

When Boards Seek Outside Counsel

by Craig C. Martin and Devlin Su

In today's legal environment, the scrutiny of corporate management and boards continues to grow more focused, more intense, and pose more challenges. Management and boards also face challenges to how they address issues of risk and liability. In these situations, boards need to assess whether to retain independent outside legal counsel.

The most common scenarios for retaining independent outside counsel include audit committee investigations, shareholder derivative lawsuits, and risk committee investigations and analyses. Beyond the expertise that outside counsel bring to bear on such legal matters, their independence and judgment is perhaps the most valuable service they provide.

An independent outside counsel can help resolve some of the most serious audit committee investigations.

Internal investigations of corporate behavior have become increasingly common among U.S. companies, large and small. Legislative and regulatory forces like the 2010 Dodd-Frank Act increased the incentives for the plaintiffs' securities bar, often with the assistance of whistleblowers, to bring cases against financial services companies and other large corporations. In addition, in the wake of the 2008 financial crisis, the Department of Justice, the Securities and Exchange Commission, and other regulators have escalated their enforcement efforts, particularly under the Foreign Corrupt Practices Act (FCPA).

These efforts seek to punish fraud, accounting irregularities, and other types of misconduct, and raise the stakes significantly for board members. The best defense to these serious allegations starts with a full understanding of the facts through a thorough investigation.

Often, these investigations begin once manage-

ment raises serious allegations to the board level. Given the general responsibility of a board's audit committee to oversee internal controls and reporting, the board frequently taps the audit committee to oversee the investigation.

Unlike a general internal audit, this type of investigation targets specific events or allegations. Depending on the specific committee charter, though, the allegations do not always have to be of a purely accounting or financial nature.

Specific examples of audit committee investigations may include:

- Illegal payments to gain business, especially in foreign countries.
- Senior management theft, fraud, or harassment.
- Improper accounting for business activities, backdated stock options, or falsified accounts.
- Conflicts of interest among fellow directors.
- Leaks of confidential information to competitors.

These examples often share common characteristics, such as:

- Financial reporting irregularities.
- Potential for major financial damage.
- Allegations of misconduct by senior management or directors.
- Potential for corporate reputational damage.
- Regulatory or law enforcement involvement.

Once problems rise to this level of seriousness, an audit committee's first step is deciding whether to engage outside investigatory experts, including outside legal counsel. At first, working with in-house counsel may seem more attractive than retaining outside counsel. In-house counsel have a working understanding of the corporation's structure; its policies, procedures, and record-keeping practices; and some of the personalities and politics involved in the underlying claims. In-house counsel will also

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likely be less expensive than outside counsel, who may require some start-up time to ramp up their resources and do preliminary work.

More damaging than any real lack of independence for your investigation is the perception of a lack of independence.

On the other hand, using in-house counsel to investigate serious wrongdoing can have serious disadvantages. Chief among them is the potential lack of independence from company management. Given that the allegations may implicate senior management (often, their immediate supervisors), in-house counsel may face practical constraints on the objective analysis they can provide.

More damaging than any real lack of independence is the *perception* of a lack of independence. Criticism now travels faster and reaches more people than ever before. The mere perception by a regulator, shareholder, or even the public that an internal investigation suffered due to a conflict of interest with the investigator can cause them to question the investigation's findings. Such reputational damage may have serious effects not just on a company's public brand, but also on a regulator's assessment of its problems.

Thus, the choice of an independent outside counsel lends the investigation instant credibility, which is most tangibly helpful when a regulatory or law-enforcement authority is involved. Over the past few years, and certainly since the financial crisis, that prospect has become increasingly likely. The number of SEC enforcement actions has trended up since the financial crisis, and the average price to settle an FCPA enforcement action spiked dramatically in 2013 (*see chart on page 13*).

These trends depict an involved (and expensive) government presence. As a result, boards should understand how to limit their potential exposure. Often, the best way is to conduct a robust internal investigation.

