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EXECUTIVE COMPENSATION

Executive Compensation Litigation: The Newest Cases, Lessons Learned & A Look Ahead

By Richard Gallagher and Juliano Banuelos

The steady increase in litigation over executive compensation over the past decade has resulted in a large and evolving body of case law falling within a number of sub-categories, including:

- Traditional shareholder derivative challenges to executive pay packages that some shareholders perceive to be wasteful. Such cases—perhaps the most well-known being the 2005 *Disney* litigation in Delaware Chancery Court—must overcome formidable legal hurdles arising from the business judgment rule and the pre-suit demand requirement. Despite the challenges, many such cases are filed each year, including recent versions arising from HP's allegedly wasteful severance payment to its CEO and Morgan Stanley's allegedly excessive pay practices during the federal bailout.

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- Shareholder and SEC challenges to stock option grant practices, which resulted in hundreds of cases filed in 2007, many of which are still making their way through the judicial system. Well over a hundred public companies faced such cases, which were largely derivative, but which also spawned large numbers of investor class actions and SEC claims.

- Stock drop cases in which insiders exercised stock options and/or sold shares shortly before a steep stock loss. While such cases are typically not about executive compensation *per se*, selling by insiders makes a company materially more likely to face a class action securities lawsuit in the wake of a stock drop. Since congressional passage of the the Private Securities Litigation Reform Act of 1995, hundreds of companies have faced securities fraud claims bolstered by allegations of fortuitously timed insider stock sales.

- More recently, plaintiffs' lawyers have launched multiple derivative cases arising from companies' application of the deductibility rules under Internal Revenue Code (IRC) Section 162(m). Such cases typically allege that proxy disclosures regarding the company's 162(m) policies are materially incomplete or misleading. In some cases, plaintiffs argue that faulty disclosures effectively invalidate shareholder approval of a stock plan. Other plaintiffs have alleged that a board's supposed failure to conform with the deductibility requirements of Section 162(m) resulted in corporate waste. Notable recent examples of 162(m) cases include a Delaware case accusing the board of XTO Energy of failing to properly structure executive bonuses under Section 162(m), as well as a case against Qualcomm's executives for allegedly filing a proxy statement containing misstatements about the availability of tax deductions under Section 162(m). Such cases face significant hurdles under the pre-suit demand requirement and the business judgment rule, among other defenses. However, some cases can be potentially expensive to defend because of the lack of clear, binding guidance with respect to the underlying substantive 162(m) issues.

- Class action cases arising from M&A transactions in which plaintiffs attempt to overcome the business judgment presumption by pointing to large change-in-control payments, accelerated vesting, and other compensation-related benefits received by executives of the target corporation. A large body of Delaware case law generally recognizes that such compensation features encourage directors and management to maximize shareholder value. Nevertheless, merger cases have doubled since 2007, with over 500 such cases being filed in 2011 alone—most of which challenged (among other things) supposed "windfalls" received by the target's executives. Such cases are regularly settled via a supplemental disclosure by the target company, for which the plaintiffs' lawyers receive a substantial fee for their service.

- In 2011 and 2012, multiple plaintiffs filed lawsuits challenging executive compensation awards following a "no" vote on a shareholder Say-On-Pay vote. Despite the expressly non-binding nature of such Say-on-Pay votes under Dodd-Frank, several dozen companies in 2011 and 2012 faced allegations that their board members violated fiduciary duties by failing to alter certain features of compensation awards following a "no" vote by shareholders. Although an Ohio judge allowed the *Cincinnati Bell* case to proceed past the pleading stage in 2011, nearly every ruling thereafter has been against the plaintiffs, usually due to the lack of a pre-suit demand or the applicability of the business judgment rule.

- Following an accounting restatement occurring as a result of misconduct within a company, Section 304 of the Sarbanes-Oxley Act of 2002 empowers the SEC to seek a clawback of certain bonus or other incentive-based or equity-based compensation received by a CEO or CFO during the 12 months prior to disclosure of the restatement. Only the SEC (not private plaintiffs) can seek such

clawbacks, and the SEC has pursued such actions sparingly over the past 10 years.

Clearly, the private plaintiffs' bar will take every opportunity to challenge corporate pay and equity award practices, whether or not the crux of the case is about executive compensation. Such allegations play off the perceived public resentment of executive pay. The allegations also (at least hypothetically) threaten a company with prolonged litigation, including discovery, on a corporate governance topic that many board members and executives would greatly prefer to avoid. This, of course, raises the likelihood of a quick and profitable settlement for the plaintiffs' lawyers.

As noted above, however, the problem for the plaintiffs' bar is the historically steep set of legal hurdles that such suits face at the outset. The business judgment rule, the demand requirement, and other well-developed areas of Delaware jurisprudence have historically resulted in a high dismissal rate for such cases. As a strategic matter, companies facing suit will often make their best effort to win an early dismissal before even considering a settlement. With the exception of M&A cases, which typically proceed very quickly in a pre-merger environment, companies typically have sufficient time to seek dismissal prior to entertaining settlement and, historically, this strategy has been successful in many cases.

Recently, a new form of executive compensation litigation has emerged, which seeks to bypass the traditional hurdles of the business judgment rule and the demand requirement. Since mid-2012, approximately 20 public companies (with the number growing each month) have faced putative class action suits in which plaintiffs seek to enjoin a shareholder Say-on-Pay vote, or a vote on a proposal to increase the share reserve for stock plans. Such suits allege that a court should enjoin any shareholder vote until after the company publicly files supplemental disclosures.

In other words, many of these new suits do not necessarily challenge a given pay practice directly, but instead seek more detailed disclosures of various details prior to a shareholder vote. Companies that do not agree to supplement their disclosures (which would potentially put the company on the hook to pay fees to the plaintiffs' lawyers) face the unpleasant prospect of an accelerated preliminary injunction proceeding aimed at enjoining a proxy vote. In this regard, the plaintiffs' bar has borrowed from the playbook of M&A litigation, in which the threat of a near-term injunction often creates sufficient near-term pressure to generate a settlement premised upon supplemental disclosures (with a fee to the plaintiffs' lawyers for their services).

A review of these new cases reveals many strategies for defeating the cases after they are filed. However, from a corporate governance perspective, the best litigation defense is to prevent the litigation from happening in the first place, or to take steps that maximize the chances of a quick dismissal in the event a case does occur.

Lessons Learned in Preparing Proposals

Based on a review of several recent challenges, the following practices for proxy proposals will dissuade the plaintiff's bar from filing a complaint, or will increase the odds of a swift victory in the event litigation does occur.

1. Stock Plan Share Reserve Increase Proposals

   - Disclose the number of shares currently available for issuance under the stock plan. As many claims are based on a failure to discuss the need for new shares, include an explanation as to why the existing share reserve is insufficient to meet the future needs of the company. For example, a disclosure might explain that based on the current burn rate and anticipated hiring of new executive officers, the company expects to exhaust the existing share reserve in the next 12 months

and without the additional shares the company would be unable to attract and retain the most qualified employees.

- Explain the planned use of the existing share reserve and the additional shares, including how long the company expects the new share reserve to last.

- Describe the methodology used to determine the requested number of additional shares. As part of the methodology, the company should consider, and discuss in the proposal, the historical and post amendment annual burn rate, shareholder value transfer and overhang with respect to the stock plan.

2. Say on Pay Votes

- Remove any quantitative data or items that need further explanation from the SOP proposal. Sometimes "less is more."

- In the Compensation Discussion and Analysis ("CD&A"):

    1. Discuss the process used to hire the company's compensation consultant and summarize the consultant's role and any advice/recommendations.

