the case, particularly if, as is typical, the company's independent registered public accountants have concurred in the judgment that a restatement is required and in the revised accounting. If the SLC concludes that it may rely on certain aspects of the prior work, then it can focus its additional investigation and analysis on assessing the involvement and potential culpability of the derivative defendants, evaluating potential claims, and assessing whether it is in the corporation's best interest to pursue them. While that investigation will still involve substantial document review and interviews — undoubtedly including interviews of some individuals who were also interviewed in the prior investigation — the more focused nature of the SLC investigation and analysis will eliminate needless duplication of effort.

Judgments concerning the scope and organisation of the SLC investigation, including the extent to which the SLC may appropriately rely on certain prior work, must be made independently by the SLC and its counsel, based on their assessment of the facts and circumstances. The touchstone of their analysis must be their evaluation of whether the resulting investigative process will be sufficiently thorough, diligent and independent to discharge their duty and withstand judicial scrutiny.[19] The best assurance that reasonable judgments will be made in this regard is for the board to appoint an SLC whose members have sound, practical judgment and understand the importance of efficiency, and for the SLC, in turn, to hire experienced counsel with similar qualities.

The company has a somewhat greater ability to control costs with respect to counsel for individuals for whom the company is advancing reasonably incurred legal fees. The company may have some discretion to veto individuals' selection of counsel who appears to lack the experience or judgment to provide both effective and cost-effective representation, or whose rates appear excessive. The individuals' execution of undertakings to repay legal fees in the event it is determined they are not entitled to advancement of such fees gives them at least some incentive to seek efficient representation. The company may also review counsel's bills and reject amounts that appear grossly unreasonable or excessive. Depending on the stage of the proceedings, the company may be able to take steps to facilitate more efficient representation. For example, it may be possible to make certain documents or factual information available to the individual's counsel pursuant to a joint defence agreement. The extent to which this is possible will depend on the stage of the investigation and the position of the individual.

UNCERTAINTY CREATED BY NEW SEC COOPERATION GUIDELINES

The preceding discussion, and its focus on a strategy for managing the overall process that is guided by corporate defence counsel, reflects experience gained under the SEC's policies as they have existed for the

past decade. Those policies included the concept of 'cooperation credit' for corporations, which created significant incentives for corporations to self-investigate and remediate violations, including firing culpable employees, and otherwise to cooperate with the enforcement staff.[20] Under this regime, the corporation and its counsel largely controlled the strategy for addressing the risks presented by government investigations and ancillary litigation. Of course, such control was imperfect, particularly where the strategy involved the initiation of an internal investigation with independent counsel or a special litigation committee, but at least the initiative largely rested with the corporation.

The SEC's recent adoption of a new policy for evaluating cooperation by individuals, and potentially giving them credit for cooperation, may change this.[21] By creating incentives for individuals to report misconduct and/or to cooperate in an ensuing investigation, or to encourage others to cooperate, the SEC has, at least potentially, created a condition in which the corporation and its officers or employees may be in competition for cooperation credit. The extent to which this will actually occur is unknown; it is likely to depend on the facts and circumstances of each case and whether the SEC develops a track record of applying the policy that leads individuals and their counsel to conclude that it offers them genuine benefits. But, to the extent the SEC's new policy does stimulate competition to cooperate, it seems likely both to accelerate the pace of investigations and to render the relationship between officers or employees and their counsel, and the company and its counsel, more complicated.

References

(1) See SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations, SEC Press Release No. 2010-6 (13th January, 2010), available at http://www.sec.gov/news/press/2010/2010-6.htm; SEC Statement on Enforcement Cooperation Initiative (13th January, 2010), available at http://www.sec.gov/spotlight/enfcoopinitiative.shtml. See also Securities and Exchange Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (23rd October, 2001) ('Seaboard Report'), available at http://sec.gov/litigation/investreport/34-44969.htm; Securities and Exchange Commission Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, Exchange Act Release No. 34-61340 (19th January, 2010), available at http://www.sec.gov/rules/policy/2010/34-61340.pdf (noting that 17 C.F.R. § 202.12 states that '[t]here is a wide spectrum of tools available to the [SEC] and its staff for facilitating and rewarding cooperation by individuals', and outlining four criteria the SEC considers in assessing cooperation credit); SEC, SECURITIES AND EXCHANGE COMMISSION DIVISION OF ENFORCEMENT: ENFORCEMENT MANUAL ('*SEC Enforcement Manual*') §§ 6 (Fostering Cooperation), 6.1(Initial Considerations); 6.2 (Cooperation Tools), 6.3 (Publicising the Benefits of Cooperation) (2010), available at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf; Memorandum from Mark Filip, Deputy Attorney Gen. of the US Dep't of Justice, to Heads of Department Components Regarding Principles of Federal Prosecution of Business Organisations at 7 (28th August, 2008) ('*DOJ Filip Memorandum*'), available at http://www.justice.gov/dag/readingroom/dag-memo-08282008.pdf (noting that '[i]n determining whether to charge a corporation and how to resolve corporate criminal cases, the corporation's timely and voluntary

disclosure of wrongdoing and its cooperation with the government's investigation may be relevant factors').

