

Internal Investigations and Civil Liabilities: How Cooperating with the Government Impacts Civil Liability

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The SEC's Guidelines on Cooperation and the Conduct of Internal Investigations

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A. INTRODUCTION

In the five years since the passage of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or “the Act”), we have seen a new era of enforcement by the Securities and Exchange Commission (“SEC” or “Commission”). The SEC has used, and the courts have begun to assess, the new authority that Sarbanes-Oxley granted to the SEC. At the same time, public company audit committees have expanded their oversight of financial reporting and investigation of allegations of internal company misconduct, as the Act envisioned they should. Sarbanes-Oxley followed upon the Commission’s Section 21(a) Report on cooperation issued on October 23, 2001. With that report -- commonly known as the Seaboard report -- the Commission provided guidance on compliance and self-policing, with the intent of incentivizing issuers to self-report and self-correct, while allowing the enforcement staff to harbor its limited resources.

This outline briefly discusses developments in these areas, focusing on developments regarding the SEC's guidelines on cooperation and the conduct of internal investigations.

B. COOPERATION

1. The SEC's Section 21(a) Report in the Leon-Meredith Action

The SEC provided significant guidance on cooperation and self-policing in its October 2001 Report of Investigation (the “Seaboard Report”) pursuant to Section 21(a) of the Exchange Act¹. The Seaboard Report set forth the criteria the SEC will consider in determining whether, or how much, it will credit self-policing, self-reporting, remediation, and cooperation in making enforcement decisions.

The Seaboard Report identifies four broad measures to be considered by the staff in deciding whether and how to exercise its prosecutorial discretion: self-policing, self-reporting, remediation, and cooperation.

a. Self-Policing

The Seaboard Report states the SEC will take into consideration policies and procedures a company has in place, prior to the discovery of misconduct, in its enforcement decisions. In this regard, the SEC will consider:

- Whether the company had procedures in place intended to prevent and detect the misconduct;
- The reasons the procedures failed to prevent the misconduct;
- The “tone at the top:” Whether the misconduct arose from pressure to achieve specific results, or there was a tone of lawlessness set by those in control of the company;
- The nature of the misconduct;
- The position of the wrongdoer;
- The actions or inactions of senior personnel;
- The pervasiveness of the misconduct; and
- How and by whom the misconduct was uncovered.

In the underlying enforcement matter, the SEC found significant that the violative conduct was limited to three employees of a company subsidiary. Senior personnel acted promptly, utilizing the company’s internal auditors to ascertain the nature and extent of Meredith’s misconduct.

b. Self-Reporting

According to the Seaboard Report, how and when the SEC and investors learn of wrongdoing, and a company’s own actions after learning of potential wrongdoing, will influence whether and to what extent prosecutorial discretion will be exercised. The SEC will consider:

¹ Exch. Act Rel. No. 34-44969; Accounting and Auditing Enforcement Rel. No. 1470 (Oct. 23, 2001), found at <<http://www.sec.gov/news/litigation/investreport/34-44969.htm>>. The *Seaboard* Report arose out of an SEC enforcement action against an employee of a subsidiary of the Seaboard Corporation. In that matter, the SEC settled a proceeding against a subsidiary company employee, alleging inaccurate books and records and misstated periodic reports, but took no action against the parent company. *In the Matter of Gisela de Leon-Meredith*, Exch. Act Rel. No. 44970 (Oct. 23, 2001).

- Whether the company promptly disclosed on its own initiative the wrongdoing and its impact to the investing public, to the SEC and the relevant self-regulatory organization;
- Whether the company demonstrates a commitment to learn the truth, fully and expeditiously;
- Whether the company informs relevant persons, including its independent auditors, audit committee and Board of Directors; and
- Whether the company undertakes a thorough, expeditious, and comprehensive review of the nature, extent, origins and consequences of the conduct.

