Conference Panel Discussion

Internal Corporate Investigations*

Prof. Shipman: Art's paper is incisive and thorough, and suggests any number of questions. First, I would like to turn to Stanley Schwartz, Jr. with the question of whether to use inside counsel, outside counsel that regularly represents the company, or outside counsel that is a special counsel with no connection with the company. What are your views on the calculus? These are important issues, both from a standpoint of expense and of putting the matter to rest.

Mr. Schwartz: Morgan has asked me to supplement Art Mathews' remarks from my own perspective, that of an Ohio corporate lawyer, a non-specialist who has participated in two internal investigations.

The first investigation occurred in a company which I had represented for a relatively short period of time. There were material errors in this company's published financial statements extending over a period of years, resulting in both the expected litigation and an informal investigation by the Enforcement Division of the Commission. The matter was further complicated by the fact that a former executive had written a letter to the Enforcement Division accusing other members of management of various misdeeds and cover-ups. We advised the board of directors that this was a textbook case for immediate investigation by independent outside counsel under the direction of the audit committee composed of independent directors. That advice may be characterized as a "no brainer." Since we had previously represented the company, it was clear that we should not participate in the investigation. The report of independent counsel, approved by the audit committee, was accepted by the Enforcement Division of the Commission. The press release that we attached to the Form 8–K[1] served as an alternative to public dissemination of the report.

The second investigation was less public. As outside general counsel of a regular client, I became concerned about certain questionable offshore practices of the client. The situation involved possible violations of local law, rather than questionable payments. My concern arose from the overly broad and overly zealous interpretations of the United States wire fraud[2] and mail fraud[3] statutes asserted by certain federal prosecutors, which appeared to provide that violations of local law at any place in the world constituted a violation of United States law.

For various reasons, the best solution was an internal investigation by counsel under the audit committee of the board. In this case, I participated but insisted that two other firms join me. One was completely new to and independent of the client,

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* The panelists were moderator Morgan Shipman, Professor of Law, Ohio State University; Marshall Cox, Partner, Cahill, Gordon & Reindel, New York, New York; Paul Gonson, Solicitor, United States Securities and Exchange Commission; Stanley Schwartz, Partner, Schwartz, Shapiro, Kelm & Warren, Columbus, Ohio; Stanley Sporkin, General Counsel, Central Intelligence Agency; Stuart Summit, Partner, Burns, Summit, Rovins & Feldesman, New York, New York.

1. 17 C.F.R. § 249.308 (1984).
2. 18 U.S.C. § 1343 (1982).
3. 18 U.S.C. § 1341 (1982).

and the other was the client's special counsel in the type of law that was the subject matter of the investigation. Counsel prepared a joint report which was adopted by the audit committee and the board. Foreign counsel determined that the questionable practices did not materially violate local law. To eliminate any question of liability in the future, the board ordered the practices discontinued.

If I had to do it over again, I probably would have abstained from the process completely and left it entirely to outside counsel. I would have taken this approach for two reasons. First, as you know, a camel is a horse designed by committee. It is very difficult for three lawyers to agree on anything, and the committee process itself is cumbersome for an investigation. Secondly, and more importantly, it is very difficult for lawyers to conduct investigations of their own clients. Personal relationships that must be preserved in order to render legal advice efficiently over the years become strained. Listening to the Southland story today reinforces the conviction I have gained from my own experiences: in my opinion, lawyers should not undertake an internal investigation of their own clients.

Let me put on my Ohio hat for a moment. Art spoke of the institutionalization of the internal investigation. I thought I would take a look at Ohio law and see what has been done in this state. Ohio General Corporation Law section 1701.13(E)[4] contains Ohio's indemnification provision. Paragraph (E)(4) of that section provides methods for determining whether a party seeking indemnification meets applicable standards. It goes on to state that this determination may be made by a majority vote of a quorum of disinterested directors. If a quorum is not obtainable, or if a majority of the quorum of disinterested directors so directs, the determination may be made "in a written opinion by independent legal counsel other than an attorney, or a firm having associated with an attorney, who has been retained by, or who has performed services for the corporation or any person to be indemnified within the last five years . . . ."[5]

We can back-door into a judicial sanction of investigations by counsel in connection with the question of the board's role in stockholder derivative actions. Now, Ohio is not Delaware with its plethora of law in this area. The only Ohio case that I could find directly in point is a rather obscure Common Pleas Court case, *Rice v. Wheeling Dollar Savings & Trust Co.*[6] In this case, the court decided that directors not involved in the misconduct alleged, "acting under the advice of counsel,"[7] may properly refuse to bring a derivative action after a shareholder's request. If the directors reach that conclusion, no derivative action will lie.[8] Incidentally, I said this case was obscure, but it is cited in the concurring opinion of the famous and definitive case of *Burks v. Lasker.*[9]

From clues like this we may assume that internal corporate investigations by

4. OHIO REV. CODE ANN. § 1701.13(E) (Page 1978).
5. *Id.*
6. 71 Ohio L. Abs. 205, 130 N.E.2d 442 (C.P. 1954), *order on appeal rev'd on other grounds*, 163 Ohio St. 606, 128 N.E.2d 16 (1955).
7. *Id.* at 213, 130 N.E.2d at 448.
8. *Id.* at 214, 130 N.E.2d at 449.
9. 441 U.S. 471, 487 (1979) (Stewart, J., concurring).

counsel have become a permanent fixture of the corporate culture both in Ohio and the United States as a whole.