(2) See, eg, Del. Ch. Ct. R. 23.1 (requiring that a shareholder make a pre-suit demand before instituting a derivative action); *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000) (noting that demand jurisprudence is designed in part to 'deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms'); *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988) ('[T]he demand requirement recognises the fundamental precept that directors manage the business and affairs of the corporations.' (Internal quotation marks and citations omitted). See also *In re Dow Chem. Co. Derivative Litig.*, 2010 WL 66769, at *6 (Del. Ch. 11th January, 2010); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009) ('[T]he demand requirement and the strict requirement of factual particularity under Rule 23.1 "exist[] to preserve the primacy of board decision-making regarding legal claims belonging to the corporation".' (Citation omitted.)).

In cases where there are directors who are not 'disinterested', either because their conduct is at issue or because they are defendants in the proposed litigation, special committees of disinterested directors may be used. See, eg, *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981) (A 'board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors' and the 'interest taint of the board majority is [not] per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members'.). 'The purpose of the independent committee . . . is to act as an independent arm of the ultimate power given to a board of directors . . . to determine whether or not a derivative plaintiff's pending suit brought on behalf of the corporation should be maintained when measured against the overall best interests of the corporation.' *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206, 1212 (Del. Ch. 2002).

(3) See 8 Del. C. § 145(a) ('A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, . . . (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, . . . against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement . . . if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.'). See also *Carlson v. Hallinan*, 925 A.2d 506, 541 (Del. Ch. 2006).

(4) See *Upjohn Co. v. United States*, 449 US 383 (1981) (holding that attorney-client privilege attaches to communications between employees and attorneys in order to provide legal advice to the corporation); ABA, UPJOHN WARNINGS: RECOMMENDING BEST PRACTICES WHEN CORPORATE COUNSEL INTERACTS WITH CORPORATE EMPLOYEES at 3 (17th July, 2009), available at http://new.abanet.org/sections/criminaljustice/CR301000/PublicDocuments/ABAUpjohnTaskForceReport.pdf (suggesting language for *Upjohn* warning and noting that warning should be delivered from written statement).

The failure to issue an *Upjohn* warning, and perhaps more seriously, the failure to document the warning can result in severe consequences. For example, in *United States v. Nichols*, 606 F. Supp. 2d 1109 (C.D. Cal. 2009), *rev'd sub nom. United States v. Ruehle*, 583 F.3d 600 (9th Cir. 2009), a federal district court in

California expressed 'serious doubts [about] whether any *Upjohn* warning was given to' the company's CFO, where he 'did not remember being given any warning, no warning is referenced in [the attorney's] notes from the meeting, and no written record of the warning even exists'. *Ibid* at 1116-17. The court went on to find that the privilege did not belong exclusively to the corporation because no appropriate *Upjohn* warning was given, and the CFO had reason to believe he personally was represented by counsel. *Ibid* at 1117. The court harshly criticised counsel for essentially representing both the CFO and the company without informing them or obtaining consent for the dual representation and referred the matter to state bar disciplinary authorities. *Ibid* at 1113. The Ninth Circuit ultimately reversed the district court for failure to apply the appropriate privilege standard, and because the evidence demonstrated that the CFO understood that the information he provided would be disclosed to third parties (the company's auditors) and not maintained as confidential. *Ruehle*, 583 F.3d at 607-12. But the case reflects the risk to corporate counsel (and its client) of failure to properly document *Upjohn* warnings.

(5) See SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations, SEC Press Release No. 2010-6 (13th January, 2010), available at http://www.sec.gov/news/press/2010/2010-6.htm; 17 C.F.R. § 202.