In deciding not to institute an enforcement action against Seaboard, the SEC found significant the Company's speed and candor in disclosing the wrongdoing. The audit committee and full board were notified in a timely fashion, and the company disclosed to both the SEC and the public that its financial statements would have to be restated. The SEC found relevant that the price of Seaboard's stock did not decline after disclosure of the need to restate its financial statements, or the restatement itself. The SEC also noted that Seaboard quickly engaged counsel to conduct an internal investigation.

c. Remediation

Once a company confirms that misconduct has occurred, the SEC will take into consideration what steps are taken. For example, the following steps may be viewed favorably by the staff in formulating an enforcement recommendation:

- Disciplining or terminating culpable employees;
- Changing or strengthening internal controls and procedures to prevent recurrence of the misconduct; and
- Identifying the extent of damage to investors and other corporate constituencies and compensating those affected by the misconduct.

In the underlying enforcement matter, the staff looked favorably on Seaboard's swift and decisive actions. The Company terminated the responsible employee within 12 days of learning of the misconduct. Two employees responsible for supervising that employee were also terminated. Seaboard strengthened its financial reporting processes to prevent a recurrence of such misconduct in the future. These steps included the development of a detailed closing process for the subsidiaries' accounting personnel, consolidating the subsidiaries' accounting functions under a Seaboard CPA, hiring additional qualified employees responsible for preparing the subsidiaries' financial statements, changing the subsidiaries' annual audit requirements, and vesting Seaboard's controller with supervisory responsibilities over the subsidiaries' reporting processes.

d. Cooperation

The fourth factor to be considered by the SEC in assessing an enforcement action against a company is the level of cooperation provided. The SEC will consider:

- Whether the results of the company's review, as well as all relevant documentation, is shared with the staff;

- Whether information is disclosed to the staff that was not requested and otherwise might not have been discovered;
- Whether the information shared is thorough and reliable so that it may be used by the staff to facilitate prompt enforcement action against those who may have violated the law;
- Whether results of internal investigations are memorialized in a writing and shared with the staff in a format that can be used by the staff in an enforcement proceeding; and
- Whether the company encouraged its employees to cooperate with the staff's investigation and whether efforts were made to secure such cooperation.

In the Seaboard matter, the SEC found the company's cooperation to be real and meaningful.² The company provided the Staff with all information relevant to the underlying violations, including details of the internal investigation and notes and transcripts of interviews conducted. In this regard, the SEC found it significant that Seaboard did not invoke the attorney-client privilege, work product protection, or other privileges or protections with respect to any information uncovered in the investigation.

2. SEC Statement Detailing Framework for Imposing Civil Penalties Against Corporations in Settlements

On January 4, 2006, the SEC issued a statement (the "Statement on Penalties") setting forth the criteria it will consider in determining whether, and to what extent, to impose civil penalties against corporations.³ The Statement on Penalties was released simultaneously with the SEC announcing the filing of two settled actions against corporate issuers, McAfee, Inc., which agreed to pay a \$50 million civil penalty, and Applix, Inc., which was not required to pay a penalty.⁴

The Statement on Penalties reflects the Commission's evolving approach to financial penalties in enforcement actions against public companies.⁵ The Commission's posture on this issue has changed dramatically in the last five years. For approximately the first decade after being granted the authority to obtain such penalties in 1990, the Commission rarely sought them against public companies, reasoning that the burden would ultimately be borne by the company's shareholders, whom the securities laws were intended to protect. Between 2002 and 2006 however, the Commission demanded

² Importantly, the SEC has demonstrated an increased concern with companies that it believes have failed to cooperate fully with enforcement investigations. For example, in March 2004, the SEC imposed a \$10 million penalty against Banc of America Securities for failure to promptly furnish documents requested by the SEC staff. *In the Matter of Banc of America Securities LLC*, Exch. Act Rel. No. 49386 (Mar. 10, 2004); *See also SEC v. Lucent Technologies, Inc.*, Litig. Rel. No. 18715 (May 17, 2004) (SEC imposing \$25 million penalty for Lucent's alleged failure to cooperate with the staff's investigation and for actions the company took after the company reached a settlement in principle with the SEC).

