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Outside Counsel And Internal Investigations

Law360, New York (October 16, 2009) -- A defining characteristic of the post-Enron, Sarbanes-Oxley world of corporate governance is the imperative that corporations self-police, self-report and self-remediate wrongdoing by management and employees.

The hallmark mechanism for investigating and addressing alleged corporate misdeeds is the special committee of the board of directors, comprised of outside directors that are “independent” of the conduct being investigated, and the committee’s outside counsel, also required to satisfy the independence requirement.

In two recent cases, Kirschner vs. K&L Gates LLP and Roberts vs. McAfee Inc., corporate stakeholders have taken the unprecedented step of suing, and seeking substantial recoveries from, attorneys engaged to assist special committees in investigating and evaluating corporate malfeasance.

These cases highlight the enormous tensions inherent in this process, and a new risk faced by outside counsel increasingly asked to play a pivotal role in making judgments which produce both winners and losers among the various corporate stakeholders.

At the heart of both cases is the allegation that outside counsel did not perform an independent, thorough and comprehensive internal investigation.

In most internal investigations, the company’s board of directors forms a special litigation committee (SLC), which retains outside counsel as a neutral and independent party to carry out its duties and investigate potential wrongdoing, improper conduct or fraud perpetuated by high-level employees.

In assessing the decisions made by the SLC, courts look to the independence of the SLC and its advisors, including lawyers. Additionally, reasonableness is a key factor in a court’s analysis of the adequacy of the investigation.

Both cases serve to remind outside counsel of these strict and essential requirements that conducting such an investigation impose.

The plaintiff in Kirschner is the bankruptcy trustee overseeing the liquidation of Le-Nature's. He is suing K&L Gates and an accounting firm, Pascarella & Wiker for malpractice, negligence, breach of fiduciary duty and negligent misrepresentation for allegedly failing to detect fraud before the company was forced into Chapter 11 bankruptcy.

In 2003, the company's CFO and two other senior financial managers resigned from the company because they believed the CEO was engaging in improper and unusual conduct. Le-Nature's board of directors formed a special committee, which retained K&L Gates to investigate the alleged problematic conduct.

K&L Gates and Pascarella delivered to the company, through the special committee, a written report concluding that that they found no evidence of fraud with respect to any of the transactions at issue. The plaintiff alleges that the defendants' internal investigation was deficient in two important respects.

First, the plaintiff contends that, despite having been provided with detailed information concerning a wide range of areas and transactions in which improper activity was suspected, the defendants improperly limited the scope of the investigation to discrete transactions to protect the wrongdoers.

Second, the plaintiff alleges that the investigation was not independent because the defendants improperly permitted the CEO to dictate critical aspects of the investigation despite the fact that he was one of the principal subjects of the investigation.

For example, the complaint alleges that the defendants improperly (1) allowed the CEO to participate in the discussions concerning the scope of the investigation; (2) submitted document requests through the CEO; (3) allowed the CEO to provide the responses to the document requests; (4) provided the CEO, in advance of the interviews, a description of the topics to be covered with specific employees; and (5) complied with the CEO's request that certain employees and third-party witnesses not be interviewed or that certain follow-up interviews not be permitted.

The plaintiff alleges that defendants' failure to detect the ongoing fraud caused the company to suffer more than $500 million in damages and led to its bankruptcy.

In Roberts, the former general counsel of McAfee is suing his former employer for defamation, invasion of privacy and malicious prosecution for allegedly making him the scapegoat of the company's stock option backdating scandal.

Though not named in the lawsuit, the plaintiff accuses the company's outside lawyers, Howrey LLP and Wilson Sonsini Goodrich & Rosati (Howrey), of allegedly helping the company to frame him. Specifically, the plaintiff is critical of Howrey's internal investigation of McAfee's stock option grants.

Like Kirschner, the plaintiff alleges that the investigation was not independent, accusing the company, through its special committee and with the assistance of outside counsel, of protecting the then-CEO and other more senior officials at the general counsel's expense.

