

Lead Director Network ViewPoints

Issue 8 August 10, 2010



Board leadership during investigations

Introduction

The seventh meeting of the Lead Director Network (LDN) was held in New York City on July 14, 2010. Members discussed board leadership during special investigations.¹

ViewPoints reflects the network's use of a modified version of the Chatham House Rule, whereby names of members and their company affiliations are a matter of public record, but comments made before, during, and after meetings are not attributed to individuals or their companies. Members' comments are shown in italics. For further information about *ViewPoints*, see "About this document," on page 15.

The lead directors who participated in the meeting included:

- Dan Feehan – Presiding Director at RadioShack
- Ray Gilmartin – Lead Director at Microsoft and Presiding Director at General Mills
- Bonnie Hill – Lead Director at The Home Depot
- Karen Horn – Lead Director at Eli Lilly
- Phil Humann – Presiding Director at Coca-Cola Enterprises and Equifax and Non-executive Chairman at Haverty Furniture Companies
- Linda Fayne Levinson – Lead Director at NCR Corporation
- Jack O'Brien – Lead Director at TJX and Non-executive Chairman at Cabot
- Jim Robinson – Presiding Director at The Coca-Cola Company
- Wes von Schack – Lead Director at Bank of New York Mellon

The following members, who were not able to attend the meeting, participated in both pre-meeting and post-meeting discussions. Their perspectives are also reflected in this document:

- Frank Blount – Presiding Director at Caterpillar and Lead Director at KBR
- Roy Bostock – Non-executive Chairman at Yahoo!
- Dan Carp – Non-executive Chairman at Delta Air Lines
- Dick Goldstein – Presiding Director at Interpublic Group
- Bob Kidder – Chairman at Chrysler and Lead Director at Morgan Stanley
- Bob Lawless – Lead Director at Constellation Energy

¹ The LDN brings together a select group of lead directors, presiding directors, and non-executive chairmen from Fortune 500 companies for private, candid discussions about ways to improve board governance. For the purposes of this network, the term *lead director* is used to refer to all three titles – lead director, presiding director, and non-executive chairman – except where otherwise stated.

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King & Spalding partners participating in the meeting included:²

- J. Kelley, Partner, Corporate Practice Group
- Michael Smith, Partner, Business Litigation Practice Group
- Chris Wray, Partner, Chair Special Matters and Government Investigations Group

Executive summary

At any publicly held company, incidents and issues may emerge that require investigation. While many may be trivial or unsubstantiated, others can be real, financially material, and potentially damaging to the business and reputation of the company. Members shared specific examples and key lessons learned from their own experiences with matters that required thorough investigation and board involvement.

- **Trigger events** (*Page 3*)

Members agreed that there were two broad categories of trigger events: whistleblower or employee allegations and external allegations. Both types of allegations have their own risks and nuances. In some situations, the company preemptively launches an investigation. In other cases, a regulatory agency, enforcement agency, or congressional committee initiates an investigation, which then triggers an internal investigation by the company. Regardless of the specifics of the trigger event, if the allegation is “*serious and material to the company,*” members emphasized that the board should be made aware of the allegation immediately.

- **Organizing the investigation** (*Page 5*)

One member stated that organizing an investigation is more “*art than science.*” Once the investigation begins, the board and management determine whether management, the full board, or a subset of the board is responsible for leading the investigation. The board and management should consider the person(s) implicated in the allegation when determining who should lead the investigation. They should also weigh the importance of the perceived objectivity of the investigation. Board-led investigations are often chosen because of their independence – a key factor in establishing credibility during an investigation. Ultimately, the board will stay actively involved in any major investigation, regardless of who takes the lead.

- **The lead director’s responsibilities** (*Page 7*)

The lead director’s primary responsibility in a major investigation is helping maintain good communication among the key stakeholders, including the top management team, the board, the external auditor, shareholders, the public, outside legal counsel, outside experts and any regulatory or enforcement agency. Members agreed that good communication is an essential element of a smooth investigation process. In addition, members reflected on the fact that a lead director may have a role in

² Chris Wray is the former assistant attorney general in charge of the Criminal Division at the US Department of Justice (DOJ) and specializes in government and internal investigations. Michael Smith specializes in securities and shareholder litigation, including securities fraud class action litigation, shareholder derivative actions, audit committee investigations, and SEC enforcement actions. Mr. Wray and Mr. Smith have given permission for a selected portion of their comments to be attributed; these remarks are not italicized.

