In-House Counsel as Corporate “Gatekeepers”

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Managing the corporate gate
Overview

• Background
• Case Studies
• Investigation Procedures
• Compliance Programs
In-House Counsel as Corporate “Gatekeepers”

Background
Who is a corporate “gatekeeper”?

“The sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and the boards of directors responsible for oversight of company management. They're paramount in ensuring that our markets are clean. And Congress recognized that when it enacted Sarbanes-Oxley.”

Stephen Cutler, SEC Director of Enforcement, during a speech at UCLA Law School in September 2004
The other shoe drops

- SEC Enforcement files a complaint against Electro Scientific Industries’ General Counsel under Rule 13b2-2

- Alleges GC didn’t do enough to prevent fraud committed by CFO
  - Didn’t aggressively question the CFO
  - Didn’t inform the Audit Committee of possible wrongdoing
  - Didn’t provide contrary legal advice from outside counsel to the Board, Audit Committee and outside auditors

- General Counsel entered into settlement with SEC and paid $50,000 fine
Subsequent Enforcement Against the Gatekeepers

“General Counsel Under Attack—Criminal and Enforcement Proceedings, Investigations and the Travails of In-House Counsel”

• October 2007 – ABA Committee on Corporate Counsel report
  • Documents 77 recent cases
• One-third involved options back-dating
• Fate of in-house counsel in completed cases
  • Nearly all lost their jobs
  • Over a dozen involved prison sentences
  • Over $10 million in fines were handed down
Enforcement Against the Gatekeepers

Often sanction \textit{failure to advise}

Not just \textit{bad legal advice}
When does the lawyer’s conduct violate the federal securities laws?

“If the lawyer provides the CEO with a balanced legal view and the CEO then disregards the implications of that view… rarely will the lawyer be viewed as primarily or even secondarily liable under the securities laws absent further participation in the misconduct”

But “there are many cases where every securities lawyer ought to know the answer, or where a non-securities lawyer cannot in good faith fail to seek advice – and in those cases, the lawyer may properly be held responsible for [the] corporate conduct in which he or she participated”

Giovanni P. Prezioso, SEC General Counsel, Pebble Beach, CA
April 28, 2005 Speech to Association of General Counsel
In-House Counsel as Corporate “Gatekeepers”

Investigation Procedures
Discovering you have a problem

How Fraud is Detected

- Company controls
- Reported to Company
- External Sources

Some Initial Considerations

• Should the investigation team be internal or external?
  • If internal, will they be sufficiently independent?
• Does the investigation team have the resources to meet timing requirements?
• Have you seen this problem before?
• Is an e-mail review required, and if so, how extensive?
• Be careful with materiality, “who” may be more important than “how much”
Parties involved in an Investigation

- Special Committee / Board of Directors / Audit Committee
- Investigations Team
- Government / SEC / DOJ
- Company / Management
- Auditor
- Outside Counsel
Importance of Managing Interested Parties

- Need to resolve and remediate issues in a timely manner
- Need to protect privilege
- Desire to reach a cost effective resolution
Special Committee / BOD / AC

- Hire counsel and/or forensic investigators
- Help define initial scope of investigation
- Approve work plan of investigators
- Encourage cooperation from management and Company personnel
- Review and assess findings of investigation
Government / SEC / DOJ

- Safeguard interests of shareholders/capital markets

- How does government get involved?
  - Informal inquiry
  - Formal inquiry
  - Self-reporting

- Need to determine when, if and how often they should be contacted / updated
- Need to balance government’s requests with concerns over privilege
Company / Management

- Demonstrate cooperation

- Consider public disclosures

- Interact with other interested parties
  - Stock exchanges
  - Financial institutions
  - Government
  - Auditors

- Remedial actions
Consider public disclosures

- Timing
- What information can/should be shared?
- Filing deadlines impacted?
- Reliance on previously issued financial statements?
Requests for documents (electronic and paper)

• Should you provide?
• When do you provide?
• How and in what form?
  • Electronic?
    • PDF or Native?
  • Paper?
Managing Requests

Do you create a report?
- What format?
  - Detailed or Memo?
  - PowerPoint or Verbal?
- Who gets the report?
- Different reports for different parties?

Risks of reports and “status updates”
- What if your position changes?
- Document could be released to public?
- Reputational risk for company and auditor
- Potential for litigation
Observations

- Manage the process up front and throughout
- Lay out the ground rules
- Understand expectations of each party
- Keep interested parties in the loop
- Be aware of potential impact on privilege
Corporate Compliance and Counsel as Cop
Strong corporate compliance policies and programs are more important than ever to:
- Beat the regulators to the punch
- Demonstrate effective compliance controls
- Enable timely and appropriate disclosures
- Reduce enterprise exposure to enforcement action

Key drivers of compliance policies and programs:
- Desire to promote ethical business cultures
- Implementation of Sarbanes-Oxley mandates
- Independent auditor demands
- Regulatory crime and punishment guidelines
Sarbanes-Oxley Mandates

Audit committee duties (301)
  • Mandatory whistleblower hotline
  • Must receive reports of audit, accounting issues

CEO/CFO certifications (302, 404, 906)
  • Requires internal controls certification, including controls over legal compliance

Code of ethics for financial officers (406)
Legal counsel watchdog role (307)
Auditors are responsible for detecting fraud

“with relatively few exceptions, they should find it.”

The Seaboard Guidelines

In determining leniency, the SEC will consider the effectiveness of a company’s compliance policies and efforts:

- “What compliance procedures were in place to prevent the misconduct?”
- “Why did those procedures fail?”
- “What steps did the company take upon learning of the misconduct?”
- “What assurances are there that the misconduct is unlikely to recur?”
Federal Sentencing Guidelines

Organizations may get credit for an “effective compliance and ethics program,” including

- “Due diligence to prevent and detect criminal conduct”
- “An organizational culture that encourages ethical conduct and a commitment to compliance with the law”
Persistent Ethical Dilemmas for Legal Counsel

- You are the **trusted legal advisor** for the company, which is acting through management. You solicit full and candid disclosure of client confidences to enable you to give sound legal advice.

- *But* you are a **compliance cop**, required to counsel management to act in a compliant manner and, if management does not, to “report up the ladder.”
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