He alleges that the two law firms improperly (1) discussed the investigative process in advance with senior managers and directors; (2) provided relevant documents to senior managers and directors prior to their being interviewed; (3) allowed attendance by the Special Committee at the senior managers' and directors' interviews; and (4) permitted senior managers and directors to produce documents on a voluntary basis; and (5) took no affirmative steps against senior managers and directors after realizing that emails had been deleted in violation of the SEC's freeze order.

Lawyers in the Crosshairs

The arguments made by the plaintiffs in these cases are not unique; indeed, they closely track developing law in Delaware and elsewhere with respect to requirements that internal investigations be both independent and thorough. What is unusual is the context in which these arguments take place.

These arguments typically occur in the context of derivative litigation in which plaintiff shareholders accusing the company of wrongdoing seek to overturn the presumption that the board is in charge of such matters by arguing that the process was not objective and/or comprehensive.

Here, the plaintiffs have brought the lawsuits outside the context of derivative litigation and are seeking to hold the attorneys liable for negligently conducting an internal corporate investigation.

Practical Guidance

Both Kirschner and Roberts serve as poignant reminders that lawyers must take steps to ensure the integrity of the investigative process.

First, in addition to the members of the SLC, outside counsel to an SLC, must also be independent. Outside counsel is deemed independent when it has not performed material amounts of legal work or other work for the company or for any individual directors involved in the investigation.

In ideal circumstances, independent counsel should have no relationship, or at the very minimum, small ties to the company, its officers, or directors.

If outside counsel has served as the company's lawyers in the past, the prior representation may undermine the independence of the SLC because the law firm has an interest in obtaining a favorable result for the company in order to secure future work.

Additionally, the American Bar Association recently compiled a list of Corporate Governance Practices.

Specifically, Corporate Governance Practice No. 9 provides that "[e]ngagements of counsel by the board of directors, or by a committee of the board, for special investigations or independent advice should be structured to assure independence and direct reporting to the board of directors or the committee."

Because independent counsel conducts the investigation on behalf, and at the direction of the SLC, lawyers should not report directly to in-house counsel or management regarding the substance or progress of the SLC's work in order to maintain the independence of the SLC. Rather, outside counsel should report to the entity that hired it — the SLC.

Second, after determining that outside counsel is independent, courts will determine whether the investigations was reasonable. Courts will examine whether the SLC actively directed and supervised the investigation; and, second, whether the investigation was sufficiently thorough and comprehensive to support the SLC's conclusions.

The SLC is expected to manage and direct the investigation with reliance upon its independent counsel. Courts will demand assurance that the SLC is not merely a false front to an investigation directed by management or corporate wrongdoers.

In both Kirschner and Roberts, the plaintiffs claim that the defendants protected the alleged wrongdoers by giving them a central role in determining the course and scope of the investigation. It is critical that any individuals alleged to have engaged in improper activity not be given any role.

Additionally, courts assess the thoroughness of an investigation based on the following factors: (1) the persons interviewed and how they were selected; (2) the scope of the review of documents and records relating to the substantive allegations; (3) the issues investigated, especially if certain areas and individuals were suggested and provided to the SLC; and (4) the written report and conclusions drawn.

To ensure that the investigation is independent, thorough and comprehensive, it is imperative that the investigative team, not company management, take the following actions: (1) interview key decision-makers and their subordinates, as well as any individuals identified by the derivative shareholder issuing the demand or the whistleblowers; (2) determine who is to be interviewed; (3) have access to and review all of the materials related to the subject matter of the demand; (4) determine the scope of the investigation and ascertain at the outset the areas of inquiry without company management; and (5) draft a written report describing the investigation, the findings and the recommendations of the SLC.

Conclusion

Because most of the work of an SLC is typically carried out by outside counsel, courts will determine whether they were impartial and whether their investigation was reasonable to the extent their investigation comes under attack.

It is clear that independence is essential in defending against any corporate wrongdoing or malfeasance.

To avoid any potential pitfalls, outside counsel should have limited contacts with the company to maintain its impartiality and feel free to conduct a thorough investigation without jeopardizing future work from the company.

Moreover, in performing the internal investigation, it is critical that outside counsel not limit the scope of the investigation too narrowly or give any role to those individuals alleged to have committed misdeeds. If outside counsel follows these basic, but strict, principles, they may not find themselves in court.

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