    2. Clearly disclose how management is involved in the compensation process.

    3. Minimize references to specific peer group benchmarking on compensation targets and payouts and, in the event such references are necessary, provide a summary of the 25th median and 75th percentiles of pay in the peer groups if possible.

    4. Closely assess any proposed statements correlating executive pay and peer group ranking to company performance and, where possible, link compensation changes to internal company year-over-year performance rather than relative to the peer group.

    5. Discuss the underlying analysis or criteria and any applicable weighting used to make specific decisions.

    6. Clearly describe the basis for any executive pay changes disclosed in the CD&A, for example, a peer group change or target compensation percentage increase.

3. Section 162(m) Cases

- Ensure that the proxy statement does not promise deductibility under Section 162(m) and that the Compensation Committee has stated latitude to pay non-deductible compensation.

- Ensure that the features of the 162(m) plan in question, the operation of the plan and the disclosure of the plan in the proxy fit squarely within the requirements of the performance-based compensation exception under Section 162(m).

Litigation Considerations

Companies in the unfortunate position of facing litigation seeking to enjoin a shareholder vote must take several steps in the near term:

- Act quickly to establish that the necessary legal protections will apply; most notably, the business judgment rule and other process-oriented defenses available under Delaware and most other state laws.

- Evaluate existing proxy disclosures to assess and reduce ongoing risks posed by the litigation, such as the risk of a meritorious or partially meritorious injunctive motion.

- Take steps to structure the litigation so that any threatened motion seeking injunctive relief will not disturb a planned proxy vote.

- Analyze whether supplemental disclosures are appropriate and, if so, whether the nature

of such disclosures will trigger fee liability to the suing plaintiffs' lawyers.

- Reduce or eliminate the burden on senior executives by anticipating and addressing discovery obligations.
- Evaluate preliminary pleading challenges that may terminate the litigation at the outset and without further legal expenditure.
- To the extent any further disclosures occur, implement such disclosures in a manner that reduces as much as possible the company's risk of fee liability.
- Confirm that all appropriate document retention practices are in place.
- Evaluate whether insurance policies will apply to such suits and begin a dialogue with carriers.
- Consider the impact and applicability of existing indemnity provisions.
- Carefully consider whether any proposed settlement will actually benefit the company and its shareholders and, if a settlement occurs, structure the settlement in a manner that minimizes any negative financial impact on the company.

Deft handling of court complaints over executive compensation can result in an early end to the litigation, minimize legal spend, and reduce distractions to senior management.

What's Ahead?

Perhaps the most impactful new form of executive compensation litigation will arise when the SEC is able to promulgate new clawback rules required under Section 954 of Dodd-Frank. The new rules will require listed public companies to develop and implement clawback policies with terms more onerous than those under Sarbanes-Oxley. Such policies will require that, in the event of an accounting restatement due to the material noncompliance of a company with any financial reporting requirement under the securities laws (whether or not such noncompliance is the result of misconduct), the company must recover any incentive-based compensation (including stock options) paid to any current or former executive officer during the preceding 3-year period. It is unclear whether private plaintiffs will be empowered to enforce the policy.

Depending upon how the SEC writes the required rules under Dodd-Frank, the new clawback regime (which is far more expansive than that under Sarbanes-Oxley) could lead to a significant increase in shareholder litigation. Originally, the SEC estimated that it would complete the new clawback regulations by the first half of 2012. That time estimate was later pushed and, currently, the SEC is not providing any time estimate for completion. Accordingly, it is looking increasingly likely that Dodd-Frank clawback problems will be issues for late 2013 or, more likely, 2014.

Top Seven Things You Need to Know About The New DOJ/SEC FCPA Guide

By Peter Spivack, Stuart Altman, Evans Rice and Dena Roth

On November 14, the Department of Justice (DOJ) and the SEC issued their long-awaited "guidance" on the Foreign Corrupt Practices Act (FCPA) in the form of a "guide" called *FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act.* The guide's stated aim is to "provide helpful information to enterprises of all shapes and sizes" about the approach taken by the DOJ and the SEC in enforcing the FCPA. As the guide notes, it is "an unprecedented undertaking . . . to provide the public with detailed information about [the agencies'] FCPA enforcement approach and priorities."

At over 130 pages, the guide provides a comprehensive view of the two agencies' interpretation of the FCPA, their enforcement priorities and their approach to investigations and settlements. The guide also offers, perhaps for the first time, specific guidance by the agencies on the types of conduct that may be pursued without violating the statute and the types of conduct that can result in liability. Although much of the guide rehashes positions previously announced by the DOJ and the SEC, the guide provides significant new practical advice to business enterprises on the limits of legal conduct in some areas where the lack of black-and-white answers in the FCPA itself has resulted in significant uncertainty.

We highlight seven important lessons companies and their employees can take away now from the new guidance:

1. Long Reach of the FCPA: Agency Claims of Far-Reaching Jurisdiction

The guide reiterates the agencies' aggressive position on the reach of the FCPA's jurisdiction. For issuers and domestic concerns, the guide contends that the broadest definition of "interstate commerce" applies, so that sending an e-mail, a text message, or a fax from, to, or through the United States is a sufficient jurisdictional hook for enforcement action by the DOJ or the SEC. In a recent action, *SEC v. Magyar Telecom Plc (2011)*, the SEC used the location of e-mail servers in the United States as a basis to assert jurisdiction under the statute. Similarly, in the agencies' view, sending a wire transfer to or from the United States, or otherwise using the United States banking system, creates jurisdiction. Thus, under this theory, a dollar transaction that takes place in another country, but that involves a correspondent bank because of the use of the dollar currency, presumably could be enough to trigger prosecution.

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The guide also articulates the theory employed by the agencies in a number of enforcement actions, including *SEC v. Panalpina, Inc. (2010)*, to assert jurisdiction over foreign entities. Under this theory, a sufficient jurisdictional basis exists if an agent of a foreign entity commits an act in furtherance of a corrupt payment, and that act is committed in the United States. The guide also expressly addresses co-conspirator liability and "Pinkerton" liability, two time-worn theories used by prosecutors everywhere. Under these latter theories, the agencies may assert jurisdiction over a foreign entity that enters into a conspiracy with an agent of an issuer or a domestic concern, so long as it is reasonably foreseeable (in the agency's judgment) that the agent would bribe a government official.

The guide could be read to suggest that the DOJ and the SEC might use these theories to get at virtually any corrupt payment. Although jurisdiction is always an issue worth considering in evaluating potential conduct or defenses to enforcement action, the very broad jurisdiction for prosecution asserted in the guide indicates the severe test that jurisdictional challenges could encounter.

2. Winning Business: What Are the Limits on Hospitality, Gifts and Travel?

Recently, many companies have incorporated into their FCPA compliance programs draconian prohibitions on payments for the entertainment of foreign officials or the provision of even token gifts to foreign officials. The guide makes clear that many of these restrictions may extend beyond measures required to ensure compliance with the FCPA. While the guide reiterates that an organization must have "clear and easily accessible guidelines and processes" for gift-giving and hospitality, the DOJ and the SEC indicate that they are seeking enforcement of the statute only for payments that are truly bribes disguised as gifts, and in every case are asking whether there is a corrupt intent behind the purported gift.

