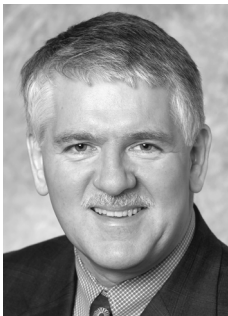


Responding to a corporate crisis — A framework for dealing with bad news

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ABSTRACT

In today's climate, a company's failure to act promptly and properly in response to a government inquiry, to allegations raised by a whistleblower or a union, or to a story being written by a reputable reporter, can lead to severe negative consequences for that company. This paper focuses on the importance of, and key factors for, developing a framework to respond to such inquiries, including considerations that should guide the fact-finding process and development of a remedial plan. Effective corporate governance and appropriate planning can be determinative factors between a corporate crisis and a well-managed problem with an acceptable outcome.

Keywords: corporate crisis, government inquiry, internal investigation, independent inquiry, compliance and risk management, corporate governance, Securities and Exchange Commission (SEC)

INTRODUCTION

At some point, many public companies will receive a call from a member of staff at the Securities and Exchange Commission (SEC) asking for information about an issue the staff has gleaned from a 10-K filing, a newspaper article, testimony taken in pending litigation or in materials supplied by a disgruntled employee turned

whistleblower. A press release announcing the need for an accounting restatement almost always invites SEC attention. Or, the inquiry might arise after a union challenge regarding executive compensation or perks. The SEC staff member might ask for information about particular reserve accounts, aged accounts receivables, the company's practices for certain revenue recognition or for bill and hold arrangements. Recalling the frenzy in 2006 over stock option practices that appeared to cut across many industry sectors, this was triggered by articles in the *Wall Street Journal*. Even more alarming, government agents may appear unannounced at the home of a current or former employee seeking an interview.

Notwithstanding media scrutiny on company practices over the past five years, management and board members often are unprepared for such a development. How management responds, what actions it takes (or declines to take), how it informs its Board, and how its Board responds, in many instances, can set the stage for the way in which the crisis unfolds and possibly, for a comparatively more favourable outcome. In today's regulatory climate, failure to act promptly and properly often will lead to more severe negative consequences for the company, employees and officers, and, at times, individual Board members.

As recent events have shown no company or financial institution, regardless of how well it is managed or how big it is, is immune to these types of inquiries and the almost inevitable fall-out from them. Given the number of high-profile SEC enforcement investigations and record-setting settlements and enforcement actions and the articles and continuing education classes that address how public companies should respond to regulator and media inquiries, whistleblower complaints, and union allegations, one might expect that

every entity has a contingency plan in place. Based on the authors' first-hand experiences, both as inside and outside counsel, these plans are the exception, not the rule, and management and the Board often are unprepared when such an inquiry is received. Equally important, many public companies fail to convert the crisis into an opportunity to improve compliance and risk management functions already in place, and to enhance existing controls.

This paper first lays out a flexible framework for responding to such inquiries. (The authors are not attempting to offer a manual on conducting internal investigations or to catalogue the lawyerly intricacies attendant to every investigation.) The paper then turns to considerations guiding the remediation process, including close review of the existing risk management and compliance function and of corporate governance processes. While a crisis avoided is always preferable to a crisis solved, a crisis can be managed successfully with some forethought, sound judgment, and strong governance from the company's board and senior management team. Proper management can go a long way to restoring stakeholders' confidence in the credibility of the enterprise and to demonstrating to a regulator, union, or whistleblower that the company has taken appropriate steps to investigate and address alleged shortcomings.

EARLY AND CRITICAL FIRST STEPS WHEN THE SEC STAFF COMES KNOCKING (OR CALLING)

Most public companies and every financial institution routinely engage with regulators and government agencies and with the press as a matter of course. While those exchanges can be stressful, they do not raise alarms over whether something may be amiss. A government inquiry,

whether ‘informal’ or by subpoena, a whistleblower complaint, union claims, or media stories that raise questions about the accuracy of a company’s financial reporting, or certain accounting practices, or potentially improper payments are the calls that provoke sleepless nights.

It is not uncommon for senior management to perceive such requests as challenges to their integrity and character and to deny that any problem exists. Significant resources, energy, and time are regularly devoted to efforts to derail the inquiry, rather than to deal with the request head on. That approach rarely works and only wastes valuable time. Virtually every public company has announced its commitment to ‘best practices’ and ethical decision-making. Because most employees and directors have little, if any, direct experience in addressing these types of challenges, it is not surprising that companies frequently make significant mistakes when an unpleasant and unwelcome press inquiry, whistleblower complaint, or regulatory request for information is received. A common theme among companies facing these challenges is that they frequently get it wrong.