³ *See* Statement of the Securities and Exchange Commission Concerning Financial Penalties, Release 2006-4 (January 4, 2006). The Statement on Penalties may be found at <<http://www.sec.gov/news/press/2006-4.htm>>.

⁴ *SEC v. McAfee, Inc.*, Civil Action No. 06-009 (PHJ) (N.D. Cal.) (Jan. 4, 2006); *In the Matter of Applix, Inc.*, Securities Act Release No. 8651 (Jan. 4, 2006).

⁵ In April 2007, Chairman Christopher Cox announced new settlement procedures requiring the SEC staff to obtain Commission approval before commencing settlement negotiations in cases "in which a monetary penalty against a company might be involved." Christopher Cox, Chairman, Sec. and Exch. Comm'n, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch041207cc.htm>. The new procedures follow on the Commission's Statement on Penalties, announced in January 2006.

millions of dollars in penalties from public companies to settle enforcement actions, including numerous settlements of \$10 million or more, and a handful in excess of \$100 million.⁶

In the Statement on Penalties, the SEC sought to articulate the criteria it will consider in determining whether to impose corporate penalties. Of particular significance, the Statement on Penalties was issued unanimously by all five Commissioners, a marked contrast to the previous public discord among the Commissioners as to the appropriateness of such penalties. In this regard, the Statement on Penalties pointedly notes that "corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws."

The Statement on Penalties states that it intends to provide "the maximum possible degree of clarity, consistency and predictability in explaining the way the corporate penalty authority will be exercised." As a substantive matter the Statement on Penalties provides little fresh guidance in this regard. The criteria set forth in the Statement on Penalties are generally consistent with SEC practice and staff statements of the past few years. Perhaps reflecting the process that accompanied the search for consensus on this Statement on Penalties, the articulation of the criteria to be used with regard to corporate penalties is quite broad. The result is that difficult policy judgments, such as assessing what violative conduct may actually be said to have benefited shareholders, or evaluating when the Commission should involve itself in allocating resources from current to former company shareholders as a means of compensation --the two principal considerations identified in the Statement on Penalties -- are deferred for resolution on a case-by-case basis. The Statement on Penalties provides the framework in which those policy questions will be addressed in future cases.

The Statement on Penalties' clear message is that corporate issuers that are the subject of SEC enforcement investigations will continue to face the risk of significant monetary penalties. It is therefore essential that a company faced even with the prospect of such an investigation take steps to address the criteria that are within its control through prompt and effective mitigation efforts. Self-policing and timely remediation are imperative to avoiding or lessening the SEC's wrath in the face of perceived misconduct within the organization.

The Statement on Penalties identifies two primary factors to be considered by the SEC in deciding whether, and to what extent, to impose civil penalties against corporations: whether the corporation improperly benefited as a result of the violation and the impact a penalty may have on shareholders. A corporation that receives a direct and material benefit or is otherwise unjustly enriched from a violation is a stronger candidate for a civil penalty in settlement than a corporation whose shareholders are the principal victims of the offense. Likewise, the SEC is more likely to impose a penalty against a corporation if the penalty can be used as a meaningful source of compensation to injured shareholders than if the penalty will unfairly injure investors, the corporation, or third parties.

⁶ That change in approach was not without dissent. Some Commissioners publicly expressed contrary views, and at least one proposed settlement that included substantial penalties was reportedly stalled after the Commission deadlocked in a 2-2 vote while Chairman Cox awaited confirmation. See Paul S. Atkins, *Speech by SEC Commissioner: Charles Hamilton Houston Lecture* (April 4, 2005); Amy Borrus, *What To Expect From Chris Cox*, *BusinessWeek*, June 20, 2005, at 42. The speech can be found at <<http://www.sec.gov/news/speech/spch040405psa.htm>>.