Prof. Shipman: Thank you very much, Stanley. I want to ask Marshall Cox a question. We have been discussing the internal corporate investigation as a formal affair that occurs infrequently. All of us know, of course, that there are all kinds of ongoing legal compliance programs (securities and antitrust) and day-to-day investigations. When regular counsel (be it inside or outside) conducts, say, a legal audit for antitrust problems or violations, are there dangers in eroding the trust and confidence between counsel and client so that those being audited are less likely to contact you with problems as they arise? All of us know that the best result for everyone usually comes when the client phones the lawyer at the earliest sign of trouble. Is the regular counsel in this hypothetical unwisely combining the roles of advisor and investigator-enforcer? I'd also like Marshall to speak to the role of *Upjohn*[10] in the informal, low-key corporate investigation and the role of *Upjohn* generally.

Mr. Cox: It seems to me that the point at which the conflict arises for either the inside lawyer or the regular outside lawyer is when the usual relationship between lawyer and client is put at risk. In conducting a routine antitrust audit to see how things are going, you do not usually encounter that kind of risk. If, God forbid, you find out that, say, the chief executive officer of your client has been meeting regularly with his opposite number at his major competitor for improper purposes, you have to face up to that problem. But you cannot go into every relationship you've got with your client and expect to find that kind of highly unusual circumstance.

If the internal audit is not being conducted entirely by an inside lawyer (as in many instances it is), an inside lawyer should be there when the outside lawyers are carrying on whatever investigation they are. At least, it's been my experience that the individuals whom one is likely to interview are going to know and look to the inside lawyers, and you as an outside lawyer are going to have a great deal more credibility if you are accompanied by someone they view as their lawyer. With that added credibility, you can work yourself into a position where you become their lawyer. In much the same way, it's certainly been my experience that the inside lawyer recognizes the personalities within the company, the flow of papers, and other facts which make it possible to move in relatively quickly and find out what's going on.

As I read *Upjohn*, most of the kind of information collecting that goes on in these circumstances (whether it's by an inside lawyer or by an outside lawyer) ought to be subject to the attorney-client privilege, and any notetaking or that kind of thing ought also to be subject to a work product privilege. *Upjohn* has made the control group concept irrelevant.

On the other hand, it is the corporation that is the client. To the extent that there is a privilege, be it an attorney-client privilege or work product privilege, it belongs to the corporation and normally does not cover the individuals. I feel it's important to notify any individuals who are providing information that this is the fact. This is a

10. Upjohn Co. v. United States, 449 U.S. 383 (1981).

sort of *Miranda*[11] warning. If I'm talking to an executive of a client, he should know that I'm not representing him, that I'm representing the corporation, and that I believe what he tells me is privileged as to the corporation but not necessarily as to him. Along with that, again depending on the setting, if it's at least potentially criminal (as it often is in the antitrust setting), I usually indicate that if he wishes to consult his own counsel or counsel retained for him by the company, I think that's appropriate too. In my experience, companies have usually benefited by having executives individually represented in circumstances where there may be some criminal risk.

Prof. Shipman: Marshall, thank you very much. We have been developing material that leads to a major question: Is it proper and legal to represent both the corporation and its directors, officers, and employees in an SEC investigation, a formal corporate investigation, or in a criminal case? Though the Supreme Court of the United States has gotten tougher and tougher on conflicts of interest, it has never laid down a strict per se rule, and it has noted strong counter-considerations—joint defenses save money and a joint defense may be more effective against a prosecutor.[12] I will ask Stan Sporkin to comment upon policy and practicality.

Mr. Sporkin: First of all, I have got to tell you that when I go, I want Art to give my eulogy. Maybe that's what he was giving today.

As Mr. Cox indicated, the multiple representation problem presents a real dilemma for lawyers. Often lawyers represent more than one client in a proceeding. They do not give the problem much consideration at the commencement of the representation. They reason that if and when a conflict arises during the course of the representation, they will pick and choose the client that they want to represent. Then they will cut the other one adrift. They may, however, find when they want to cut them adrift that it's too late. When lawyers obtain information that can be used against that person or is detrimental to the other client that they represent, they find themselves in a very difficult position. This event usually arises when they have two clients and information they receive from one client conflicts with the representation of the other. Instead of being able to pick and choose, and say "okay, client *A*, I'm going to represent you; client *B* you're on the sidelines," what normally happens is that the lawyers themselves are on the sidelines representing neither one. Both clients get other lawyers.

Let me give you some real examples that I encountered at the SEC.