‘Bad news’ requests should be seen as a business contingency, and every company ought to develop a framework to plan and manage an effective response. The General Counsel, as the Chief Legal Officer of the entity, or the Executive Officer in charge of compliance and risk management, should be tasked with developing that framework. Among other things, the plan should require the President, COO, CFO, CAO, internal auditor, and others to report quickly and clearly to the CEO whenever an inquiry of any real moment from a regulator arrives and/or when bad news (or an early suggestion of bad news) is received, from whatever source. The plan should also make clear that, if the

matter is potentially serious, the CEO will promptly report this information to the Board, or to a committee of independent directors, without playing down the issue or its potential significance.

The plan should task management with preparing a framework, within a couple of days, to respond to any such request or perceived bad news, which includes:

1. assembling a list of potential sources needed for the information to respond;
2. identifying individuals who will assemble and review the materials;
3. evaluating the substance of the issue on the table;
4. providing regular updates to the audit committee, or the committee of independent directors assembled to manage the issue on the review’s status;
5. analysing whether outstanding disclosures should be withdrawn or revised; and
6. devising a protocol and reasonable timetable for making decisions about whether and how to communicate with the regulator, the reporter, the whistleblower, or the union.

Developing a plan acknowledges the possibility for bad news. But this is just the beginning. After that call or request comes in, and management reports to the audit committee chair, or lead independent director, what are the next steps? First, the audit committee, or a properly formed committee of independent directors, should meet with management to assess:

1. management’s plan as to what needs to be done to gather the facts quickly, and
2. who should get the facts.

Gathering as many facts, before any response is needed, allows the company to gain some control over events by better understanding the scope of the issues at

stake and evaluating available options. Assembling and evaluating the facts and preparing a credible response take time, and companies may not have that luxury. A company may be required to disclose a data breach, for example, while the forensic work needed to determine how the breach occurred, or who or what may be responsible for the breach, is ongoing.

Where a request comes from a reporter, or allegations are made by a whistleblower or a union with an interested media outlet, the news cycle won't wait until the company assembles the facts in order to speak reliably to the media. Entities can be tried and convicted in the court of public opinion long before a regulatory investigation is completed or the dispute is sorted out in court, and sometimes, before the facts are known. Media interest in a story often cannot be managed away. Where prompt disclosure is not clearly required, there is almost always a strategic decision to be made as to whether the company wants to speak publicly about the issues. If the company decides to speak, it should be on top of the facts. While there is a natural urge to respond to the media and defend the company and its actions, speaking too quickly with inaccurate information only compounds the problem.

The same approach holds true for regulators. Although it may be in the best interests of their stakeholders for public companies to be proactive, no company should place a premium on an immediate response ahead of an accurate response. Even in the face of government demands for immediate explanations, the consequences of providing incomplete or inaccurate information can be irreversible and must be resisted. Such a step can undermine the credibility of the company and the individual making the presentation.

Where a regulatory investigation has commenced, senior management, along with company directors, needs to consider

what, if any, additional steps also should be taken. Does the company have an immediate disclosure obligation? Should any past statements made by the company be modified, supplemented or withdrawn in light of what is currently known? Given the complexity of disclosure and reporting issues and the need to re-evaluate them as additional facts are learned, management and the Board should regularly consider, with legal counsel, what disclosures, if any, should be made and whether additional disclosures would be prudent, even if the company concludes that there is no affirmative duty of disclosure under the federal securities or other laws. Should the company's outside auditors be informed? Should the trading window for executives be closed in light of non-public, material information that the company now may have? Should it shut down any equity-based programmes for employees? Is there a proposed acquisition or other transaction that needs to be put on hold? If there is a whistleblower involved, what steps should be taken to prevent retaliation?

One of the first steps that a company must take when it learns that a regulatory investigation has commenced is to suspend its regular document destruction practices. After the Arthur Andersen debacle in connection with Enron, it is clear that destruction of relevant documents can have dire ramifications with the potential threat of obstruction charges.¹ Even if the government concludes that there is not sufficient evidence to bring obstruction charges, it is likely to view the company with suspicion and question the accuracy and completeness of its submissions and document productions. In this increasingly electronic age, document preservation requires far more than sending out a preservation notice and obtaining a confirmatory email response from employees. Depending upon the company's network topology and data storage practices, locally

stored e-mail, server e-mail boxes, other server data and backup tapes may have to be maintained, and forensic images of hard drives may need to be taken of employee (and departing employee) computers, including home computers.² In many companies, the IT department struggles to keep up with daily demands for services and often does not have a full understanding of the company's actual practices in storing electronic data. The IT manual may say one thing about what data is accessible while the practice may be quite different.

When a crisis erupts, it often creates uncharted paths, even for the most experienced companies. Legal considerations are always a significant part of crisis management, and the Chief Legal Officer and his or her team play a central role in flagging the issues and proposing possible solutions.