The SEC's 2001 Seaboard Report set 13 criteria that it will consider in determining whether, and how

much, to credit self-policing, self-reporting, and cooperation by a company during an SEC enforcement action. Criteria include the company's response to learning of the misconduct, including whether the company promptly and completely disclosed the violation to investigators and the authorities; and the quality of the information provided to the SEC, including whether the company prepared a thorough report about its findings.

Retaining independent outside counsel can signal to regulators and the public that the board investigation will be thorough, complete, and objective.

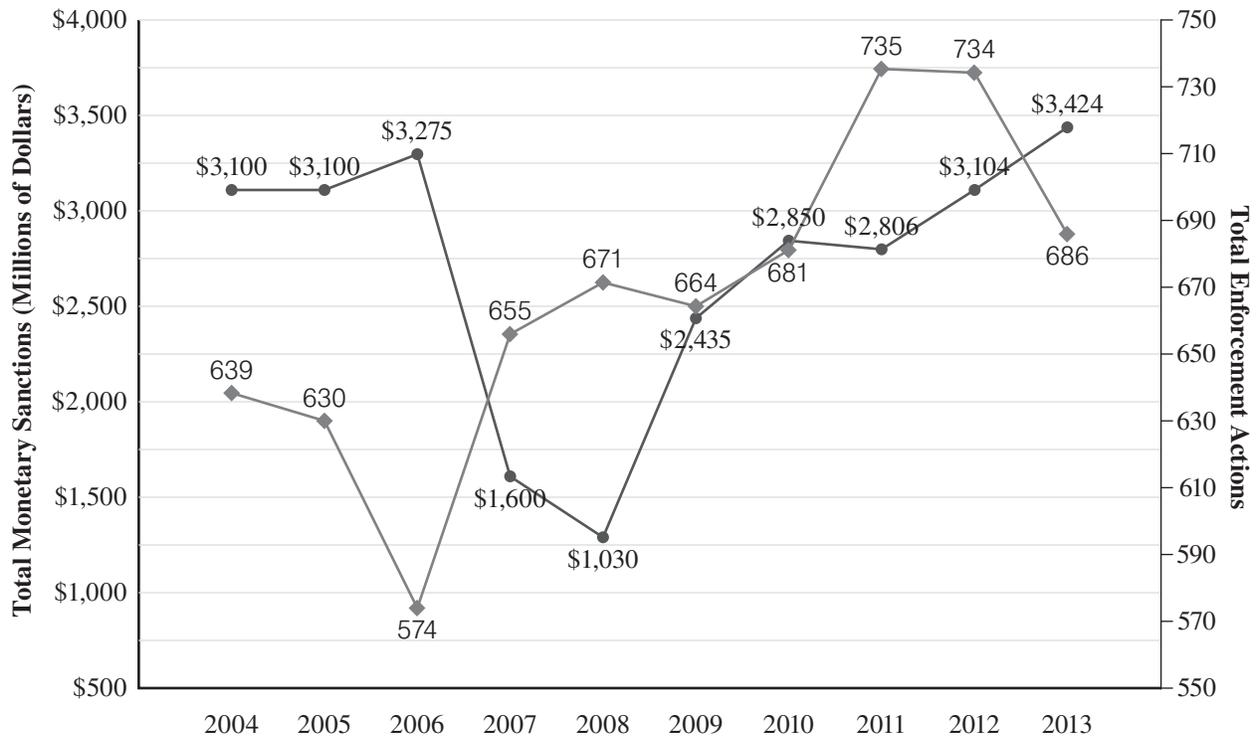
Further, the SEC has stated that it would specifically account for whether independent advisors like outside legal counsel conducted the investigation, and whether the company placed any scope limitations on the investigation. As an example of this policy statement in action, the SEC in 2010 did not levy a monetary penalty against a heavy-vehicles manufacturer despite significant financial fraud and false accounting practices. In its administrative proceeding opinion, the SEC explained this decision by pointing to the company's decision to conduct an independent outside investigation and its remedial steps.