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helping the board carefully consider the need for outside legal counsel and other experts. Members summarized seven specific responsibilities that lead directors may take on during an investigation. They may: (1) work directly with and manage outside counsel or other experts throughout the investigation; (2) keep the board informed and engaged; (3) work with management; (4) oversee disclosure to the external auditor, shareholders, and the public; (5) interact with regulators; (6) bring an investigation to its conclusion; (7) oversee remediation efforts.

■ **Preventing a problem** (Page 14)

In the wake of a major investigation, boards may choose to reexamine the company's compliance and ethics program. LDN members articulated specific compliance and ethics-related steps and processes that their boards and management teams have implemented to anticipate or prevent future violations and positively affect corporate culture. Overall, members emphasized that the *"tone at the top"* underpins all compliance efforts. However, members cautioned that a comprehensive compliance and ethics program and a positive tone at the top cannot absolutely prevent employee misconduct or shareholder lawsuits from occurring.

Trigger events

Members generally agreed on two broad categories of issues that require the board to get involved in – or to initiate – an investigation:

- Whistleblower or employee allegations
- External allegations

The board's level of involvement under each circumstance varies depending on the specifics of the allegation. However, members emphasized that all serious allegations, either external or internal, should be brought to the board immediately. One member stated, *"The general rule is, err on the side of caution and bring everything to the board."* Another member concurred: *"Anything that is in writing automatically comes to the board. On the boards that I've been on, we see virtually everything that's brought forward to management as a broad complaint."*

Whistleblower or employee allegations

Members agreed that allegations by a company's employees can require the board to initiate an investigation. The Sarbanes-Oxley Act of 2002 requires audit committees of all publicly traded companies to oversee an anonymous whistleblowing channel that employees can use to report instances of internal financial fraud. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act has increased incentives for and protection of certain types of whistleblowers. As part of the legislation, "U.S. enforcement authorities will now pay potentially hefty awards to corporate whistleblowers who voluntarily provide original information that leads to an SEC enforcement action recovering monetary sanctions in excess of \$1 million ... For whistleblowers, this law provides extraordinarily lucrative incentives to report

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perceived misconduct.”³ Typically, any allegation concerning accounting and financial matters that comes through the whistleblower hotline is handled by the audit committee. One member said, *“All whistleblower complaints are reviewed by the audit committee and the full board.”*

Employee allegations that are non-financial in nature, such as reports of malfeasance or misconduct, are typically handled by other board committees. When the Audit Committee Leadership Network met to discuss special investigations, audit committee chairs said they thought increasingly that lead directors should be dealing with non-financial investigations, with one audit chair saying, “The lead director is typically the first choice [to lead an investigation] unless it’s a financial issue.”⁴ One member described a situation in which the formation of a special committee is warranted: *“We had an issue around our company’s relationships with its vendors ... We formed a special committee to address the issue because it did not fall naturally to the audit committee or any other board committee.”*

External allegations

A significant portion of members’ discussions focused on investigations involving regulatory or law enforcement bodies such as the Securities and Exchange Commission (SEC) or the Department of Justice (DOJ). In these investigations, the regulatory or enforcement entity initiates an investigation of an allegation that, if confirmed, constitutes a violation of the law that is subject to penalty or prosecution. In addition to the SEC or DOJ, an agency (such as the Food and Drug Administration) or congressional subcommittee may also initiate proceedings against a company when it believes there has been a violation of law.

Depending on the nature of the allegation, management or the board may launch an investigation to determine the appropriate response. In some cases, the company may launch an investigation preemptively to ensure that the company is adequately prepared for a regulatory or enforcement inquiry or to assess whether the company ought to self-report an issue to the authorities. One member said, *“We knew about the violation and were investigating it when the authorities got involved.”*

In other cases, it is the enforcement agency’s opening of an investigation that triggers an internal company investigation. One member said, *“The Department of Justice was investigating one of our products, looking at emails and different documents. We [the company] read some of those documents [which implicated another product]. The company then became concerned that we had a worse problem. That’s when the company launched an investigation [into the second product].”*

An outside stakeholder such as a customer, supplier, member of the media, or shareholder can report an allegation, which may then trigger an investigation. One member said, *“We received a demand letter [from a shareholder] alleging that management gave the compensation committee bad information ... We set up a special committee with directors from the compensation committee to investigate. Ultimately we found that there had been no wrongdoing on the company’s part.”*

³ King & Spalding, “Financial Reform Law Establishes Financial Incentives for FCPA Whistleblowers,” Client Alert, July 21, 2010.