MANAGEMENT OF THE INTERNAL REVIEW

Once the proper document preservation steps have been taken (and e-mails are regularly sent to remind individuals of their continuing obligations), the next step is to collect the facts underlying the request for information. Historically, many public companies were somewhat casual about responding to an informal request for documents from a regulator or to allegations from whistleblowers, who often were dismissed as disgruntled employees. Those days are long gone. Every company facing a regulator's request for voluntary production of information, a media inquiry, whistleblower complaints, suspicions of workplace misconduct, or the like needs to have a much more nuanced process for assessing potential problems.³

When a preliminary assessment determines that there is some credibility to the questions raised, a more thorough review is likely to be both prudent and required.

It is critical for the company to understand whether the concerns are well founded, what occurred and who was involved, and to address it so that the company can demonstrate that it has acted reasonably and promptly to proactively investigate the issue and to remediate whatever weaknesses were identified.⁴ The question then becomes who should conduct the investigation and its scope.

The growth in internal investigations over the past five years has been fuelled, in part, by statements from the US Department of Justice and the SEC advising that credit may be given to organisations that conduct prompt and thorough internal independent investigations⁵ and by court opinions holding that independent directors may be insulated from liability in shareholder derivative actions if a special independent committee of the Board investigates the allegations and determines whether they conduct independent investigations.⁶ Not every issue requires a Board-sponsored, independent inquiry, and there is no 'one size fits all' answer to the question whether the inquiry should be directed by management or by independent directors. Directors and senior management should understand that any investigation, whether led by management or by independent directors, may well be expensive, time-consuming, and distracting.

Where management's credibility is not involved and management is not part of the problem or otherwise compromised or conflicted, either model could be used, and there are risks and benefits to each. Management's knowledge of the company's operations and personnel usually enable it to conduct a more efficient, economical, and minimally disruptive inquiry. Management is also likely to use corporate counsel to lead the investigation, and that counsel's familiarity with the company, senior employees, and directors reduces

the learning curve. However, when a regulator is involved, the regulator may give little, if any, deference to and credit for a management-led inquiry⁷ and may look closely at the investigative work done by company counsel to see if the counsel ‘may have conducted [the] investigation [] in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigation []’.⁸ If the underlying matter is serious, or if there is any scepticism at all about the integrity of the internal review, a regulator is likely to commence its own investigation in parallel with the management inquiry, which is internally disruptive and costly to defend and lingers for a significant period of time. The cascade of bad news may continue: the stock price takes a hit; the company becomes a favourite media target; securities class actions are filed; and senior management is left in the abyss, waiting for the regulator to finish the probe and determine what charges, if any, to bring.

Board-sponsored investigations, directed by independent Board members, may enable the company to reach an agreement with regulators to ‘stand down’ until the independent investigation concludes, provided that the independent directors share the results with the regulators.⁹ Even with expanded resources, regulators must focus their resources and effectively manage their caseload, and an independent review of sufficient scope, that is thorough and timely, and led by outside counsel with no prior relationship with the company, provides a road map, complete with relevant documents and witness recollections, on which they can rely. If the investigation identifies a problem, a promptly developed and implemented remediation plan may set the groundwork for an early resolution of the issue with the regulator and reduce the likelihood or severity of the charges and regulatory penalty. There

are some issues that may not be susceptible to a management-led inquiry because they call into question the conduct or judgment of senior management. For example, an independent Board committee investigation could be warranted where accounting errors, involving significant revenue recognition or reserves, are found because those errors could involve a management effort to manage results. Allegations involving potentially inappropriate foreign payments are often investigated by an independent Board committee with its own counsel.

Every internal investigation ought to document the investigative steps taken. The integrity of every internal investigation hinges on the rigor used to collect and review hard copy and electronic documents and e-mails from potentially relevant custodians and to identify and interview current and former employees who may have knowledge of the issues. The Board’s audit committee (and/or a committee of independent directors) should receive updates on the progress of any internal investigation. As facts are learned during the investigatory process, the independent directors should be sufficiently fluent with the information so that they can evaluate whether management’s conduct has been called into question and what steps, if any, should be taken before the inquiry is completed. Depending on the size and nature of the issues, the outside auditors should be informed promptly. Every internal investigation should review whether any existing controls failed, what processes and controls should be enhanced or improved, and what actions have been or should be taken to prevent a recurrence.

COOPERATION WITH THE GOVERNMENT

Credibility with the government is critical

at every stage of the process, and government requests for information, whether fashioned as a 'voluntary' request or by subpoena, must be answered completely, accurately, and in as timely a fashion as practicable. Responding to these requests is a different matter than whether to 'cooperate' with the government.¹⁰

Assume that a company discovers a problem on its own, or, in responding to a regulator's request for information, discovers either that there is a problem, or that there is a different (and potentially more serious) problem than the issue raised by the request for information. Should the company disclose to the regulator that it is conducting an internal investigation? Should it disclose the findings of that investigation to the regulator? To the stock exchange? To a state attorney general or federal law enforcement authorities?