One common area of concern for organizations involves payments for or in connection with promotional events attended by foreign officials. The guide clarifies that, under normal circumstances, companies do not violate the FCPA by providing prospective foreign government customers at a trade show with refreshments or promotional items such as t-shirts or hats bearing logos. Moreover, under the guidance, it also would be permissible for a company to invite foreign officials for drinks or a moderately-priced meal at the end of the day. The key to compliance is to avoid excess. Although buying a foreign official cocktails at the hotel bar is likely acceptable under the law, purchasing champagne at a luxury night club could draw inquiry. The former payment could be seen simply as a way of obtaining additional time to meet with the official, while the latter might be viewed as crossing the line to reward the official for doing business and therefore as evidencing a corrupt purpose.

Companies often are faced with the challenges of foreign environments that encourage gift-giving as part of the business culture. The guide makes clear that the FCPA does not necessarily prohibit gift-giving in these circumstances. In the example presented in the guide, the agencies indicate that no violation of the statute would occur where a moderately-priced crystal vase is presented as a wedding gift to a general manager of a foreign government-owned entity. According to the guide, such "tokens of esteem or gratitude" are permissible where they are appropriate under local law, customary where given, reasonable for the occasion, and properly recorded in the company's records.

Many companies bring foreign officials to the United States for contract negotiations, site visits or training. The guide clarifies that paying for such travel is appropriate where the visit has a legitimate purpose, such as training or a performance review. The guide indicates that even paying for business class airfare, an expenditure often prohibited under company FCPA compliance policies, is permissible for foreign officials where appropriate to the length of the trip and provided on the same terms as to the company's

own employees. Meals and moderate entertainment that make up a small part of total costs are likewise permissible. In contrast, as would be expected, the guide suggests that enforcement proceedings would result from trips to cities that have no connection to the contract or the contracting companies, that involve spouses or family members, or whose purpose is to provide an incentive for the official to misuse his or her position or influence.

The focus of the DOJ and the SEC in these areas seems to be on whether the nature of the gift or hospitality suggests a corrupt intent. Under the agencies' guidance, expenditures that are modest, in line with local custom or similar to those to which the company's employees are entitled in similar circumstances are likely to be permissible.

3. They Made Me Do It: Extortion and Duress Under the FCPA

The FCPA does not prohibit payments made in the face of extortion or under duress where the payments are necessary to preserve the safety of employees or company property. As the guide notes, paying money in response to a threat to demolish a company facility or arrest an employee cannot be said to have been undertaken with a corrupt intent to obtain or retain business (although it could trigger violations of other laws if, for example, the payment were made to a terrorist organization).

The guide makes clear, however, that economic coercion is not, in and of itself, sufficient to trigger this exception to the payment prohibition. The guide indicates that, where a company makes the "conscious decision" to pay an official to gain or retain business, the company will violate the FCPA even if there is no perceived alternative to the payment. Under this guidance, a violation of the FCPA can occur even in a situation in which all bidders for a contract are asked to pay bribes in order to submit bids or to receive a contract award. The fact that all bidders are on equal footing does not excuse liability. Likewise, a threat by a government official to terminate a contract or otherwise harm the company's economic interests unless a bribe is paid is not sufficient to provide protection from prosecution for payment of the bribe.

4. Foreign Officials: Broad Reach and Interpretation

In addressing the critical determination of who is a "foreign official" barred by the FCPA from receiving bribes, the guide essentially recapitulates the position the agencies have taken in settlements and court filings, including most recently *United States v. Esquenazi*, where the meaning of foreign official and what constitutes an instrumentality of a foreign government (a related issue, as discussed below) is currently being adjudicated by the U.S. Court of Appeals for the Eleventh Circuit. The guide emphasizes that, because the statute defines a foreign official as "any officer or employee of a foreign government" and those acting on the foreign government's behalf, the FCPA prohibits corrupt payments to low-level employees and high-level officials alike.

The guide also addresses the views of the DOJ and the SEC concerning what constitutes an "instrumentality" of a foreign government, and therefore which officers and employees of state-owned or state-controlled entities should be treated as foreign officials. Those who hoped for a clear definition of "instrumentality" will be disappointed. Rather than announcing a bright-line definition, the guide asserts that the term is broad and encompasses both state-owned and state-controlled entities. The guide indicates that whether a particular entity is an "instrumentality" requires a fact-specific analysis of an entity's ownership, control, status and function. Notably, the guide does not concede that 50 percent or greater ownership of an entity by a foreign government is determinative of the entity's status as an instrumentality. In the press conference announcing the guide, SEC Enforcement Director Robert Khuzami noted that the guide does not draw a bright-line standard here because there are "many indirect ways of ownership and control." Further, Assistant

Attorney General Lanny Breuer pointed out that, although the DOJ is unlikely to consider a foreign entity that is less than 50 percent controlled by a foreign government to be an instrumentality, "specific factors" could lead to a different conclusion.

5. All in the Family: Liability for Subsidiaries, Parents and Successors

The guide focuses on two aspects of corporate liability, the liability of a parent company for the acts of its subsidiary and the liability of a successor company following a merger or acquisition. Notably, it includes specific guidance for companies acquiring and integrating new businesses. With respect to parent-subsidiary liability, the guide provides no new guidelines, but instead simply restates familiar principles of agency law that undergird current enforcement positions. Under these principles, a company is liable for the acts of its agents undertaken within the scope of their employment and intended, at least in part, to benefit the company. In determining whether an agency relationship exists between a parent and a subsidiary, the DOJ and the SEC will examine the parent's control over the subsidiary, including the parent's knowledge and direction of the subsidiary's actions.

The guide devotes considerably more attention to the principles of successor liability, affirming that successor liability does not create liability where none existed before. For example, an issuer is not liable for the pre-acquisition acts of a foreign company that was not subject to the FCPA.

The guide focuses on the ability of the successor company to reduce its risks of liability by conducting thorough anti-corruption due diligence, and reporting and remediating any misconduct it discovers. The DOJ and the SEC set out in the guide five "practical tips" for actions they encourage companies to take in pursuing mergers and acquisitions:

- Conduct thorough risk-based anti-corruption due diligence on the target company;

- Ensure that the acquiring company's code of conduct and anti-corruption policies apply as quickly as possible to the acquired business;

- Train the acquired business's directors, officers, employees and, where appropriate, agents and business partners on applicable anti-corruption laws and policies;

- Conduct an FCPA audit as quickly as practicable on the newly acquired business; and

- Disclose to the DOJ and the SEC any corrupt payments discovered in the due diligence process.

These "tips" may well prove to be the DOJ and the SEC's baseline expectations for an acquiring company's conduct of FCPA due diligence, and integration. But even companies that undertake each of these actions, including disclosure of corrupt payments to the agencies, do not eliminate the risk of liability, as the guide indicates only that the DOJ and the SEC "may" decline to bring enforcement actions in such cases.

6. Books and Records: What Does the Other Part of the FCPA Really Mean?

The guide does not break any new ground for issuers in its treatment of the FCPA's accounting provisions, including the books and records provision, which is set forth in Section 13(b)(2)(A) of the Exchange Act, and the internal controls provision, which is set forth in Section 13(b)(2)(B) of the Exchange Act. This part of the guide, however, does outline several important legal positions.

First and foremost, the guide makes explicit what often gets lost in the consideration of how payments get recorded, which is that the FCPA's accounting provisions do not apply solely to the recording of improper payments made to government officials. Rather, because those provisions require all public companies to account for their assets and liabilities accurately

and in reasonable detail, the failure to record appropriately other types of improper payments, such as commercial bribes, embezzlements, and proceeds of fraud or export control violations, also can create liability under the FCPA for issuers subject to these provisions. Although the DOJ and the SEC have brought cases, such as the action in *SEC v. Johnson & Johnson (2011)*, alleging both government bribes and commercial bribes, the guide points out that either a books and records violation or an internal controls violation can be brought as a stand-alone case based solely on the payment of a commercial bribe.