⁴ Audit Committee Leadership Network, “The audit committee’s role in overseeing investigations,” *ViewPoints*, March 23, 2010, 4.

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Organizing the investigation

Once an allegation is made, the board and management team begin a process of determining who will be responsible for leading the investigation. One member said, *“It is usually the general counsel who brings an issue to the board, but I have seen cases where the CEO brought it to the board.”* The general counsel or CEO must then determine whether the allegation merits board consideration. One member stated, *“If there were elements of wrongdoing that didn’t necessitate any regulatory involvement, the CEO would handle it in the executive session with the board – as merely an update for the board. But the CEO wouldn’t necessarily suggest the board get engaged unless there was a question of serious misconduct.”*

If the general counsel or CEO determines that the allegation is sufficiently important to be brought to the board, the first step is often to report the issue to the lead director. Any notification of a potential investigation by a regulatory agency would immediately be brought to the lead director. As one member said, *“If we receive a Wells notice⁵ from the SEC or a notice that the DOJ is looking into our practices, the lead director would know the same day.”* The lead director will then present the issue to the full board. Once the full board and key members of management are aware of the allegation, the management team, the full board, or a subset of the board assumes responsibility for the investigation.

Management-led investigation

In some cases, senior executives assemble a management team to lead the investigation. Oftentimes, particularly if the investigation has a potentially significant financial impact on the business or on the company’s reputation, the board may choose to maintain a high degree of involvement in the investigation. One member said, *“This was obviously an allegation that we took very seriously ... This was not a board investigation; this was a management-led investigation, but the board was informed regularly about the progress of the investigation. We discussed a separate board-led investigation, but decided against it and instead undertook processes that made us comfortable with a management-led investigation, such as a number of executive sessions with our outside counsel.”*

Mr. Wray offered a legal perspective on board involvement in management-led investigations: “There are plenty of cases where management-led investigations are perfectly acceptable to government authorities. However, even if management is leading the investigation, the full board needs to be much more actively involved in getting briefed and making sure they feel comfortable with the specifics of the investigation.”

Board-led investigation

If an allegation involves senior management, the board typically assumes responsibility for leading the investigation. Companies sometimes prefer board-led investigations because of the perception of great objectivity. One member commented on this rationale: *“The government uses credibility of the management team and credibility of the independent directors as a rubric to judge the investigation and its outcome. In most cases, I find that it’s best for the independent directors to undertake the investigation, because management always seems to leave a question mark in the regulators’ minds about the independence of the investigation.”*

⁵ A Wells notice is a notification from the SEC staff of a preliminary decision to recommend an enforcement action against the company.

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Once it has been determined that the board should conduct the investigation, the full board will decide whether the investigation will fall to the entire board, an existing board committee, or a special committee of the board. The lead director may also choose to act immediately, sending the investigation directly to a board committee or forming a special committee to deal with the allegation.

Full board investigation

While the full board is generally kept abreast of all ongoing investigations, some investigations are so critical that they require the full board's more active engagement. One member described such a case: *"[It was] an event which had the potential to take down the entire company, so we decided to keep the entire board involved."* Another member said, *"The full board should be involved in all extraordinary events."*

One member described a hybrid approach, whereby the audit committee led the investigation, but the entire board attended every audit committee meeting for the duration of the investigation: *"I was the chair of the audit committee at the time, and I asked that everyone sit in on the audit committee meetings. I did not want to undertake the job of reporting comprehensively to the entire board on a matter this serious and this detailed on a regular basis."*

Existing committee investigation

Many investigations fit naturally into an existing board committee's oversight responsibilities. One member said, *"We've had a lot of whistleblowers within the internal audit group complaining about management not being productive on various audits. In between two board meetings, the general counsel asked one of his internal lawyers to look into allegations concerning the internal auditors, and that report was presented in the audit committee meeting. We asked the [audit] chairman if he'd heard of this, and he said no, and we chastised the general counsel that the audit chair should have been called right away. That has to go directly to the audit chair by phone call."*

In one LDN member's experience of an allegation involving a director of the company, the member chose to send the investigation to the governance committee: *"We have a governance committee that I chair, as lead director. Because it was one of our directors [being investigated for stock options backdating], it was clearly a governance committee matter, and we told them we had to have a special investigation."*

LDN members stressed that the full board should stay involved: *"You should assign investigations to the appropriate existing board committee ... In one instance, our public policy committee handled the investigation. And as lead director, I needed to make sure that the rest of the board had everything they needed from the public policy committee. The full board needs to recognize that they must stay engaged."*

Special committee investigation

In some cases, the board may decide to establish a special committee of independent directors to oversee the investigation. Lead directors may choose to seek outside legal advice when deciding to form a special committee. Mr. Smith said: *"The purpose of the investigation and the constituencies with whom the investigation results will be shared will dictate who should be a member of the committee, how it should*

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be organized, and what counsel should assist the committee. The board's outside counsel can offer advice whether to form a special committee, how it should be constituted, and what its objectives should be."