The policies laid out on the SEC's Seaboard Report also match some of the practices of the DOJ. For example, the DOJ's internal guidelines for the prosecution of corporations highlight certain mitigating factors that may support a no-charge decision, including full cooperation with the government and its investigation, complete and voluntary disclosure of violations, and effective remediation of violations.

Retaining independent outside counsel can thus signal to regulators and the public that the audit committee investigation will be thorough, complete, and objective. While retaining outside counsel may appear more expensive than working with in-house counsel, outside counsel can recoup those expenses by delivering a favorable outcome down the road.

Retaining independent outside counsel is just as essential when facing a shareholder derivative

SEC Enforcement Actions The Risks Are Increasing



Source: www.sec.gov

suit. In a shareholder suit, a plaintiff sues on behalf of the corporation over some perceived wrong—self-dealing, waste of corporate assets, regulatory sanctions, accounting restatements, misconduct by officers or employees, massive business losses, and many, many other potential injuries.

In order to sue derivatively on behalf of a corporation, a shareholder plaintiff must overcome a number of legal hurdles. One is to demand formally that the corporation’s directors act to address the alleged injury, or demonstrate that making that demand would be futile. Thus, shareholder derivative suits will frequently rise to the board level, bypassing management altogether.

From the plaintiff’s perspective, there are a few drawbacks to making a formal demand on the board. The chief drawback is that courts will presume that a board that rejects the demanded action acted in good faith and in the best interests of the company

and its shareholders. This is a tough presumption to overcome, so most plaintiffs instead choose to demonstrate that making the demand on the directors was futile.

However, the corporation can still retain control of the litigation by appointing a special litigation committee (SLC) of independent and disinterested directors to investigate the complaint’s allegations. The ultimate job of an SLC is to determine whether litigation is in the corporation’s best interest after considering factors like the merits of the shareholder allegations, the size and likelihood of a recovery of damages, and any remedial steps already taken by the corporation.

If an SLC’s objective, thorough investigation concludes that dismissal of the lawsuit is in the best interests of the corporation, the committee may move, in the corporation’s name, to dismiss the derivative suit. If the motion is granted, then the SLC investi-

gation will have saved the corporation considerable time, effort, and expense.

An SLC investigation, however, will only defeat a derivative suit if a judge dismisses the case. In deciding whether to dismiss, the judge reviews the findings of the committee investigation, taking great care to determine if it remained independent and disinterested throughout.

A key factor in this decision is the SLC's choice of legal counsel. Indeed, the likelihood of a court's dismissing the suit can depend considerably on the choice of truly independent legal counsel. For example, SLCs that hire outside counsel who have previously represented the company on the very subject matter of the shareholder's demand frequently lose their motion to dismiss the derivative suit.

Often, the company's regular outside corporate counsel is unsuitable to represent the special litigation committee.

Courts also vary across the country about whether outside counsel to the SLC who have represented the company in the past (even on matters wholly unrelated to the derivative suit) are truly independent. Some courts flatly reject the independence if outside counsel had a prior working relationship with the company. Others inquire into the role that outside counsel played in the company's past, or examine whether business from that company comprises a significant percentage of outside counsel's revenues. Still others may scrutinize the most trivial connections (including personal ties) between a committee's chosen counsel and management, directors, or the plaintiff's attorney. If a court questions the impartiality of any of these relationships, the SLC often loses its motion to dismiss and its investigatory work will have been for naught.

This practical legal requirement of independence often means that the company's regular outside corporate counsel is unsuitable to represent the SLC. The same often goes with in-house counsel. Thus, before embarking on their investigations, SLCs should interview potential outside counsel carefully about

any conflicts. This requirement of independence may make the counsel-selection process exacting at times, but the potential reward—defeating a shareholder derivative suit at an early stage—can be worth the effort.

One of the most important responsibilities of a board is to understand and manage the risks inherent in the company's business strategy at the entire enterprise level. To that end, a board may allocate specific risk oversight responsibilities to several pre-existing committees. Most commonly, that means a board's audit committee pulls double duty, which is often sensible in light of the committee's role in managing financial reporting risk. In fact, for companies listed on the New York Stock Exchange, one of the audit committee's chartered responsibilities is to discuss with management the company's policies about risk assessment and risk management.