Second, the guide articulates the agencies' position that an internal controls violation is an FCPA offense separate from and independent of an improper payment. Most internal controls violations of the statute involve systemic failures in policing improper payments, but the guide does not limit the application of the internal controls provision to such situations. Other violations of the securities laws also could violate the internal controls provision.

Third, the guide notes the importance of an effective compliance program that addresses FCPA risks to an issuer's internal controls. The guide reminds issuers that internal controls are not one-size-fits all, and that issuers should assess their FCPA risks in designing and employing their internal controls.

7. Resolution: Do the DOJ and the SEC Really Ever Decline to Pursue Cases?

FCPA practitioners vigorously have debated in recent years whether self-disclosure by companies of FCPA violations to the DOJ and the SEC has resulted in more favorable enforcement outcomes. The debate has been sharpened by the sense among some practitioners that self-disclosure, no matter how small the issues or how great the cooperation involved, seems to have led to some sort of negative resolution of the matter for the company involved.

Perhaps in response to this sentiment, the DOJ and the SEC go to great lengths in the guide to discuss how they regularly decline to pursue FCPA cases, noting that, in the past two years, the DOJ declined to pursue "several dozen cases against companies where potential FCPA violations were alleged." The guide reiterates that these decisions generally will be made in accordance with the *Principles of Federal Prosecution* and the *Principles of Federal Prosecution of Business Organizations* issued by the DOJ. Most significant, the guide provides six examples of cases in which the agencies decided not to pursue FCPA enforcement actions against public companies. The key factors affecting the agency decisions in these matters included the following:

- The companies made quick and complete voluntary self-disclosure;
- The companies moved swiftly after initial discovery of the corrupt payments to investigate and terminate the relevant business ties;
- The amounts at issue were relatively small;
- In several cases, the conduct was discovered as a result of a well-functioning compliance program or pre-acquisition due diligence;
- Responsibility for the payments could be attributed to a small number of local or low-level employees who were terminated or otherwise disciplined; and
- The companies immediately implemented remedial plans and/or enhancements to their compliance regimes.

Although the DOJ and the SEC still enjoy relatively unfettered discretion to pursue or decline enforcement action under the FCPA, these examples at least will provide a somewhat more informed view of the process for companies considering self-disclosure.

Conducting Sound Internal Investigations: Now More Important Than Ever

By Scott A. Coffina

In an era of the 24-hour news cycle, social media, avaricious plaintiffs' lawyers and aggressive government enforcement, discrete (and discreet) problems can spin out of control in the blink of an eye. Moreover, Congress has "deputized" the entire corporate work force to serve as law enforcement, providing substantial financial incentives for employees to report wrongdoing by their organizations. Building on the tremendous success of the False Claims Act, Congress established the IRS whistleblower program in 2007—through which a former UBS employee was recently rewarded $104 million for information about overseas tax shelters—and the SEC whistleblower program in 2010. In this environment, it is more important than ever for companies and institutions to understand how to use effectively internal investigations to minimize and possibly eliminate these risks.

Problems can take many forms—financial fraud, kickbacks, unsafe working conditions, cutting corners in the manufacturing process and producing a substandard product, security leaks, sexual harassment, etc. The common denominator in this parade of horribles is that each can significantly detract from an organization's mission or even threaten its very existence. Even the most innovative compliance program cannot overcome all human frailties that can lead an organization to peril—for example, criminal prosecution, lawsuits and a loss of support from customers and key benefactors. An entity facing allegations of serious wrongdoing will be judged as much by how effectively it responds to the situation as by the occurrence of the misconduct itself, especially when the organization has a vital compliance program in place. In many instances, an effective response begins with a thorough but focused investigation of the facts as soon as credible allegations are reported.

Early Warning System

An organization cannot respond effectively to a problem unless it is promptly informed about it. Traditional internal auditing practices do uncover valuable information about financial malfeasance within an organization but, for budgetary reasons, often are limited in scope and, experience shows, can be thwarted by efforts to conceal the wrongdoing. Therefore, organizations must, in the first instance, depend on their employees to support the goal of compliance with the law.

Where that goal is not met, employees must believe they have a legitimate avenue to report noncompliance without fear of retaliation. Most organizations now have a compliance hotline. Employees should be encouraged to use it, and the company should provide quick acknowledgment and follow-up on information about possible wrongdoing.

At annual performance reviews, supervisors should actively elicit information about potential problems by asking employees directly if they have been asked to do anything that makes them uncomfortable ethically, or are aware of any wrongdoing by company employees. Retaliation against whistleblowers should be expressly discouraged, and treated as instances of serious employee misconduct whenever it occurs.

Internal Investigation

Conducting an internal investigation at the first sign of trouble can give an organization the ability to manage the resulting information and address the issue proactively. It also can provide

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reassurance if the initial concerns are not substantiated. An internal investigation need not be large or particularly expensive. It just needs to be sufficient under the circumstances for the organization to be confident that it understands the issue and has sufficient information to act (or not act).

An internal investigation into suspected wrongdoing demands initial planning to ensure that it serves its purpose of getting to the truth of the matter, without creating more problems than it solves. For an organization to rely upon the results of an internal investigation to justify the action it takes—or doesn't take—it is critical that the investigation is credible, meaning that it is even-handed in its approach, thorough and effective in uncovering the facts. Conducting a perfunctory or biased investigation will inevitably compound the organization's difficulties.

Accordingly, the following issues should be considered at the outset when conducting an internal investigation:

- Who should conduct the internal investigation
- Applicability and protection of attorney-client and work product privilege
- Conduct of investigation: document collection, employee interviews and Upjohn warnings
- Counsel for employees
- Expected end product and audience for report of investigation

These issues should be considered holistically, because they are generally interconnected, and flexibly, because new information might warrant a change of course.

Who Should Conduct the Internal Investigation?

While an experienced human resources employee or member of the compliance team might be adequate to conduct an investigation in relatively straightforward situations, such as employment discrimination allegations or routine expense report problems, there are several benefits to having an investigation conducted by counsel when more complicated or serious allegations arise. Counsel experienced in internal investigations will have the capability in real time to apply the information uncovered to the applicable law, to assess the company's exposure to potential enforcement action or securities claims, and to advise senior management or the board of directors accordingly.

Moreover, investigations conducted by counsel in most instances can be protected from disclosure, at least in part, by the attorney-client and work product privileges. The applicability of these privileges gives the organization flexibility to limit disclosure of the uncovered information to key internal decision-makers, or to make a disclosure to law enforcement, to a court or to the public on its own terms if circumstances warrant.

The question also arises whether inside counsel or outside counsel ought to conduct the investigation. There is no definitive answer, and several factors might influence this decision.

Inside counsel offers the advantage of knowing the key players, policies and operations of the organization, and may seem less threatening to employees as they collect documents and conduct interviews. An investigation by inside counsel may also be more cost effective in the short term.

However, there also are risks to having inside counsel conduct an internal investigation. For example, inside counsel may have been consulted at some point about the matter under investigation, which could compromise his or her objectivity and perhaps even make the lawyer a witness at some point if litigation or a government investigation ensues. An insider also may feel constrained by personal or even reporting relationships from aggressively following the evidence wherever it leads, especially if it leads to the upper reaches of the executive

suite. In addition, because inside counsel often provides business as well as legal advice, his or her investigation may be susceptible to a privilege challenge because only legal advice is covered by the attorney-client privilege. Business advice is not.