The lead director may direct the formation of the special committee, but members agreed the lead director does not necessarily need to participate or chair the special committee. One member stated, *"If I were the lead director but not chair of the committee [leading the investigation], I would have suggested the appropriate committee run the investigation and keep the board apprised, but I wouldn't insist on being part of the special committee."* Lead directors should choose the board members who participate in the special committee carefully: *"Being on a special committee adds a lot of time to your board duties, so you have to make sure you appoint directors to the committee who have the time to conduct a thorough investigation."*

Special committees are often formed when there is no natural place for the investigation within the existing committee structure. In a previous conversation, one member said, *"It came down to a judgment call by me as lead director and others on the board to determine the next steps in responding [to the allegations]. We decided to form a special committee because it wasn't clear [who should be managing the issues]."* In addition, a special committee offers an additional measure of independence and legitimacy, particularly for any matter concerning a conflict of interest or related-party transaction.

The lead director's responsibilities

The lead director is normally responsible for keeping the board informed and engaged and for working with management. However, executing these responsibilities assumes a heightened importance during an investigation. One member characterized the lead director's responsibilities as *"pronounced and intense"* during an investigation. In addition, there are aspects of an investigation that may require the lead director to take on certain additional, unique responsibilities. Members identified seven activities that lead directors may undertake during the course of an investigation:

1. Work directly with and manage outside counsel or other experts throughout the investigation
2. Keep the board informed and engaged
3. Work with management
4. Oversee disclosure to the external auditor, shareholders, and the public
5. Interact with regulators
6. Bring an investigation to its conclusion
7. Oversee remediation efforts

Work directly with and manage outside counsel or other experts throughout the investigation

Members engaged in an in-depth discussion about whether and what type of legal counsel boards should employ during an investigation. The lead director may play a key role in helping the board consider these options. Mr. Smith stated, "Whether a board investigation should be assisted by 'independent' outside

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counsel who has no affiliation with the company depends on the nature and purpose of the investigation. Independent investigations are inherently more disruptive and costly than investigations assisted by regular company counsel. The question of whether the committee needs independent outside counsel is certainly one that the lead director should weigh in on and help think through.” If forensic accountants are involved in investigating a company’s practices, the lead director may also play a role in working with and managing the relationship with these outside experts.

Determining whether outside counsel is necessary

During an investigation, lead directors and their boards must consider whether to seek independent outside counsel or use the company’s outside counsel. Boards must also consider whether to use board counsel who is on retainer or independent legal counsel with no previous affiliation to the company or the board. These determinations are not necessarily easy to make and require nuanced consideration.

Members described the following scenarios in which the board should consider using independent outside counsel:

- **If the allegation involves senior executives or board members.** One member stated, *“Because the investigation involved senior management, we contacted outside counsel right away.”*
- **If the board seeks to enhance the perceived objectivity and independence of the investigation.** One member said, *“It seems like best practice these days, if you want to avoid any questions around your independence, to get an independent counsel who has no history with the board or the company.”*

However, one member stated, *“There are instances where even though a law firm works for the company, it is perfectly appropriate for the board to use that firm as well.”* Mr. Wray agreed: “Much of the time, Department of Justice and SEC officials are prepared to accept the company’s regular outside counsel as the board’s counsel during an investigation. The board could make a mistake, however, if it tries to position company counsel as completely ‘independent’ in the investigation. The key is accurately representing counsel’s role; with the right experience, rigor, and credibility, a firm hired by the company will still often be recognized as capable of giving an objective account of what happened.”

A lawyer on the board

Members reiterated the importance of considering the advice and guidance of the board’s outside counsel, but also suggested the potential value of choosing practicing lawyers as board members.