The answer to these questions is likely to hinge on the nature and size of the issue, who is involved, and what will be required to address the problem. Each circumstance is different and turns on the nature of the facts involved. Assuming a decision is made to report the problem and the internal investigation to the government, the company must be very careful as to the commitment or promises it makes at the outset, as these will bind the company down the road.

In the current regulatory climate where there is at least some genuine scepticism about the government's delivery on its promises of 'credit' for cooperation, a real dilemma can arise as to whether to self-report when a problem falls in the grey zone where it can be fixed internally, with some possibility of little or no significant public exposure. In these instances, identifying the problem and remediating the issue is precisely what good corporate compliance systems have been designed to do. If self-reporting is likely to elevate the prospect of both publicity and govern-

ment action for a matter that the organisation has effectively addressed and for which disclosure is not independently mandated, an argument can be made that not all problems and issues warrant self-reporting to, and involvement of, the government. This indeed would seem to be a reasonable decision in many cases. Obviously, the risk is that if the conduct or problem goes beyond what the review and remediation assumed, and/or becomes public anyway, the government, with the benefit of hindsight, will be sceptical of the decision not to self-report.

Fulsome cooperation with the government has potential benefits but carries real risks. Policy statements from the US Department of Justice and SEC advise that speed matters in reporting problems and in conducting internal investigations, and that cooperation from corporate entities enables the government to conduct complex investigations quickly and thoroughly.¹¹ Both commit that they will consider, among other things, self-reporting; thorough, timely internal investigations; cooperation; and remediation when they make charging decisions.¹² Recent data compiled by the US Sentencing Commission shows that, for fiscal year 2008, 34 per cent of the criminal prosecutions against organisations involved fraud charges and more than 96 per cent of organisations prosecuted and sentenced for criminal activity had fewer than 500 employees.¹³ Its data also demonstrates that, in recent years, the US Department of Justice has increasingly resolved criminal investigations against organisations with more than 500 employees with deferred prosecution and non-prosecution agreements. To the extent that such information may be gleaned from publicly available documents, the largest percentage of such agreements — 58 per cent — were in fraud cases. This data suggests that most large organisations facing the poten-

tial for federal criminal fraud charges decide to cooperate fully with the government in order to obtain a non-prosecution or deferred prosecution agreements, rather than fighting the charges.

Cooperation with the enforcement staff at the SEC may result in the exercise of prosecutorial discretion to reduce the charges (or penalties) to be brought.¹⁴ Unlike the criminal context, where clear standards provide guidance on the degree of mitigation that will be obtained from cooperation, the SEC has not clearly and consistently followed its announced guidance and entities have limited, if any, ability to assess reasonably whether cooperation will result in no charges, reduced charges, no penalty, or a reduced penalty, or what the impact of cooperation on charging decisions made by the Commission would be.¹⁵ (By definition, cooperation requires an organisation to settle with the government because the results of the internal inquiry that are shared with the government are effectively an 'admission' and form the basis for the government's charges against the organisation, which then has no ability to challenge any such charges.)

A few years ago, the government typically required an organisation seeking to cooperate to waive the attorney-client and work-product protections, which engendered a great deal of controversy. While the government largely has withdrawn from compelling an organisation to waive its attorney-client privilege as part of cooperation,¹⁶ it regularly seeks work-product protected materials generated in connection with internal investigations. Organisations have attempted to protect those materials through non-waiver agreements with the government.¹⁷ Notwithstanding any non-waiver agreement, civil litigants successfully have challenged such agreements and obtained work product generated during the

inquiry, which has included detailed factual findings of the investigation that were presented to the regulators.¹⁸ Any written report of the investigation's findings, which may be published in whole or summary fashion in the company's filings, constitutes admissions by the company and compromises the company's defences in civil class action litigation, which increases the settlement costs. As a result, cooperation and transparency typically increase the costs of litigating related civil actions.

At the same time, a company must assess the potential risks of non-cooperation. Should it refrain from sharing the results of an internal inquiry with the government, the government may increase the pace and scope of its inquiry, which increases defence costs and causes a lot of internal disruption. In the event the government is able to uncover sufficient information to make a case, it may bring substantially greater charges than it would have brought had the company cooperated, and seek a far greater penalty, including criminal charges. In that event, the costs, both to company finances and to its reputation, can be staggering.

Each circumstance requires an individual assessment of the risks and benefits of cooperation. Whatever decision is made about cooperation, the company should, as a matter of good governance, use the facts learned during the internal investigation to address any weaknesses in internal controls and processes, including gaps in the accounting and compliance organisations, in order to prevent the problems from recurring.