(6) In an informal investigation, the SEC typically requests by letter that the respondent voluntarily provide documents or other information by letter. *SEC Enforcement Manual* § 3.2.3. Although a formal order of investigation is required for issuance of a subpoena, the Commission has taken steps to make it easier to obtain such orders of investigation. In 2009 the Commission delegated to the Director of the Enforcement Division authority to open a formal investigation and issue subpoenas pursuant to that order, and the Director has stated his intention to delegate that authority to other Enforcement Division senior officers. See Robert Khuzami, Dir. of SEC Division of Enforcement, Remarks before the New York City Bar: My First 100 Days as Director of Enforcement (5th August, 2009) http://www.sec.gov/news/speech/2009/spch0870509rk.htm. The Director has clearly stated that refusals to comply with voluntary requests for production, or dilatory tactics, will result in prompt issuance of orders of investigation and accompanying subpoenas. *Ibid*. The SEC may obtain a court order to compel compliance with a subpoena. See Securities Exchange Act of 1934 § 21(c); 15 U.S.C. § 78u(c) ('In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, and other records.'); *SEC Enforcement Manual* § 2.5.3 (noting that the 'Commission may file a subpoena enforcement action in federal district court, seeking an order compelling compliance').

(7) For example, the 'SEC encourages and rewards cooperation by parties in connection with staff's investigations. One important measure of cooperation is whether the party has timely disclosed facts relevant to the investigation. Other measures of cooperation include, for example, voluntary production of relevant factual information the staff did not directly request and otherwise might not have uncovered. . . .' *SEC Enforcement Manual* § 4.3; see also *ibid*. §§ 6.1.1, 6.1.2. Clearly resisting SEC information requests undercuts any

claim of cooperation. See also *DOJ Filip Memorandum* at 7 ('In determining whether to charge a cooperation and how to resolve corporate criminal cases, the corporation's timely and voluntary disclosure of wrongdoing and its cooperation with the government's investigation may be relevant factors.').

(8) See, eg, Sarbanes-Oxley Act § 802; 18 U.S.C. § 1520 (setting forth criminal penalties for destruction or alteration of certain audit related records), *SEC Enforcement Manual* § 3.2 (Documents and Other Materials); Fed. R. Civ. P. 26(a), 34 (governing production of documents); *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec.*, 685 F.Supp. 2d 456, 461 (S.D.N.Y. 2010) ('[C]ourts have a right to expect that litigants and counsel will take the necessary steps to ensure that relevant records are preserved when litigation is reasonably anticipated, and that such records are collected, reviewed, and produced to the opposing party.').

(9) Sarbanes-Oxley Act § 802; 18 U.S.C. § 1519 ('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 the investigation or proper administration of any matter . . . shall be fined under this title, imprisoned not more than 20 years, or both.'); Fed. R. Civ. P. 37(b)(2) (enumerating sanctions for not obeying discovery order, including but not limited to, striking pleadings in whole or in part and treating as contempt of court the failure to obey any order except 'an order to submit to a physical or mental examination'); *Pension Comm.*, 2010 WL 184312, at *6-7 (noting that available sanctions include further discovery, cost-shifting fines and other monetary sanctions, special jury instructions for permissive or mandatory adverse inferences, preclusion of certain claims or defences, and the entry of default judgment or dismissal).

(10) See references 1 and 7.

(11) See, eg, *Pension Committee*, 685 F.Supp. 2d at 473 (noting that the litigation hold instruction did not 'direct employees to *preserve* all relevant records . . . nor [did] it create a mechanism for *collecting* the preserved records . . .'.); *ibid* at 477 (imposing sanctions where '[a]lmost all plaintiffs' pre-2005 conduct, apart from the failure to issue written litigation holds, is best characterised as either grossly negligent or negligent because they failed to execute a comprehensive search for documents and/or failed to sufficiently supervise or monitor their employees' document collection'.).

(12) The importance of metadata, which reflect among other things an electronic document's creation date, was demonstrated in the stock option backdating cases, many of which turned on metadata demonstrating that documents were in fact created long after the dates on which they purportedly were created and executed.

(13) In class action securities fraud cases, the parties typically agree to a stay of the obligation to answer or move until lead counsel is selected and a consolidated amended complaint is filed. See 15 U.S.C. § 78u-4(a)(3). Under the Private Securities Litigation Reform Act, a motion to dismiss automatically stays discovery pending resolution of the motion. See 15 U.S.C. § 78u-4(b)(3)(B). Where an internal investigation is pending, plaintiffs frequently will agree to stay the proceedings pending the outcome of the investigation so that they may be able to file an amended complaint that takes account of the results of the investigation. Courts in derivative litigation also have sometimes been willing to stay proceedings pending the outcome of such investigations, even if they are not by a special litigation committee.