One member said, *“I called one of our directors, who was a lawyer, and asked what we should be doing [after receiving a demand letter from a shareholder activist]. [That director] offered an interesting perspective about possible next steps. Having a lawyer on the board can be helpful.”*

Another member stated, *“We have a lawyer on the board who has a very sophisticated perspective. [That director] is a voice of common sense and reason when you’re dealing with an SEC investigation and is less apt to have an immediate knee-jerk reaction to the SEC’s requests, and instead helps us think through our options.”*

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Choosing outside counsel

A majority of members in the LDN meeting reported that they do not have a retainer arrangement with independent counsel. In most cases, the board selects counsel on a case-by-case basis. Lead directors may play an important role in helping boards choose outside counsel.

Members identify outside firms based on recommendations from board members, the general counsel, or the lead director. One member stated, *“We have retained independent counsel. We got a short list from the general counsel of three names, and we had our own short list ... We picked two [from those lists] that we were interested in.”* Another member said, *“I would talk to other board members who’ve been through an investigation previously and get some insight on what they thought of the different law firms they had used.”*

In other instances, boards choose law firms based on the nature of the allegation and the law firm’s specialty. One member said, *“The board had some suggestions, and I interviewed each of the potential law firm candidates, with a particular focus on their areas of expertise.”* Another member said, *“Some firms want a retainer, but we don’t go that far. We have two or three firms that we feel would be appropriate to go to during an investigation, and we reach out to them depending on the [nature of the] investigation.”*

Managing outside counsel

Once the board has determined that independent outside counsel is necessary, members suggested that lead directors stay actively engaged with the outside counsel to ensure that the investigation is focused and comes with the least reasonable cost and disruption to the company. One member said, *“I would say one of the most important things you can do is manage the lawyers and the scope of the investigation. They tend to want to go through this exhaustive, overly detailed process that can prolong things significantly.”*

Maintaining an ongoing relationship with outside counsel

Many boards initiate a relationship with outside counsel during an investigation, then choose to maintain that relationship after the investigation has ended. In some cases, the firm is kept on retainer for the company, while in other cases, the firm is used as an informal adviser to the board. The lead director is often the point person for guiding and maintaining this ongoing relationship.

One member stated, *“Most boards bring somebody in on an ad hoc situation, but in this case, [the outside counsel] has done a terrific job and has a great knowledge of the company. I’ve kept him involved, so he’s very knowledgeable.”* Another member said, *“In situations where the board needs outside judgment, I will pick up the phone and have him come in to provide a point of view, and he knows he has that kind of special relationship with me and the board, but it’s not a retainer situation ... There is an advantage in continuity and involvement because he knows the company, management, and the board.”*

Keep the board informed and engaged

Members assert that one of the lead director’s most critical responsibilities is keeping the board informed of the investigation’s progress. One member said, *“I keep the board looped in all the time, but it’s just more*

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important and time consuming during an investigation.” The lead director plays a central role in communicating with board members: *“If there’s an issue that comes up and I’m working with outside counsel on that issue, I always bring in the other chairs of the board committees and ask them what they think. I think one of the things that is most important is to make sure the board is as involved and engaged as I am.”* One member cautioned, *“The lead director can’t start feeling like the de facto leader. They just have to keep the board involved and engaged and make sure everyone on the board is brought in, because in the long term [the board] should have the same exposure [to the investigation] as the lead director.”*

In addition, the lead director must ensure that the board stays focused on the salient aspects of the investigation: *“Some directors get very nervous about issues like the perceived personal financial risk to the independent directors. I had to ensure that we stayed calm and focused on the key issues.”*

Work with management

Members reported that good communication among management, the board, and the lead director is critical for ensuring a smooth investigation. In a board-led investigation, lead directors keep management informed about key developments in the investigation. One member stated, *“One key responsibility [for the lead director] is keeping management comfortable, because you can create this tension that you’re doing all these things with the committee, and all of a sudden they [management] don’t trust you and you’re taking on too much responsibility.”* Likewise, when management is leading an investigation, the lead director is kept up to date: *“I would meet with management regularly and hear updates on how things were going [with the investigation].”* In addition, if an investigation might trigger a large insurance claim, the board may help management oversee the relationship with the company’s insurer – for instance, by asking management about the implications of insurance coverage, policy status, or claims preparation.