Accordingly, it might be best to retain outside counsel to conduct an internal investigation, particularly in serious, complex matters where a law enforcement investigation and/or a shareholder lawsuit seem likely and the internal investigation will be closely scrutinized. The use of outside counsel may be essential to establishing the true independence of the investigation, thus enhancing the investigation's credibility in the eyes of a prosecutor or court.[1] Outside counsel represents "fresh eyes" and is not likely to be beholden to management in a way that might subtly or even unconsciously influence their findings. Outside counsel might also convey a sense of purpose and seriousness that can cut through reticence on the part of employees who need to be interviewed.

Applicability of Attorney-Client Privilege or Attorney Work Product Protection

Maintaining a privilege over the documents prepared in the course of an internal investigation is a dicey proposition. No matter how well planned and executed the internal investigation might be, attorney-client privilege or work product protection can be challenged, or eventually waived to serve the larger interests of the organization. The best approach, therefore, is to preserve the privilege in the course of the investigation as best as possible to provide the most flexibility to senior management or the board in addressing the underlying concern.

There are two privileges most relevant to internal investigations – attorney-client communications and attorney work product. Avenues to preserve these privileges should be considered together (for both can be waived) and separately (for each can be challenged). Start with the engagement letter for outside counsel, which should make clear that counsel is being retained to conduct an investigation in order to provide legal advice to the entity – magic words for attorney-client privilege protection. If the underlying issue reasonably might result in litigation, that should be noted in the engagement letter as well, which will help buttress a claim for work product protection over documents and memos generated in the course of the investigation. As the investigation progresses, it will be important to avoid disclosure of attorney-client communications to third parties, which likely would waive the privilege.

The organization ultimately may decide that it is in its interest to waive attorney-client privilege in order to demonstrate the forthrightness of its investigation, or to make a disclosure to law enforcement in order to stave off, mitigate or even assist in, a criminal prosecution. In some cases, such as hostile work environment claims, a company could rely upon an internal investigation as a defense to liability, in which case any claim of privilege with respect to the investigation will almost surely be deemed waived.

The bottom line is that while there are many advantages to protecting the information developed during an investigation under the cloak of privilege, both counsel and client should approach an internal investigation expecting that at some point, the organization will decide to disclose at least the facts that are uncovered. In practice, this means that draft memos and reports should not be retained, and sensitive information—especially any preliminary conclusions that are drawn—should be communicated orally when possible, and not by email.

Conduct of Internal Investigation

An organization virtually will be forced to make some kind of public report from an internal investigation into such calamities as the BP oil spill in April 2010 or the Jerry Sandusky scandal at Penn State University. Particularly in high-profile matters, the organization can

expect that the quality of its internal investigation will be scrutinized heavily by government enforcement agencies, the media, shareholders and the public. Two of the most important measurements by which the credibility of the investigation will be judged are whether the investigation is truly independent, and whether the investigative team had unfettered access to all of the relevant documents and witnesses (a third, of course, is the diligence with which the facts are pursued).

As discussed above, utilizing outside counsel, particularly "special counsel" with limited or no prior relationship with the organization, can help substantiate the independence of the review.

Additionally, no one in the organization with any connection to the possible wrongdoing should be involved in decision-making regarding the selection of counsel or the scope of the investigation, or be in the reporting chain for counsel conducting the investigation. Finally, the organization's leadership should be deferential (within reason) to counsel's judgment concerning the scope of the investigation, and the documents and witnesses to which counsel believes it needs access. It is not unusual for counsel to have to expand the scope of an investigation based upon information learned in its course, that suggests different or more widespread problems than the original precipitating allegation had indicated.

Preserving and Collecting Documents

The collection and review of documents usually are essential elements of an internal investigation. Documents, of course, can be damning or exculpatory on their face, but more often will help develop and focus lines of inquiry for interviews with company employees.

Obviously, if an investigation is triggered by the receipt of a government subpoena, the organization will have immediate responsibilities to preserve, collect and produce responsive documents. Routine email purges should be halted immediately, and as soon as practical—it reasonably may take a little while in larger organizations—a "hold notice" should be sent by in-house counsel to those employees expected to have responsive documents, with clear direction to preserve documents related to the subject matter of the subpoena. Then, a plan for collection of documents can be developed.

Subject to time and resource constraints, a substantive review of the documents to be produced to the government (in addition to the necessary privilege review) should be done to identify issues and potential defenses to be developed in the internal inquiry in parallel to (and ideally one or two steps ahead of) the government's investigation. With sufficiently targeted search terms, such a review can be conducted cost effectively.

Where an investigation is prompted by an internal report of employee wrongdoing, the universe of relevant documents generally is defined by the nature of the allegation. Document collection for an internal investigation should be planned in the same manner as the other aspects, with the goal being to access all of the information reasonably obtainable in a timely fashion to provide as complete a picture of the underlying facts as possible. Collecting and reviewing too wide a swath of documents can slow down the progress of the investigation and significantly increase its cost. Conversely, a document review that is not broad enough (or quick enough) heightens the risk of spoliation of evidence, overlooking important information, or later criticism about the scope of the investigation itself.

Certain allegations could impel counsel (through experienced IT support staff) immediately to image employees' hard drives to ensure that key evidence is preserved. This can be especially important where allegations against an individual or a small group of "rogue" employees are raised, such as embezzlement, sexual harassment, or a discrete kickback scheme. In other cases, sending a document preservation notice to employees who may have

relevant information should be sufficient to ensure that the documents will remain available as the investigation unfolds. It is often helpful to allow employees to review the documents they can expect to be shown during a scheduled interview in advance of that interview, so they could provide thoughtful responses to questions about those documents.

Interviewing Employees

Another area that demands some attention throughout an investigation is how to handle interviews with current or former employees. Current employees have an obligation to cooperate with an internal investigation. Still, interviews of current employees need to be handled delicately to foster earnest cooperation in uncovering the facts and in dealing with other interviews or depositions requested by law enforcement or other third parties—as well as to protect their rights, preserve their relationship with the organization, and avoid costly distractions from the progress of the investigation.

At the outset of any interview of an employee by outside counsel, it is essential to provide them with the so-called Upjohn warnings, which have evolved from the U.S. Supreme Court's decision in Upjohn Co. v. United States, 449 U.S. 383 (1981). The Upjohn warnings require counsel to make clear to the employee that they represent the entity, not the individual, and that counsel's duty of loyalty is to the organization alone, and not to that employee. Accordingly, there is no confidentiality in the interview vis-à-vis senior management or the board members to whom counsel is reporting. Moreover, counsel must further advise the employee, the interview is privileged, but that privilege belongs to the organization, and may be waived by the organization through a disclosure to the government or in a public report.

Although these words obviously can have a chilling effect on the interview, it is important for the employee to understand the role of counsel to which he or she is speaking, and the limitations on the confidentiality that applies to the discussion. Indeed, it should be documented in the memorandum of interview that is later generated that the Upjohn warnings were given, and the interviewee acknowledged that he or she understood them. This will minimize the risk of collateral arguments, or even litigation, with an employee claiming to have an independent attorney-client relationship—and correspondingly, an independent attorney-client privilege—with the investigating attorney. Such disputes can be very damaging to the organization, by detracting from the credibility of its investigation, delaying or even preventing a voluntary disclosure by the entity as part of an effort to resolve the matter, increasing legal costs, and perhaps jeopardizing counsel's engagement by forcing counsel to become a testifying witness in the matter.