The Statement on Penalties identifies seven additional factors to be considered when deciding whether to impose a corporate penalty. They are:

- Deterrence: A corporate penalty is more likely to be imposed where it will serve as a strong deterrent against similar conduct than in situations containing unique circumstances that make the violative conduct unlikely to recur.
- Injury to innocent parties: The more widespread and significant the harm to investors, innocent parties and society, the more likely a corporate penalty.
- Pervasiveness of the conduct: As the number of corporate employees engaged in wrongdoing increases, so does the likelihood of a corporate penalty.
- Intent: A corporate penalty is more likely in matters involving deliberate, intentional fraudulent conduct than matters involving inadvertence, honest mistake or negligence.
- Difficulty detecting the offense: Offenses that are difficult to detect merit a high level of deterrence and therefore weigh in favor of a corporate penalty.
- Remediation: Failure by management to take swift and decisive remedial actions upon learning of a violation weighs in favor of a corporate penalty.
- Self-reporting and cooperation: Whether a corporation promptly self-reports securities laws violations and cooperates with the investigation and remediation will also be considered by the SEC.⁷

C. INTERNAL INVESTIGATIONS

Internal investigations are frequently key to the proper handling of incidents of possible misconduct on the part of a corporation. It is often difficult or even impossible for a company's Board or its management to chart an appropriate course in the face of potential allegations of wrongdoing without sound legal advice about the company's areas of exposure -- and counsel often cannot provide that advice unless and until they have ascertained the facts through a thorough internal inquiry. In addition, as noted above, an effective and thorough internal investigation may assist an issuer in achieving the best resolution in an SEC inquiry. Although the primary factor used by the SEC staff to decide whether to institute an enforcement action is the nature of the misconduct, conducting a thorough internal investigation may help the company in trying to persuade the staff (1) not to proceed with its investigation; (2) to refrain from proceeding with its investigation pending completion of the internal investigation; (3) not to recommend enforcement action; (4) to recommend lesser charges and/or sanctions than what may initially be contemplated; or, at the least (5) to insert mitigating language in settlement documents.

Some of the key issues in internal investigations are discussed briefly below.

⁷ Notably, the Statement on Penalties does not provide any guidance on the factors considered by the SEC in determining whether a corporation cooperated with an investigation.

1. When Is An Internal Investigation Warranted?

In general, as soon as a company has reason to believe a problem exists implicating securities trading, its SEC reporting, or other material disclosures, an investigation may be warranted. Such a problem could involve a potential violation of law or regulation or simply a violation of, or deviation from, company policy. The company need not, and in fact should not, wait for a telephone call, informal request, or subpoena from the SEC before commencing its own investigation. Indeed, the SEC has indicated that the company's response upon learning of a potential problem is a factor it will consider in exercising its prosecutorial discretion.

2. The Role of the Audit Committee

Sarbanes-Oxley has formalized the role of the audit committee in monitoring compliance with respect to financial and accounting issues. The Act requires audit committees to establish procedures for (1) "the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters," and (2) "the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."⁸ In addition, the statute requires that the audit committee "have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties," and requires the company to provide appropriate funding for payment of compensation to those advisers.⁹

In light of these provisions, an audit committee may find it appropriate or necessary to conduct an internal investigation to fulfill its statutory responsibilities under Sarbanes-Oxley. In addition, an Audit Committee may, in the ordinary course of business, determine to undertake an internal investigation for purposes related to the defense of allegations that are or may become the subject of a government investigation or enforcement action.

3. Determining Who Should Conduct an Internal Investigation

As a general rule counsel should conduct or supervise the investigation. Sensitive legal questions invariably are raised in the course of such investigations, including the ultimate question of whether the conduct at issue constitutes a violation of law. Whether in-house or outside counsel should be responsible for conducting the investigation is subject to a number of considerations. In-house counsel typically are better acquainted with the company's history, procedures and operations, and may be received more openly by employees that are the subject of company requests for interviews, information and documents. On the other hand, outside counsel may be somewhat more objective in assessing questioned practices. The judgment of outside counsel experienced in defending government investigations involving similar practices also may be a valuable asset to a company faced with allegations of wrongdoing. In-house counsel may be viewed by the government as lacking independence due to their status as part of the corporate management structure. The government is

⁸ See Sarbanes-Oxley § 301(c)(4), 15 U.S.C. § 78(f).