Among members of management, the general counsel is especially important during an investigation. It is in the company’s best interest for the lead director and the board to maintain a strong relationship with the general counsel both during an investigation and throughout the course of the year. Members spent a significant portion of the meeting discussing the general counsel’s invaluable role as a *“confidante”* and *“sounding board”* during an investigation. One member stated, *“The lead director is as important to the board as the general counsel is to the company ... [the general counsel] offers strong legal knowledge and is a sounding board for the board members and the CEO.”*

Members also discussed the role lead directors and the board can play when a company has a *“weak general counsel.”* One member elaborated on this point: *“A weak general counsel becomes very clear during board meetings. In discussions with the CEO and during our executive sessions, we confirmed that there was not a lot of confidence in the general counsel. The board then asked to be involved in choosing a new general counsel, and I helped lead that process as the lead director.”* Another member said, *“We had a weak general counsel during a very serious investigation. He was frightened of the chairman, and we had to immediately act and bring in a new general counsel in his place. We hired an outside firm to lead us through that process, and I worked with [the outside firm] from the beginning.”*

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Oversee disclosure to the external auditor, shareholders, and the public

One thorny issue for boards and lead directors is determining whether and when to disclose information about an investigation to the external auditor, shareholders, and the general public. If the company determines that disclosure is necessary, the board must consider a host of complex questions, such as what form the disclosure should take, the timing of the disclosure, and which stakeholders should be informed. As one member said, *“The disclosure decision requires a great deal of management and thought.”*

With most allegations of significant potential wrongdoing, particularly allegations that could impact the company’s financial statements or internal controls assessment, the company’s external auditor will expect to be fully informed. In many cases, the external auditor will insist on receiving regular updates concerning the progress of the investigation and access to the materials reviewed by the investigators, which can raise difficult issues concerning preservation of the company’s legal privileges.

During boardroom disclosure discussions, the lead director is responsible for:

- **Helping the board reach consensus on disclosure.** Members agreed that the lead director can guide the board to consensus on the nature, messaging, and timing of the disclosure: *“As lead director, I didn’t take the lead on the disclosure. It was the full board that shaped the messaging of the disclosure and determined when we were going to go public. In executive session ... I made sure we had unanimity around the table.”*
- **Informing management of the board’s disclosure decision.** One member stated, *“Management thought it was too early for a disclosure, and the board disagreed. The board got its own outside counsel and subsequently decided that there had to be a disclosure statement ... I discussed it with management, and they understood that it was our call.”*

Interact with regulators

If an internal investigation uncovers a violation that is subject to action by regulators, the company would notify and begin working with the appropriate regulatory agency immediately. In addition, if regulators have prompted an investigation, the company would fully cooperate with the agency. However, if regulators are not yet involved in an investigation and it is not clear that any regulatory violation has occurred, members reported wrestling with the complexity of when to initiate contact with regulators.

Working with regulatory bodies can be challenging. One member stated, *“In terms of a settlement [with regulators], sometimes things just go radio silent ... The agency won’t tell you when they’ve closed a case, and you don’t know.”* Another member added, *“We had attorneys general from different states and Canada and different agencies. It was difficult to rein them all in and coordinate between the different agencies, but we knew we had to do it.”*

Members said that they often report internal investigations to regulators to avoid being perceived as *“uncooperative.”* Historically, companies have also often felt pressure by regulators to waive attorney-client privilege. As one member said, *“Maintaining [attorney-client privilege] during an investigation is hard; you really feel like you have to waive it, as a gesture of good faith [to the regulatory agency].”*

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The SEC recently announced new measures that would reward companies and individuals for cooperating with investigations, which may result in earlier disclosures. Both DOJ⁶ and SEC⁷, moreover, have taken some steps to reduce pressure to waive the privilege. In addition, in December 2009, a bill was introduced in the House that would prohibit government lawyers from requesting a waiver of attorney-client privilege as a measure of cooperation in civil and criminal investigations.⁸

If an issue arises, Mr. Wray encouraged members to initiate an internal investigation of the issue: “Regulators will respond positively when companies react promptly to red flags [allegations or hints of wrongdoing]. Even if these red flags only come up internally, boards need to make sure they could later explain their actions to the regulators, if necessary. For example, boards should be prepared to show that they responded immediately and thoughtfully to the issues and to articulate what explicit steps they took.”