Another issue that frequently arises in the course of interviewing company employees is whether employees need their own counsel. This question is asked often by the employees themselves at the outset of an interview. Accordingly, it may be worthwhile to address the issue up front, as part of the Upjohn warnings, by noting that the employee has a right to confer with individual counsel, but that the interviewing counsel is unable to advise them about whether they "need" counsel for themselves. However, investigating counsel still must be alert to conflicts of interest, and for the potential down the road of government prosecutors seeking to disqualify it from representing the organization in a resulting prosecution. Therefore, it may be necessary for certain employees to retain their own counsel if information is uncovered about illegal activities by those employees, or the government is asking to speak with them.

The Outcome

Once an internal investigation is concluded, decisions must be made about how to assemble the information that was gathered, to whom it should be presented, and what steps should be taken in light of what was learned. In many cases, this is the point where experienced

counsel's guidance is at a premium: applying the facts, the law and its experience to provide guidance to senior management or the board about how to address the situation effectively.

High-profile instances of illegal activity almost certainly will require some public disclosure of the results of the organization's investigation, and/or a presentation of the results to law enforcement in an effort to avoid or mitigate prosecution. Accordingly, it may be advisable for counsel to prepare two reports of investigation – one straightforward recitation of the facts for public consumption, and a separate report that also contains analysis and legal advice, directed solely to the "client" that retained them. Preparing two reports in this manner may increase the likelihood that the entity will be able to preserve the attorney-client privilege over the "internal" report, since the facts, which are not privileged, will be in the public domain, lessening the professed "need" for the privileged report sought by a potential adversary. Alternatively, when transparency is paramount and the organization wants to quiet conspiracy theorists speculating about what lurks in the "nonpublic report," counsel can prepare just one report of investigation for public consumption, and confine its legal analysis and advice to face-to-face meetings with the client.

Ultimately, an effective investigation enables counsel to report to senior management or the board: (1) what wrongdoing occurred and by whom; (2) what vulnerabilities in the organization's processes were exploited by the wayward employee(s); (3) what the legal and other consequences are to the organization from the misconduct itself, as well as the potential "holes" in its compliance program that were revealed; and (4) options to address and rectify the exposure created by the wrongdoing. The course that the organization may choose to follow is as varied as the array of problems that can arise, but an internal investigation providing the entity with this information will give the board and senior management the tools to address any problem appropriately and protect the organization from calamitous consequences.

Note

1. For this reason, the American College of Trial Lawyers recommends using an independent "Special Counsel," with little or no previous relationship to the company, to conduct the internal investigation in cases where serious criminal or securities law violations are raised.

Integrating Recruiters Into Your Job Search & Professional Network

By Randi V. Morrison

In this era of virtually constant change, job security is a thing of the past and, with few exceptions, everyone in the work force should routinely be thinking about possible next steps when considering their careers. This article provides pointers about how to utilize recruiters and other tools to facilitate that process, including procuring a coveted position on a board of directors.

I. Recruiters—Understanding the Basics

Recruiters can be extraordinarily helpful in a job search. Particularly for more senior level positions and positions in particular industries and highly specialized vocations, recruiters frequently have access to opportunities that job seekers otherwise lack.

However, keep in mind that recruiters are just one of a number of sources for identifying prospective opportunities in your overall job search. Other means for discovering opportunities include networking (the old fashioned way, as well as Linked-In and other social media), internet job boards, professional association job banks and major law firms. Whatever your preferred approach, employing a combination of methods is typically the most effective. And regardless of your seniority or expertise, networking permeates all aspects of a job search; as such, it should be an ongoing, career-long, active pursuit—not an isolated event or a "default" strategy.

Recruiters connect you with, work for, and are paid by, prospective employers. This is as opposed to employment agencies that work directly with, and are often paid for by, job seekers to help them find a job. While not all companies use search firms (and those that do typically use them to fill only certain positions), when a company retains a search firm to fill a particular position, you should fully understand and respect that process. Importantly, the recruiter represents the company—not the candidates, which is an often misunderstood concept.

There are two main types of search firms—"contingency" and "retained." Contingency search firms are paid if and when their candidate is hired by the company. These types of firms are used most often for lower and mid-level employee searches and, because they have no assurance of payment (in that their candidate may not be selected), they can't justify the significant time and effort on any particular search that is characteristic of retained searches. As a result, contingency searches focus on recruiting candidates and submitting multiple resumes (to increase their chances of success) to companies, which then must be prepared to invest the time necessary to screen and evaluate multiple prospective candidates from numerous sources.

Retained search firms have exclusive contract relationships with companies and are typically used for senior-level and executive searches for a defined time period to find the right candidate for the job. They are ordinarily paid based on a percentage of the successful candidate's salary and perhaps other compensation. As a result,

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unlike a contingency search, they tend to invest a significant amount of time vetting potential candidates inclusive of, e.g., conducting interviews, background checks, reference checks and other assessments - ultimately narrowing the candidate pool to just a few lead candidates for the company's consideration and final evaluation.

II. Guidelines for Shaping Your Recruiter Network

Generally speaking, search firms can be industry-specific (for example, retail or hospitality industries) or function-specific (such as legal, accounting), and local, regional, national or international in scope. Function-specific firms may be further focused on a specific niche—e.g., law firm placements rather than in-house, or only intellectual property positions. There are also a number of major, well-known firms with international reach whose practice encompasses all disciplines with groups of consultants dedicated to specific function areas.

While we are focused here primarily on the legal industry, whether you are seeking employment in the legal or some other industry or field, consider using recruiters who specialize in that industry or field, along with one or two other firms with a broader reach.

Work with multiple recruiters. Particularly if you are seeking a more senior or executive position, keep in mind that you're most likely dealing only with retained search firms that are looking to fill specific positions at companies that have retained them. If you limit yourself to one recruiter, your exposure to potential opportunities will likewise be limited to that recruiter's "portfolio" of opportunities. That said, it doesn't pay to not be selective and spend your time and resources judiciously.

There are literally hundreds (if not thousands) of legal search firms (see, e.g., Oya's Directory-of-Recruiters and Bullhorn Reach, set forth below, which list approximately 125 firms and over 2,000 legal recruiters, respectively). Focus your time and efforts on, and develop a rapport with, the ones whose practice specializes in or emphasizes the type of position you are targeting. Not only does this make the most sense from a time efficiency standpoint, but it also is more likely to yield a positive search experience, which will further bolster and motivate your search efforts. Quality clearly trumps quantity in this case.

III. Tap Multiple Sources to Find Recruiters Consistent With Your Career Objectives

Regardless of your current job status, developing and maintaining mutually respectful relationships with major law firms and in-house counsel is one way to increase your chances of being connected with a recruiter relative to a potentially suitable position or, at a minimum, a recruiter whose practice routinely encompasses engagements for positions of the type you are seeking or may consider in the future. If you are seeking an in-house counsel position, for example, law firm partners often have connections with the major legal recruiters and also are frequently contacted by the major search firms to find prospective candidates. Senior level in-house counsel also are frequently contacted by recruiters to gauge their interest in particular positions and for suggestions as to other potential candidates who may be suitable and interested.

Membership and active engagement in professional associations can yield multiple job search-related benefits. In addition to the fact these associations may be able to provide you with a list of relevant recruiters, they often maintain job banks (including on their social media pages on sites such as LinkedIn) to facilitate "match-making" between their members and recruiters and company human resource representatives relative to specific positions. Of course, professional associations also serve as yet another mutually beneficial and often fruitful (in multiple respects) networking venue.