REMEDICATION

Once the fact-finding of the internal investigation is completed, the nature of the facts found will drive the scope of appropriate remediation. An internal

inquiry that has found problems of any significance should have identified the weaknesses that caused the problems or permitted the misconduct to go undetected, and should have flagged the need for improved controls. Appropriate remediation and an effective compliance programme are central to consideration of reduced charges by a civil regulator and by federal criminal authorities. The following considerations should inform development of a remedial plan:

- Has the fact-finding identified an error or inappropriate conduct (whether intentional, reckless, or negligent)? If so, have all the individuals involved been disciplined, including termination where appropriate?
- Has the inquiry identified an issue with the ‘tone at the top’? Has it called into question the personal commitment of the CEO and the senior management team to high ethical standards, fair dealing, and full compliance with legal requirements? Has the inquiry found that senior management was driven by pressures to achieve short-term results, which may have encouraged a laissez-faire attitude toward appropriate accounting and/or operation of controls? Has it shown an excessive appetite for risk by senior management, which encouraged a lack of due diligence for transactions? Should some members of the senior management team be replaced?
- Has the inquiry found that internal controls were not as effective as they should have been? What controls need to be strengthened, what training should be provided on the operation of these controls, and what testing should be performed to verify the integrity of the controls?
- Has the inquiry identified gaps in written policies and procedures or just lapses in adherence to policies? Should additional policies and procedures be prepared to address identified weaknesses?
- Has there been a focus on reduced overhead costs and/or a rapid expansion in the size of the business? Have the size and technical skills of the accounting function, compliance organisation, internal audit, and other control centres kept pace with the size and complexity of the organisation? Is there a need to attract additional, skilled employees in any of these areas?
- Is there a need to provide remedial and continuing training on company policies, ‘best practices’, accounting standards, and/or applicable laws and standards, to employees?
- Have management’s estimates been reasonable and were they based on consistent fact patterns? What process has management used to monitor changes in assumptions and what methods have been used to arrive at the estimates?
- What improvements are warranted to the existing process within the management team to review the organisation’s draft quarterly and annual filings? Do existing disclosures allow investors to understand the organisation through management’s eyes? Are the disclosures consistent with directors’ understanding about the financial condition and operations of the organisation? What additional information should be provided to offer clarity into management’s thought processes about assumptions and judgments to provide greater clarification?
- Should the problems, accounting errors, or misconduct have been flagged by the internal audit function and/or by the risk management and compliance function? Are the financial practices sufficiently complex that they present a heightened risk of error, negligence, or

inappropriate risk assessment? Is the current control environment adequate to spot ‘yellow flags’ and ‘red flags’ and address and mitigate those risks? Is there a need to revise the internal audit plan and/or compliance function to focus on business risks specific to the organisation and its supply chain? Is the internal audit function appropriately staffed and funded?

- Do the external auditors have the necessary industry skill sets for the organisation?

Where an internal investigation identifies inappropriate conduct or risk-taking, there is a likelihood that one or more elements of the risk management system and compliance programme failed. Companies today face wide-ranging risks, which change as the business environment changes. Understanding the numerous dimensions of those risks, which include operations, legal, reputational, liquidity, and compliance, and managing them, is critical to the viability of the entity, and a company’s senior management and its Board should agree upon the potential set of risks and the appropriate appetite for risk taking.

In the wake of the financial crisis, there has been an increased focus on risk management. In July 2009, the SEC proposed rules that would require public companies to disclose, in proxy statements, the Board’s role in the company’s risk management process, and some form of those rules is likely to be adopted.¹⁹ There is also pressure from Congress favouring rules that would require public companies to establish a standing risk committee of the Board of Directors. Many companies are now in the process of evaluating whether the Board has the appropriate structure and processes in place to oversee the major risks facing the company.²⁰ The remediation process provides senior management

and directors with the opportunity to assess whether the existing risk management and compliance function is staffed with a complement of trained personnel, who understand the business and its risks, and have the experience, judgment, and stature within the entity to evaluate specific potential material risks across the organisation and to prevent, as well as uncover, misconduct. There is no magic formula that prescribes which functions will be effective in identifying potential business risks and in preventing and flagging misconduct. Depending on the size of the entity and the complexity of its business, it may be useful to retain an outside consultant to evaluate the sufficiency of the existing risk management system and compliance programme, and their staffing. The following questions should be considered in any such assessment:

- **Tone at the Top:** Has the Board explained its commitment to ethics and zero tolerance for compliance failures to senior management, employees, and to shareholders? Do directors adequately understand the material risks facing the company and how those risks relate to the company’s business and strategy? Does the senior management team engage in frank and open discussions with the Board? Is senior management transparent with the Board, and Board committees, regarding financial information so that the Board can understand results of operations and deviations from the budget? Does senior management communicate potential problems to the Board in a timely manner? Does it appear that senior management tolerates questions about business practices and responds in an appropriate manner?
- **Standards for business conduct:** Is there a code of conduct, written in plain English that is readily understandable,

that includes clear consequences for violations? Is the code distributed to all employees and are employees required to certify, on an annual basis, their intent to comply with the code? Is mandatory training provided on the code?