(14) To the extent legal fees and expenses are covered by insurance, insurers typically require counsel to comply with such policies. Issues of insurance coverage can

be quite complex and depend on the terms of the relevant policies. Typical directors' and officers' liability policies cover class action securities and derivative litigation defence costs, but not SEC or other government investigations, or fees incurred in respect of special litigation committee investigations in shareholder derivative actions. Recently, however, Judge Berman of the US District Court for the Southern District of New York found coverage for the costs of responding to a New York Attorney General subpoena and for expenses incurred in a special litigation committee investigation, based on the specific language of the insurance policy. See *MBIA, Inc. v. Fed. Ins. Co.*, No. 06-CV-4313 (S.D.N.Y. 30th December, 2009). In any case where there is potential insurance coverage, the applicable policies should be reviewed and analysed and the carrier should be notified promptly of any potentially covered claim. Thereafter, consistent with the insured's duty of cooperation, the insurer should be kept informed of developments in the case.

(15) See *SEC Enforcement Manual* § 6.1.2 (noting that one measure of a company's cooperation is 'self-reporting of misconduct when it is discovered, including *conducting a thorough review of the nature, extent, origins and consequences of the misconduct* . . .'. (emphasis added).

(16) See *Stein v. Bailey*, 531 F. Supp. 684, 695 (S.D.N.Y. 1982) ('Proof . . . that the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or half-hearted as to constitute a pretext or sham . . . would raise questions of good faith.' (citation omitted)); *In re ITT Corp. Derivative Litig.*, 653 F. Supp. 2d 453, 465 n.8 (S.D.N.Y. 2009) (same).

(17) See reference 2.

(18) See reference 2. Whether an SLC member is independent 'is a fact-specific determination made in the context of a particular case'. *London v. Tyrrell*, 2010 WL 877528, at *12 (Del. Ch. 11th March, 2010) (citing *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del.2004)). An SLC member does not have to be unacquainted or uninvolved with fellow directors to be regarded as independent. But an SLC member is not independent if he or she is incapable, for any substantial reason, of making a decision with only the best interests of the corporation in mind. Essentially, this means that the independence inquiry goes beyond determining whether SLC members are under the 'domination and control' of an interested director. Independence can be impaired by lesser affiliations, so long as those affiliations are substantial enough to present a material question of fact as to whether the SLC member can make a totally unbiased decision. *Ibid* (citations omitted). Independence can be vitiated by, for example, a family relationship with a named defendant, a past or current close business or social relationship with a defendant, or an SLC member's participation in or approval of the alleged wrongdoing. *Ibid* at *13-15. See also *In re Oracle Sec. Litig.*, 852 F. Supp. 1437, 1441 (N.D. Cal. 1994).

(19) Most courts require a two-step inquiry into the recommendation made by the SLC to dismiss the suit. 'First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusion . . .. The corporation should have the burden of proof.' *Zapata Corp.*, 430 A.2d at 788. Once the court is satisfied with that inquiry, it must 'determine, applying its own business judgment, whether the motion should be granted'. *Ibid* at 789. In determining the reasonableness of the investigation, courts generally look to:

1. the committee's use of independent counsel and experts;
2. the adequacy of the committee's procedures and methodologies taken as a whole;
3. 'the length and scope of the investigation,'

4. 'the corporation's or the defendants' involvement, if any, in the investigation, and'
5. 'the adequacy and reliability of the information supplied to the committee.'

Drilling v. Berman, 589 N.W.2d 503, 509 (Minn. Ct. App. 1999). See also *London*, 2010 WL 877528, at *11, 17-27; *Strougo v. Bassini*, 112 F. Supp. 2d 355 (S.D.N.Y. 2000); *Johnson v. Hui*, 811 F. Supp. 479, 487 (N.D. Cal. 1991); *Lewis v. Boyd*, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992).

(20) See reference 1.

(21) Securities and Exchange Commission Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, Exchange Act Release No. 34-61340 (19th January, 2010), available at http://www.sec.gov/rules/policy/2010/34-61340.pdf. The Commission assesses cooperation from individuals using four considerations: 'the assistance provided by the cooperating individual in the Commission's investigation or related enforcement actions ("Investigation"); the importance of the underlying matter in which the individual cooperated; the societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct; and the appropriateness of cooperation credit based upon the profile of the cooperating individual.' *Ibid* at 3. Meeting these criteria 'justifies the credit awarded to the individual for his or her cooperation'. *Ibid*.