In addition, consider accessing one or more online recruiting directories. Here are just a handful of resources to consider:

- Bullhorn Reach: allows job seekers to search for recruiters by industry and location.
- Emplawyer.net: allows you to search for recruiters by geographic regions.
- LinkedIn: generates a list of hundreds of recruiting firms that also identifies people in your LinkedIn network and job postings associated with each firm on the list.
- Riley Guide: provides lists of free and fee-based directories of recruiting firms that you may access.
- Oya's Directory-of-Recruiters: You can search for recruiters by the recruiter's specialty, geographic location, name or keyword, or interactively (allowing for a more refined search) on this site.

Finally, take advantage of social media. LinkedIn is the most well-known and widely used (over 175 million members) for professionals, so at least for any mid-level to senior-level position searches, it should be part of your job search strategy in some capacity. Note that with regard to all social media (particularly professional media sites), you should assume that search firms are actively using this media to supplement their candidate searches. In that regard, when developing your profile, while there certainly is room for creativity in presentation, it is wise to view it from the perspective of a recruiter or human resources professional to ensure that you are projecting the professional image you seek to project as a candidate. Remember that what you publicly disclose on your social media pages reflects, among other things, your judgment.

IV. How to Connect and Interact with Recruiters

Ideally, if a firm has not contacted you, it is preferable to connect with a recruiter via a personal introduction from someone in your network (whether a law firm partner, in-house counsel, LinkedIn connection, fellow professional association member, or even another recruiter with whom you have developed a rapport). Otherwise, most search firms have an online presence that includes instructions as to how to contact the firm—typically by providing a means whereby you can submit your resume and a brief cover note or letter online with your objectives and any self-imposed limitations (willingness to relocate being among the most noteworthy).

If a recruiter expresses interest in your background for a particular position or more generally for opportunities that may arise, (s)he will let you know and will seek to schedule a call and perhaps an in-person interview. Otherwise, don't be a pest. Professional, periodic follow up with recruiters you have contacted about your job search is good; badgering with frequent communications is not.

Once you are involved in a position-specific search process, it's perfectly acceptable to discuss with the recruiter the process specifics—e.g., necessary, as opposed to merely desirable, candidate qualifications, timing, and critical process events and decision-makers. Following up regularly with the recruiter throughout the process if you're awaiting feedback is perfectly acceptable; however, even then, if you overdo it, you come across as desperate, which will work against you.

At this point, assuming you are connected with the recruiter relative to a specific position, unless the recruiter encourages (or, at a minimum, indicates acceptance of) your direct communications with the company, now is not a good time to contact people you know at the company to attempt to advance your candidacy. These sorts of communications often annoy the company (companies retain search firms specifically to avoid these direct communications at this stage of the search) and the recruiter, and are ordinarily perceived as a lack of respect for the integrity of the search process or a sign of poor judgment on your part. That said,

depending on the facts and circumstances (each search being unique), the recruiter may in fact welcome your request to connect with company personnel during the process. The key is to be mindful and respectful of the process and the recruiter's role.

V. Integrating Recruiters Into Your Professional Network

As is the case with networking generally, maintaining contact with the major search firms is a career-long endeavor. Regardless of whether you are seeking your first position or you are a seasoned veteran, you should make a point of staying in touch with these firms and keeping them updated as to your whereabouts. You never know when your circumstances may change. Don't wait to identify and connect with recruiters until you've been laid off, or your company has been sold, or you're miserable in your current position. Be proactive throughout your entire career—not reactive.

Finally, positive, fruitful relationships with recruiters, like other relationships, are mutually respectful and beneficial, and look to the long-term. In that regard, when contacted by a recruiter for referrals for a particular position that is not suitable for you for whatever reason (e.g., timing, qualifications), you should thoughtfully consider this request and connect the recruiter with one or more potentially suitable candidates if you are able to do so.

VI. Recruiter and Other Considerations When Seeking a Directorship

When you are seeking a company board seat, as opposed to an in-house counsel or other legal position, you need to package yourself differently. You want to portray yourself as a strategic business consultant—not a great lawyer, for example, because the board is not looking for a lawyer. The result is a significantly decreased emphasis on your legal skills and background and an emphasis on your tangible business skills and experience. In fact, it is likely that much of the experience set forth on your "standard" resume won't be relevant for purposes of your board search resume.

Certain recruiting firms and divisions of the well-known international practice firms specialize in director searches, so you want to target those firms and practice groups specifically. Particularly for public company directorships, the demand for board diversity and independent directors with public company experience and expertise in particular industries, functions or major company developments has increased significantly in recent years, thus warranting much greater reliance on search firms in board placements than was the case historically. Note that, if you are working with a search firm for a directorship, it is highly unlikely that they will submit your board search resume to the company as is. Rather, they will ordinarily submit a brief profile and an assessment prepared by the recruiter that highlights the skills and attributes you possess relative to those the company is seeking, as well as perhaps a professional photo.

In addition to search firms, there are organizations that actively seek to develop pools of qualified candidates for corporate boards, including the DirectWomen Board Institute and the Women's Forum Corporate Board Initiative, geared specifically toward women candidates, as well as the NACD Directors Registry and GovernanceMetrics International Diverse Director DataSource (3D) commissioned by CalSTRS and CalPERS.

Most importantly, despite the distinctions, looking for a directorship should be approached with the same focus and energy as other types of job searches. As with other searches, networking and professionalism throughout the process are key.

Corporate Internal Investigations: A User Guide for Companies

By Vince Farhat, Vito Costanzo and Stacey Wang

Part Three in a Three-Part Series

Companies are under increasing pressure to investigate and self-report allegations of corporate misconduct. As government agencies become more aggressive in investigating allegations of corporate fraud and abuse, an unprepared company may unwittingly find itself mired in obstruction of justice charges because initial protective steps were not taken to identify and preserve potential sources of evidence and to establish the independence of the company's decision makers vis-à-vis the alleged misconduct.

This is the last of a three-part series giving companies a step-by-step guide for planning and conducting sensitive internal investigations into potential wrongdoing. Part one covered the initial decision of whether to conduct an internal investigation and immediate steps that should be taken to preserve evidence and create an independent investigation. Part two addressed how to design and plan internal investigations, including how to define and charter the investigation and document collection and review. This last installment of the series will cover witness interviews, memorializing findings, whether to self-report violations, handling whistleblowers and pre-investigation preparation.

Interviewing Witnesses

Pre-Interview Considerations—The central goal in interviewing company witnesses is to obtain a direct, complete and truthful recitation of the employee's knowledge. This is especially important if the government requested the witness statements because, in such cases, incorrect statements made to corporate counsel—which are then turned over to the government—may lead to obstruction of justice charges. The government has indicted executives for obstruction of justice on the theory that, by their lying to the company's counsel in the interview, they misled federal prosecutors when the interview results were turned over by the company. Consequently, document review to refresh recollection is especially important when the interview results will be turned over to prosecutors to reduce the risk that failures to remember will not be misconstrued as attempts to mislead.

(i) Prior to the interviews, counsel should distribute directives regarding cooperation and document preservation. The memorandum should describe the nature of the investigation, the possibility of witness interviews, a requirement that company employees cooperate, and that separate counsel at the company's expense may be retained. The memorandum should also include a document preservation directive, which is discussed in part 1 of this series.

(ii) Witnesses interviews often will be conducted on an abbreviated schedule while the company rushes to investigate and respond to a surprise inquiry. Nevertheless, some consideration should be given to the order of interviews. Counsel should determine whether the element of surprise is desired with a particular witness. For strategic reasons, interviews may commence with the lower level executives and up the corporate hierarchy, or *vice-versa*.

Mechanics of the Interview

(iii) Questionnaires may be effective in the interview process to obtain objective,

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biographical information. However, the majority of the interview process is most effectively conducted in face-to-face meetings.