- **Integrated Risk Management and Compliance:** Does this function understand the company's businesses across business units, products, and locations? Has it adequately and timely identified material risks across the entire company? Are processes in place so that information regarding these potential risks is distributed to decision-makers, including senior management in a timely fashion, and, where appropriate, the Board? Is this function sufficiently sophisticated to evaluate the accuracy of accounting for, or the propriety of, practices and transactions and to test the adequacy of existing controls? Can it competently assess complex issues, such as allegations of financial fraud, potential foreign corrupt practices violations, and adequacy of capital reserves? Is the chief compliance officer a member of the senior management team? Does that officer participate in senior management operational meetings and quarter and year-end close processes?
- **Benchmarking:** Is the budget for the risk management system and compliance programme commensurate with the portfolio of responsibilities? Do employees in this function have the appropriate skill sets necessary to assess the inherent risks of business practices and transactions, and to evaluate the accuracy of accounting for, or the propriety of, practices and transactions?
- **Education and Communications:** Are the risk management system and compliance programme well known throughout the organisation? Is the internal hotline publicised? Does the

compliance officer have exposure to employees at all levels of the organisation? Can employees raise concerns about business risks and/or practices without causing problems or fearing retaliation?

- **Reporting and Resolution:** Are complaints thoroughly investigated in a timely manner? Do employees understand that standards are enforced and real consequences attach for violations of laws, regulations, and the company's code of conduct?
- **Governance Oversight:** Does the Board have the appropriate structure and processes in place for overseeing and monitoring the major risks facing the company? When was the effectiveness of this structure and processes last evaluated? What reporting relationship exists between the Board's audit committee, or another committee of independent directors, and the risk management and compliance function? Are regular compliance and risk management reports provided to the appropriate Board committee? Does the Board spend sufficient time each quarter in addressing business strategy, risks and compliance?

The remediation evaluation also provides the Board of Directors with the opportunity to review the processes by which it governs itself. The recent financial crisis that the markets have undergone has caused a new focus on corporate governance by shareholders, regulators, politicians, and reporters. Although the standard for director liability in Delaware, and in many other jurisdictions, accords substantial deference to directors' actions, courts may begin to consider second-guessing Board decisions where shareholders have sustained significant losses. Auditing the effectiveness of the existing corporate governance structure and processes, including

a hard look at Board composition, assessment of current directors' skills and contributions, identification and selection of new directors, length of Board service, Board leadership, Board oversight in monitoring performance, compliance, and risk management and in evaluating executive compensation practices and policies, is a worthwhile first step. That review may identify areas that can be improved, and may lead to the adoption of practical measures that will promote long-term shareholder value.

CONCLUSION

Corporate crises are obviously events to be avoided. Where unavoidable, good governance can make the difference between a disaster and a difficult problem that is well-managed. Planning, diligent inquiry, accuracy in responses, remediation, and improvements to risk management, compliance, and governance processes can mitigate the damage that might otherwise result. Internal controls and governance can be improved, a recurrence can be prevented, and a variety of constituencies and stakeholders, including the market, the shareholders, the media, and the regulators, are likely to conclude that the enterprise passes the test of good corporate citizenship. Most importantly, the organisation will be stronger for having weathered the storm.

REFERENCES

- (1) Sarbanes-Oxley enhanced the obstruction of justice provision in the criminal code by adding a section that provides for the imposition of fines and/or a prison sentence up to 20 years for altering, destroying or falsifying documents to 'impede, obstruct, or influence' an investigation by any US department or agency. Sarbanes-Oxley Act § 802, 18 U.S.C. § 1519 (2002).
- (2) In *Zubalake v. UBS Warburg LLC*, 220 F.R.D. 212, 217(S.D.N.Y. 2003), the district court found that a company was not obligated to preserve every back-up tape upon the threat of litigation. Committee notes to Federal Rule of Civil Procedure 37(f) suggest that where backup tapes may contain information that is not otherwise available from reasonably accessible sources, the company may have an affirmative duty to preserve the tapes. Federal Rule of Civil Procedure 37(f) advisory committee's note. In many circumstances, regulators maintain that a company's obligation to retain backup tapes in connection with a regulatory investigation is broader than in civil litigation. As a prudential matter, it is wise to reach agreement with the government at the outset about what should be maintained. Where a company does not wish to engage regulators on this issue at the outset, it should consider implementation of the preservation measures outlined by the court in *Zubulake*, 20 F.R.D. at 218.
- (3) In a break from its long-established practice, the SEC has delegated to the Enforcement Division Director the authority to issue formal orders of investigation and to issue subpoenas. According to Robert Khuzami, the Director of the SEC Enforcement Division, delegation was approved to: 'streamline[] the [SEC's] internal process to make the staff "more nimble and quick"'. Mr Khuzami explained that 'if defence counsel resist the voluntary production of documents or witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely be a subpoena on your desk in the morning'. Robert Khuzami, Director, Division of Enforcement, SEC, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, (5th August, 2009), <http://www.sec.gov/news/speech/2009/spch080509rk.htm>.