The person primarily responsible for outside counsel’s contact with the regulators varies. In some cases, the CEO is responsible for the communication, while in other cases, the lead director or the head of the special committee leading the investigation works with regulators. Regardless of who helps manage the communication with regulators, members indicated that lead directors are often one of the first board members to learn of an exchange with a regulatory body: *“When I became lead director at my company, I went and met with the regulators immediately. I met with the people who would be responsible for our account. I insisted that my interactions with them be on our board meeting agendas as well.”*

Bring an investigation to its conclusion

Members agreed that bringing an investigation to closure requires ongoing board involvement. Regardless of whether management or the board is leading the investigation, the board proactively monitors the progress of the investigation in order to ensure a thorough yet timely investigation. Speaking about a board-led investigation, one lead director said, *“You can’t just give the outside counsel [or team conducting the investigation] a blank check. You have to lay out what you think the program of events is going to be for you to wrap up with a written recommendation coming out of the investigation.”*

Oversee remediation efforts

In the wake of an investigation, companies may be required to undertake certain remedial measures. The lead director, with support from the full board and the top management team, may monitor the implementation of these remedial efforts and any additional interactions with regulators.

Although these follow-up activities may strain the company’s resources, on the whole, members agreed that their companies emerged as stronger entities in the wake of these remedial actions. As one member said, *“I think we were better off as a result of having gone through this DPA [deferred prosecution agreement] experience.”*⁹ *It brought the board together and changed the culture of our company.”*

⁶ Department of Justice, [“Justice Department Revises Charging Guidelines for Prosecuting Corporate Fraud,”](#) August 28, 2008.

⁷ US Securities and Exchange Commission, Division of Enforcement, [“Enforcement Manual,”](#) January 13, 2010, 99-100.

⁸ Joe Palazzolo, [“Attorney-Client Privilege Bill introduced in the House,”](#) *Main Justice*, December 17, 2009.

⁹ Companies may enter into deferred prosecution agreements with the DOJ. These agreements allow the company to avoid prosecution provided it complies with the DOJ’s compliance agreement.

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Members discussed three particular types of remedial agreements with government agencies: deferred prosecution agreements (DPAs), non-prosecution agreements (NPAs), and corporate integrity agreements.

Deferred prosecution agreements and non-prosecution agreements

Some companies may enter into DPAs or NPAs with the DOJ to avoid the potential consequences of a broad indictment or criminal conviction. These DPAs and NPAs often require a company “to hire an independent monitor to review and evaluate the firm’s internal controls, record-keeping and compliance practices.”¹⁰ In a May 2010 speech, the Department of Justice’s criminal fraud section chief stated that roughly 50% of his section’s DPAs and 30% of the NPAs require that a monitor be appointed.¹¹

Mr. Wray elaborated on DPA agreements: “In exchange for the government not pursuing a criminal conviction of the company, the government will defer prosecution for a period of years. During that period of years, an independent, third-party monitor is often imposed by the government, but paid for by the company. This monitor reports back to the government and functions essentially like a built-in probation officer. That person’s job is to make sure you’re complying with everything in your agreement. If the company complies, the government will dismiss the pending prosecution.”

The lead director is often responsible for ensuring that the monitor has adequate resources and support from the company: “*We had a monitor for three years and spent millions of dollars of company resources complying with the monitor. We met with the monitor as a board, and I would periodically meet with the monitor on my own to make sure he was happy with our progress.*”

The monitor often maintains a collaborative relationship with the board. One member stated, “*The monitor meets with the board every other meeting for a short briefing. She comes in just to report on what she has found so far and what she’s done and the kind of progress we’re making. She’s been very helpful about coming in to brief us and did interview us one-on-one. The monitor laid out her timeline for when she comes to the board and asked for our comments on her timeline.*”

Corporate integrity agreements

The Office of Inspector General (OIG) in the US Department of Health and Human Services often negotiates corporate integrity agreements with health care providers and other entities that have come under investigation. These agreements typically last for a period of five years. As the OIG website explains it, “A provider or entity consents to these obligations as part of the civil settlement and in exchange for the OIG’s agreement not to seek an exclusion of that health care provider or entity from participation in Medicare, Medicaid and other Federal health care programs.”¹²

¹⁰ Christopher M. Matthews, “[Fraud Chief: Effective Compliance Programs Can Prevent Monitors.](#)” *Main Justice*, May 24, 2010.

¹¹ [Ibid.](#)

¹² Office of Inspector General, “[Corporate Integrity Agreements.](#)” The website further explains that “these compliance measures seek to ensure the integrity of Federal healthcare programs claims submitted by the provider. The more comprehensive integrity agreements include requirements to: hire a compliance officer/appoint a compliance committee; develop written standards and policies; implement a comprehensive employee training program; retain an independent review organization to review claims submitted to Federal healthcare programs; establish a confidential disclosure program; restrict employment of ineligible persons; report overpayments, reportable events, and ongoing investigations/legal proceedings; and provide an implementation report and annual reports to the OIG on the status of the entity’s compliance activities.”