The interview should begin with a warning that counsel represents the corporation and not the employee. (American Bar Association Rule 1.13 states that corporate counsel's relationship is with the corporation, acting through its authorized constituents, *i.e.*, the officers, directors and employees.) Consequently, although the attorney-client privilege extends to employees necessarily consulted, corporate counsel does not represent the officers, directors and employees in their individual capacities.

1) It should be standard practice for corporate counsel to warn the employees about the limitations of the attorney-client privilege. "Upjohn Warnings," based on the holding in *Upjohn Company v. United States*, 449 U.S. 383 (1981), consists of statements to the employee of the following matters: (a) that counsel is the company's lawyer and not the employee's, (b) that communications with the employee are protected by the attorney-client privilege, but the company may choose to waive that privilege and (c) that the employee should not disclose the conversation to a third party except for his/her own lawyer.

2) Upjohn Warnings are critical to the interviews because, under certain circumstances, an attorney-client relationship could develop with employees during the interview process. This can occur, for example, if an employee, while operating under the mistaken impression that corporate counsel is protecting everyone's personal interests, starts asking questions relative to his/her personal liability.

It is important to ensure the employee understands that the "client" is the company, not the individual. For example, the attorney-client privilege belongs to the company alone and the company may choose to waive it if necessary. An irreconcilable conflict may arise if multiple attorney-client relationships develop during the interview process. For example, if the company decides that it is in its best interests to disclose information obtained through employee interviews to the government, the involved employee may seek to block counsel from releasing information in subsequent proceedings. If such a conflict arises, counsel may be required to withdraw.

3) Consistent with the purpose of the Upjohn Warnings, corporate counsel should refrain from providing legal advice to the employee, even with regard to the issue of whether the employee needs separate counsel. If the employee construes counsel's comments to mean that he/she does not need separate counsel, then that person may assume that the company's counsel is protecting their interests. Accordingly, the best response is simply to advise the employee that "as the company's counsel, I cannot advise you on whether or not to obtain a lawyer." Keep in mind, however, that during these interviews, some employees—whether it is because they are nervous or uninformed about the process or because of the tone or body language of the attorney—may misapprehend a warning and become suspicious of the company's intentions toward that employee. It is helpful to make clear that this is a standard warning to prevent misunderstanding about the relationship, either by providing the warning in writing or reading verbatim from a prepared statement identically. If all employees are given the same warning and only one person believes that he/she is represented by corporate counsel, it is more likely that a court would find that belief to be unreasonable. As well, depending on the circumstances, the company may wish to provide pool counsel, which is an attorney retained and available to the employees at company expense.

4) Lastly, the fact that an employee retains his or her own counsel does not excuse that employee from the responsibility of cooperation with the company. Employees who decline to cooperate can in some circumstances face termination or be subject to other measures short of termination, such as placed on leave, and reduced bonus or seniority.

Investigation Results: Now What?

The investigation results should be memorialized in writing. In documenting the investigation, it is important to anticipate the potential uses of the findings. For example, the company may choose to disclose the investigation results to the government or in litigation in order to obtain a more favorable settlement. Further, there are obligations and agency guidelines that strongly encourage reports of certain criminal activity.

The Decision to Self-Report Violations

Deciding whether to self-report a violation of the law is more "art" than "science". The situation should be carefully managed so that, where possible, the facts alone are disclosed and attorney-work product protections are preserved. The assessment of the pros and cons of voluntary disclosure should be done with the participation of counsel so that the process itself is protected from disclosure by the attorney-client and work product privileges.

In certain situations, such as cases involving whistleblowers, the fact of disclosure is more certain. Consequently, the benefit to the company of disclosure outweighs any loss of control over the situation once disclosure occurs.

Other benefits to disclosure include the ability to credibly frame the story for the government, which necessarily involves disclosure of both exculpatory and incriminating evidence (with appropriate explanation), as well as a description of the scope of the investigation and how it was conducted. This may result in several advantages, such as a decision by the government not to serve a subpoena, which may result in more control over the flow of information, or even to reduce the scope of or cease the investigation altogether. The possibility of reduced penalties and lower cost are also significant motivating factors.

Further, there can be public relations advantages to "going public" with the problem and announcing an investigation. Recently, a college learned that an administrator had falsely reported the SAT scores of entering freshman in order to enhance its ranking. The institution decided to publicize the administrator's admission of guilt, released a "damage control" statement that it had no reason to believe that anyone else was involved and hired reputable outside law firm to conduct the investigation. This course of conduct helped soften the blow of a potentially damaging and embarrassing announcement.

Of course, there are risks inherent in voluntary disclosures. Importantly, unless it is absolutely accurate, disclosure should not occur. Otherwise, obstruction of justice charges may result from the conveyance of false information. The disclosure itself may result in criminal or civil prosecution and consequent damage to reputation or monitoring by government agencies.

Whistleblowers

Interaction with whistleblowers presents unique problems as a result of the many protections available to whistleblowers under state and federal laws, such as the False Claims Act, 31 U.S.C. § 3730(h), which was enacted in 1863 to protect individuals who reported fraud by suppliers to the government during the Civil War. The laws of many states also protect whistleblowers from adverse employment actions and other penalties. *See, e.g.*, California Whistleblower Protection Statute, Cal. Labor Code § 1102.5, which imposes significant civil penalties and potential misdemeanor charges.

These whistleblower protections can complicate the interview process when counsel is confronted by a witness who has already contacted or is about to contact the government, and who declines to be interviewed or otherwise cooperate in the investigation. While the company may normally discipline an employee for refusing to cooperate in an investigation, an attempt to discipline a whistleblower under the same circumstances could be construed as a violation

of public policy or of specific anti-retaliation statutes. The whistleblower may complain that he/she was disciplined for refusing an employer's directive to commit a crime, or reporting criminal activity to governmental authorities, or disclosing illegal, unsafe, or unethical practices of the employer, all of which may be considered to be violations of public policy or violations of anti-retaliation statutes.

(iv) Consequently, it is important that the company's guidelines include policies and procedures protecting whistleblowers, including Codes of Conduct and Business Ethics. There should be clear training and directions to employees to report suspected violations to the audit committee, human resources, compliance officer or management team. Management in these areas should receive education regarding the handling of whistleblower complaints and larger companies should consider using third-party operated telephone "hotlines" to receive whistleblower complaints.

"Adventure is just bad planning"

As Swedish polar explorer, Roald Amundsen said, "Adventure is just bad planning." Failure to have a pre-existing plan for internal investigations can result in unpleasant surprises and difficult moments. Conversely, having a plan that facilitates an immediate and reasonable response to suspected activity can help the company reduce liability, fines and punitive damages—and give company management peace of mind that a process exists to navigate the company through a potentially treacherous storm.

Effective corporate compliance programs can help avoid the need for an investigation in the first instance by encouraging the detection, reporting and remediation of misconduct, requiring management training and the development of corporate policies and procedures.

The existence of a well-reasoned compliance program is also viewed favorably by government investigators and can result in more favorable treatment if wrongful conduct does occur. In such cases, the government will look at whether the compliance program detected the offense before it was discovered by outsiders and whether the company promptly reported the transgression to the appropriate authorities. Consequently, while developing its compliance program, it is useful for the company to consider how the program will be evaluated in hindsight by the government.

When the government reviews a compliance program in retrospect, it will look for independence and appropriate oversight. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations? Are internal audit functions conducted at a level sufficient to ensure their independence and accuracy? Have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law? Favorable answers to these questions will demonstrate that the company has been thoughtful in its approach to a corporate compliance program.

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