- (4) An internal investigation serves a number of additional purposes. For example, where errors in the financial statements have been identified, an investigation can assess the reasons offered for the errors and evaluate whether employees acted in good faith. An internal inquiry can assist the company in determining whether it or any of its employees could have exposure in a regulatory or criminal proceeding or in private litigation. Certain claims or questions may trigger a company's duty to investigate. For example, *In re Joseph W. Pellechia*, Exchange Act Release No. 41,035 (10th February, 1999); New York Stock Exchange Rules 342.21, 351(e) (requiring members and member organisations to review certain trades for compliance with stock exchange rules and to conduct prompt internal investigations of trades that potentially violate the rules).
- (5) See Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (23rd October, 2001) ('Seaboard Report'), <http://sec.gov/litigation/investreport/34-44969.htm>.
- (6) As a general proposition, the decision whether a company should proceed with any given litigation matter is a business decision for its Board. See, eg, *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982) (decision to bring lawsuit normally corporate business decision for board) (citing *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917) (same)), cert. denied, 460 US 1051 (1983); *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990) (decision to litigate is management decision made by board, not shareholders) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) (same)). Depending on the nature of the allegations in the derivative complaint and/or the identity of the potential defendants, a board may be disabled from deciding whether to proceed with the litigation. In those instances, the Board can constitute a special litigation committee and delegate to it the full authority to act for the Board with respect to the putative derivative claims, and it is well settled that 'an independent committee possesses the corporate power to seek the termination of a derivative suit'. *Maldonado*, 430 A.2d at 785; see also *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1499 (D. Md. 1985) (interested board has power to appoint special committee of independent directors to review the derivative action). Where a properly constituted, independent Board committee decides, after conducting a thorough and fair investigation, not to proceed with the litigation, there is a strong likelihood that its decision will be upheld. For example, *Kaplan v. Wyatt*, 499 A.2d 1184, 1191-92 (Del. 1985); *St Clair Shores Gen. Empl. Ret. Sys. v. Eibeler*, No. 06-688, 2008 WL 2941174, at *7 (S.D.N.Y. 30th July, 2008). C.f. *In Re: Converse Tech. Inc. Derivative Litig.*, 56 A.D.3d 49 (N.Y. App. Div. 2008) (reinstating shareholder derivative claim, notwithstanding creation of special independent Board committee, where independence of committee members was called into question by allegations in the complaint).
- (7) See Seaboard Report, ref. 5 above.
- (8) Stephen M. Cutler, Director, Div. of Enforcement, SEC, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, Speech at UCLA School of Law (20th September, 2004), <http://www.sec.gov/news/speech/spch092004smc.htm>.
- (9) Sharing the results of the fact-finding does not require preparation and production of a written report and witness interview memoranda. Alternative approaches, including oral presentations and production of non-privileged documents, should be explored with the regulator where the company seeks to maintain privilege.
- (10) The current Director of the Division of

Enforcement, Robert Khuzami, has made that point emphatically: ‘While I believe in giving credit for cooperation that results in tangible benefits for investors and the Enforcement program, I don’t believe in being lenient for the sake of leniency, or for rewarding persons for simply complying with routine or expected requests. For that reason, the purpose of these tools is primarily to reward extraordinary cooperation.’ Khuzami speech, ref. 3 above.

- (11) See ref. 5 above.
- (12) See US Sentencing Guidelines Manual § 8C2.5(f),(g); SEC Enforcement Manual § 4.3, <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.
- (13) Presentation of Beryl Howell, Commissioner, US Sentencing Commission, 12th June, 2009, New Orleans, Louisiana.
- (14) Seaboard Report, ref. 5 above.
- (15) Compare, *In the Matter of Krispy Kreme Doughnuts, Inc.*, Exchange Act Release No. 34-59499 2009 WL 536623, at *1-*2, *6-*7 (4th March, 2009). (Commission accepted Krispy Kreme’s offer to settle with a cease and desist order and sought no monetary penalty when Krispy Kreme ‘fraudulently inflated or otherwise misrepresented its earnings’ for the fourth quarter of 2003, each of the quarters in 2004, and its full year results for 2004 because of significant cooperation and remediation and changes to corporate governance); *In the Matter of Cummins, Inc.*, Exchange Act Release No. 34-53236, 2006 WL 29691, at *4-*5 (7th February, 2006) (Commission accepted Cummins’ offer to settle with a cease and desist order and sought no monetary penalty involving US\$15m in accounting errors where the company self-reported, investigated, restated, and took numerous remedial steps); *SEC v. Koninklijke Ahold N.V. (Royal Ahold)*, Litigation Release No. 18929, 2004 WL 2297417, at *4 (13th October, 2004) (SEC settled matter for an injunction against future