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Mr. Wray commented: “In the healthcare, pharmaceutical and medical device industries, these agreements have become a regular part of global settlements resolving investigations. Many of the compliance undertakings imposed resemble things the company already is (or should be) doing anyway, but not all of them. In any event, these agreements are largely essential to allowing the company to stay in business.”

Preventing a problem

LDN members reported that after any major investigation, they reexamined their organization’s compliance and ethics programs to identify additional actions the board might undertake to positively shape corporate culture. In recent months, for example, the compliance function’s access to the board has assumed increased importance. For instance, the United States Sentencing Commission voted in April 2010 to modify the Federal Sentencing Guidelines for compliance and ethics programs to provide increased credit if the compliance and ethics officers report directly to the governing authority of the organization.¹³ In May, the *Wall Street Journal* reported, “Chief compliance officers increasingly report directly to the chief executive at many larger companies and have direct access to the board of directors ... ‘The intent isn’t to create an administrative layer, but to create an unfiltered voice from an expert to board members on issues they need to hear.’”¹⁴

LDN members reflected upon some specific actions that their boards and senior management teams have taken in the aftermath of an investigation. Board members and senior management have:

- **Set the right tone at the top.** *“We worked with management at our offsites and throughout the year to make sure there was a clear example being set within every unit about the company’s expectations.”*
- **Put additional ethics training processes in place for employees.** *“We set up case studies for marketing and manufacturing people and hosted discussions about what to do when you’re in an ethical dilemma.”*
- **Reexamined the reporting structures for the ethics and compliance officer.** *“We decided to put an ethics officer in place that reported to the CEO but was housed within the general counsel’s office ... We also changed the name of the whistleblower hotline to the ethics hotline ... and we made sure the ethics officer gave the board the same information [about any violations] as the CEO [received].”*
- **Ensured discipline is immediate and comprehensive.** *“You send a message to everyone in the company when you discipline not just the lower-level employees who had something to do with [the misconduct], but also the senior executives. It’s like you’re saying, ‘We really are serious about this.’”* Another member concurred: *“No executive officer at the company was implicated in the allegations, but the compensation committee decided to affect all the executive officers’ pay because we wanted*

¹³ US Sentencing Commission, [“U.S. Sentencing Commission Votes to Send to Congress Guideline Amendments Providing More Alternatives to Incarceration, Increasing Consideration of Certain Specific Offender Characteristics During the Sentencing process,”](#) press release, April 19, 2010.

¹⁴ Suzanne Barlyn, [“Compliance Watch: Sentencing Guidelines May Boost Compliance,”](#) *Wall Street Journal*, May 3, 2010.

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them, and the company, to understand that if you're a leader [at the company], we hold you responsible for your own conduct and the conduct of the other employees [who report to you]."

However, members noted that even these steps will not necessarily prevent future misconduct, shareholder lawsuits, or government investigations. Mr. Wray stated, "Where the rubber meets the road from the government's point of view and from the perspective of actually wanting to change corporate culture and behavior is with detection and discipline. You need to ensure that there are strong internal auditing and detection mechanisms and built-in incentives or disincentives for behavior at the employee level. Policies and training only get you so far ... You want to be able to credibly argue to the government that you don't need monitors in place because you have a rigorous, objective process that makes a difference in the corporate culture."

Major investigations often spawn derivative lawsuits in which shareholders sue company officers or directors on behalf of the company. These suits are often unavoidable. One member said, "*The best protection you have [from derivative shareholder suits] is to have processes in place before an incident or allegation unfolds ... I was once told by a law firm that was advising our board during a hostile takeover, 'Doing the right thing does not keep you from getting sued, but it will help you defend your behavior with integrity.'*"

Conclusion

Members emphasized that running an investigation is not an exact science: "*It's a judgment call on a case-by-case basis. It's hard in these situations to have rules and regulations defining what action ought to be taken because each situation is different. It's the lead director's responsibility, with the CEO and the general counsel, to make the call on how the investigation is organized and how the company organizes to deal with it.*" Managing this process places a significant time burden on the lead director and the board of directors, who must take steps above and beyond their usual duties to prepare their companies for the investigation. But as one member said, "*[The time commitment] is worth it. Making sure the board was prepared for this [investigation] was important for the entire company.*"

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the issues confronting lead directors. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* is encouraged to share it with those in their own companies and with their colleagues at other companies. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Lead Director Network ("LDN") is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

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