Some boards, however, have begun to separate risk-management responsibilities from the audit committee to house them in an independent risk committee. Many of these companies operate in the financial services sector and are governed by the Dodd-Frank Act. This requires a separate risk committee (made up of independent directors) for large public banks and for public nonbank financial companies supervised by the Federal Reserve. Other non-financials, especially those that face complex market, credit, liquidity, or commodity pricing risks, have followed suit. This governance structure allows their audit committees to focus on their core financial-reporting responsibilities, while encouraging and focusing director attention on those complex risks.

Outside counsel should work with the board, rather than management, to implement its risk analysis.

No matter the specific governance structure, independent outside counsel can provide a board with a fresh and objective risk analysis. Although outside counsel will tailor their analysis to the specific needs of the board, a typical risk-analysis engagement may include:

- Ensuring that management has installed a comprehensive risk-management system with no material gaps.
- Assessing the functionality of that system in practice.
- Evaluating the chief risk officer's role and responsibilities.
- Reviewing management's determination of key on and off-balance sheet risks.
- Monitoring the risk-taking behavior of management and recommending appropriate actions.
- Advising the board on insurance policies and practices as a possible risk-transfer strategy.

Most of these tasks necessarily involve a top-down review and evaluation of management procedures and decision-making. Outside counsel thus should work with the board, rather than management, to implement this risk analysis.

Independent outside counsel can also help a board manage its overall compliance risk, or the risk of failing to comply with external laws, internal policies, and voluntary commitments. Reducing compliance risk is likely of particular interest to a board given the increased willingness of courts to hold, or at least consider holding, individual directors personally liable for insufficient oversight of the company's compliance efforts.

To help manage compliance risk, outside counsel can advise boards how to adopt the appropriate information and reporting systems to ensure compliance with relevant obligations. This type of objective advice, provided from a neutral advisor outside the company, can help avoid potential director liability.

No matter the type of investigation, the following considerations may help a full board, or a board committee, manage the relationship with outside counsel.

Decide early to retain separate counsel. In general, retaining outside counsel at the outset of an important legal matter sends positive signals to co-defendants or opponents. On the other hand, when a board is initially represented by in-house counsel, but decides partway through the case to retain outside counsel, others cannot help but suspect that something has gone awry. Such reputational damage can be hard to overcome, especially in the court of

public opinion. For that reason, consider resolving any uncertainty in favor of outside counsel early on.

Assess D&O liability insurance coverage. Even though retaining outside counsel has benefits in their independence and objectivity, those benefits come with a cost. Consider whether the board's directors and officers (D&O) liability insurance policy will cover those legal fees.

Typically, D&O policies extend not only to the directors and officers, but also to the corporate entity in derivative actions. D&O policies have also been providing broader coverage for government investigations. Of course, policy language may vary. Either way, experienced outside counsel can help minimize expenses by focusing their efforts on the critical inflection points in an investigation or lawsuit.

Continually communicate the scope and progress of the engagement. Finally, before engaging outside counsel, carefully consider the scope of the engagement and communicate the objectives to counsel as early as possible. For example, if the full board or audit committee sets parameters for an internal investigation early on, the less likely the investigation is likely to spin out of control, and the more likely that outside counsel will tailor the investigation to meet budgetary and time constraints.

All of this may require actively supervising the relationship with outside counsel, including keeping in constant contact to understand the progress of the investigation or litigation. A collaborative effort is especially important in investigations or risk analyses, which often lack clearly predictable endpoints once the engagement starts (especially when they involve government regulators). Staying in constant contact can help ensure that the board and outside counsel understand when to move on to the next phase of the investigation or analysis (typically, remediation or implementation).

When resolving a shareholder derivative suit, the special litigation committee—not counsel—must be driving the investigation in order for courts to give it full effect. This requires constant contact with outside counsel, in order to balance a robust investigation with efforts to maintain secrecy from plaintiffs' counsel in the underlying lawsuit. ■