fraudulent conduct and no monetary penalty where company overstated net sales by almost US\$25bn from 1999–2001 and senior Ahold executives were involved, because the entities self-reported, conducted an exhaustive internal inquiry, cooperated with regulators, and remediated the deficiencies) with *SEC v. Doral Financial Corp.*, Litigation Release No. 19837 (19th September, 2006) Press Release, SEC, Doral Financial Settles Financial Fraud Charges with SEC and Agrees to Pay US\$25m Penalty (2006–155, 19th September, 2006) (SEC settled matter for a US\$25m penalty and an injunction against further fraudulent conduct, involving overstatement of US\$921m in revenue over five years through which the company reported an apparent 28-quarter streak of ‘record earnings, where the company self-reported, conducted an independent internal inquiry, provided significant cooperation’ to the staff, and undertook significant remedial measures); *SEC v. Tyco Int’l Ltd.*, 06-2942 (S.D.N.Y. filed 17th April, 2006) Litigation Release No. 19657 (17th April, 2006) (SEC settled matter for an injunction against further fraud injunction and a US\$50m penalty, involving numerous accounting irregularities between 1996–2002 that overstated operating income by at least US\$1bn and senior management was involved, without mentioning internal inquiry, cooperation and remediation.); *SEC v. Nortel Networks Corp.*, No. 07-8851 (S.D.N.Y. filed 15th October, 2007), Litigation Release No. 20333 (SEC settled matter for an injunction against further fraudulent conduct and a penalty of US\$35m, involving revenue inflation of approximately US\$1.4bn in 2000 and improper reserve activity and senior management was involved, where Nortel self-reported, conducted an independent inquiry, and provided ‘substantial remediation and cooperation’.); *SEC v. HealthSouth Corp.*, No. 03-615 (N.D. Ala., 19th June, 2005),

- Litigation Release No. 19280 (23rd June, 2005) (SEC settled matter for an injunction against further fraudulent conduct and a penalty of US\$100m, where earnings were inflated by at least US\$1.4bn to meet analysts' expectations, notwithstanding an independent inquiry, cooperation, and remediation).
- (16) See United States Sentencing Comm'n Guidelines Manual Supplement to Appendix C — Amendments to the Guidelines Manual No. 695 at 183 (1st November, 2006), http://www.usc.gov/2009guid/APPC_supplement.pdf (Sentencing Commission report that it struck language that could suggest that US would require privilege waivers as a prerequisite to a reduction in culpability scores).
- (17) See Implementation of Standards of Professional Conduct for Attorneys, SEC Release Nos. 33-8185, 34-47276 (5th August, 2003). In litigation, the SEC has taken the position, as *amicus curiae*, that voluntary production of privileged materials to it as part of an internal investigation does not necessarily waive the privilege as to third parties. Brief of the SEC as *amicus curiae* supporting McKesson Corp. and Supporting Reversal, at n.4, *United States v. Bergonzi*, 403 F.3d 1048 (filed 9th Cir. 2005) (No. 03-10611).
- (18) Prior to the adoption of Rule of Federal Evidence 502(c), the law on waiver where voluntary disclosure of privileged materials had been made to a federal regulator was in a state of 'hopeless confusion'. See *In re Columbia/HCA Healthcare Corp.*, Billing Practices Litig., 293 F.3d 289, 294-95 (6th Cir. 2002). See also *In re Qwest Commc'ns Int'l Inc.*, SEC Litig., 450 F.3d 1179, 1192-1201 (10th Cir. 2006) and cases cited therein (finding waiver of privilege occurred from voluntary production of materials to SEC). In September 2008, President Bush signed into law amendments to the Federal Rules of Evidence, which included a new rule of evidence, Federal Rule of Evidence 502. Federal Rule of Evidence 502(c) provides that where privileged materials have been voluntarily disclosed to a federal office or agency, such production causes a waiver only of the communication or information disclosed and does not affect a subject matter waiver of either privilege or work product unless 'fairness requires' it. Federal Rule of Evidence 502(c), as enacted, does not address whether voluntary production of otherwise privileged materials to the government, under a 'non-waiver' agreement, constitutes a 'selective' waiver extending only to the government and no further.
- (19) See Proxy Disclosure and Solicitation Enhancements, Release Nos. 33-9052, 34-60280, IC-28817 (10th July, 2009), <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.
- (20) See, eg, the Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. sponsored by Senators Charles Schumer and Maria Cantwell.