⁹ *Id.*

especially sensitive to the influence that management exercises over employees through control of their livelihoods, and this may tend to color the government's view of the conduct of in-house counsel during the course of an internal investigation.

The risk of waiver of attorney-client privilege also is a consideration in determining who should conduct an internal investigation. Since in-house counsel frequently are called upon to provide business as well as legal advice with respect to matters under investigation, it may be more difficult for in-house counsel to establish and maintain the privilege.

4. Reviewing Documents and Interviewing Witnesses

Generally, when conducting an internal investigation, it is preferable to review the relevant documents prior to commencing interviews. The documents may provide a fertile source of the identities of the individuals who will need to be interviewed and of the nature and extent of the issues of concern. Given the time constraints that may be imposed by reporting obligations or the overhang of an imminent or pending SEC inquiry, however, it may become necessary to begin interviews before the document review has advanced as far as might otherwise be desirable. The timing and sequence of internal investigative measures thus become matters of judgment based upon the flow of the case.

As to interviews, the employee must be advised at the outset of the interview that the interviewer is counsel to the company, and not counsel to the employee. Although witness interviews by company counsel generally are subject to the company's attorney-client privilege, the employee must understand that the privilege is the company's, and not the employee's, either to assert or to waive. Thus, while the employee may be requested not to discuss the interview with others in order to preserve the company's attorney-client privilege, this does not mean that the employee can prevent disclosure of the substance of the interview by the company, either internally or to the government.

5. Determining Whether Employees Should be Represented by Separate Counsel

Since a corporation can act only through its directors, officers and employees, the conduct of such individuals always is at issue in SEC investigations. These individuals generally need legal counsel to advise them of their rights and obligations in connection with an investigation, and often turn to corporate counsel for such advice. This poses the question whether such individuals may or should be represented by counsel for the company, or whether separate counsel is preferable or required. As a practical matter, sufficient facts may not be known at the time a decision about joint or separate representation must be made.

Where the company is the subject of a criminal investigation, there often is a serious potential for the existence of a conflict between it and its personnel. For example, an employee may have taken a questioned action based upon information or direction received from a supervisor. Even if contrary to company policy, the action may be attributable to the company, and the company could be held vicariously liable for it if the individuals involved possessed the requisite knowledge and intent. In such a situation, the interests of the company, the supervisor and the employee may vary, and counsel for the company accordingly should refrain from providing legal advice to the individuals involved.

There also may be tactical advantages to the retention of separate counsel by company personnel who are likely to be contacted by the government. Separate counsel may have greater credibility regarding representations made on behalf of individuals. The government may be more forthcoming to separate counsel than would be the case if the individual were to be represented by company counsel. Separate counsel can prepare the individual to be interviewed or to testify – or advise the individual not to be interviewed or to assert a privilege not to testify – with less risk of an allegation that the company improperly is attempting to influence the witness's testimony. In helping a witness prepare to provide his or her testimony, the same advice which would be regarded as good lawyering on the part of separate counsel might be viewed as improper coaching on the part of company counsel.

6. Voluntary Disclosure of Findings from the Internal Investigation

The results of an internal investigation may lead to the discovery of deficiencies or issues of concern, and to the conclusion that some form of disclosure to the SEC is in order. In these circumstances, the internal investigation itself ultimately may serve as an indication of corporate responsibility and good citizenship. Under Seaboard, the SEC may give favorable consideration to issuers which are forthcoming in disclosing and correcting deficiencies, as self-policing and voluntary disclosure are important factors considered by the SEC when deciding whether to proceed against a company.

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This is an excerpt of a broader article also discussing noteworthy recent Commission enforcement actions, based on previous publications prepared by the authors.