Case Number One: Corporate director and officer of a company goes to company counsel and explains to company counsel that he has made some illegal campaign contributions on behalf of the corporation and he wants help in responding to the SEC. The lawyer is in a difficult position, because if he undertakes the representation he realizes he's obtaining information from this client that is going to have an impact on his representation of the corporation, which is really his main client. If this problem doesn't present enough of a question, add to the hypothetical the factor that the lawyer not only represents the corporation and the chief executive officer of the

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11. Miranda v. Arizona, 384 U.S. 436, 479, *reh'g denied*, 385 U.S. 389 (1966).

12. *See, e.g.*, Wood v. Georgia, 450 U.S. 261 (1981); Cuyler v. Sullivan, 446 U.S. 335 (1980); Holloway v. Arkansas, 435 U.S. 475 (1978).

corporation but he is also himself on the board of directors. Add to this problem the fact that when the client is called to respond, he takes the fifth amendment. The corporation now wants to find out what happened. It has to engage in its own investigation. Directors are sitting around the board room. What does this lawyer/director do? Does he remain quiet? Does he tell them yes, the chief executive officer did it? This case involved a law firm in the United States and led to a rule put in by that law firm that the firm would represent only the one client, as Mr. Cox said, and that members of the firm would not sit on any more boards of directors of clients. They feel that they have a potential or actual conflict when their members sit on a client's board.

Case Number Two: The lawyer represented both the chief executive officer and the corporation. There was a major question as to where a substantial amount of corporate funds went, and the lawyer came to see me. This is after the individual client had taken the fifth amendment.

Obviously, the corporation can't take the fifth amendment, although it would have liked to take the fifth amendment and tried to do so! The lawyer said, "Stan, don't worry." I said, "I'm not worried, you have got the problem." He said, "You know, you like all these cases where you get special counsel, don't you?" I said, "When they're advisable, we try to get that." He said, "You're not going to have to worry in this case because I'm going to give you one." He said, "We'll agree to having a special counsel appointed to find where the money is." I was a little cruel, but I told him that while I usually would accept this arrangement, I was bothered by the expense to the corporation when you, Mr. Lawyer, can find out so easily where the money went by just simply asking your individual client. I concluded that it would be unfair to the corporation to saddle it with the expense, and we did not settle that case. Thus, here is a case where if the lawyer had been representing only the company, there would probably have been a suitable settlement, but because he was also representing the individual client, I did not think the proposal appropriate, particularly in view of the fact that it would have been such an easy thing for the client to supply that information. This is a case where the company, I must tell you, got a thorough housecleaning. We cleaned out the whole works. The company needed and required it. However, as is true in most cases, the grand experiment worked. An extremely able person was brought in to take over control of the corporation and brought it back from death into life and it has done quite well.

Case Number Three: Here's what happens if a lawyer decides to represent not only a broker-dealer firm but also the registered representatives who are accused of the specific wrongdoing. Here you have a number of cases that fit this mold. In one case, I think the law firm represented not only the company but also a large number of the registered representatives. This presents extraordinarily difficult problems. First, the lawyer for the company has a responsibility and a duty to recommend the firing of dishonest employees. Similarly, if you're representing the individual registered representative, you may well want to put in a defense that the-devil-made-me-do-it—that I was under tremendous pressure from my employer who told me that I wasn't making the quotas. Therefore, I had to reach a little more and become more aggressive. Now, what you're doing when you're in the so-called joint defense that Pro-

fessor Shipman mentioned is to narrow your case to defenses that both your clients can meet. In so doing, you have narrowed the field in which you can defend the case. But a defense lawyer wants the broadest playing field that he or she can have. In addition to the obvious ethical questions, I can assure you that you'll get into the problems that I'm talking about when you try to settle the case. Look at the problems. Whom are you going to prefer in the settlement? Are you going to try to get the corporate clients off? That client is paying your fee and paying the fees for all these other people. Is that going to be your primary responsibility? Are you going to toss away the individuals? Are you going to say, "I've got a good deal for you? You know, I'll give you all these representatives in a package—bar them forever and let the company go?" How are you going to do that? It's incredible. Many of you are going to say that Sporkin is overstating the case. I can assure you the fact is that these problems arise every day. These conflict of interest problems seem insoluble. Mr. Cox took my thunder by stating the simple solution to the problem. Maybe he can afford to do it because he works for a very impressive law firm, but I do think that his solution is the answer: namely, at the earliest possible time, identify your client. Be sure that the client knows that and that everybody else knows whom you're not representing. Remember, if it's a person's reasonable perception that you represent him or her, I think the courts will say that you have an attorney-client relationship and that information the person gave you is confidential information that you can not use against him or her. As Mr. Cox said, at the beginning state that "I do not represent you; I represent the company; if you tell me that you have done something wrong, I must report it to my client and perhaps recommend to my client that it take action against you; and if you would feel more comfortable in talking to your lawyer before you talk to me, I would encourage you to do so." Some lawyers have a brief written statement that they'll give a person so that the record is clear. If this care is not taken, the individual may later assert a successful malpractice claim against the lawyer on the grounds that an attorney-client relationship existed and the "client's" interests were not protected. So when you're in this one-on-one situation with the individual, it's extremely important to document your conversation.

Mr. Cox, do you do that by any kind of a piece of paper or do you make a memorandum?

Mr. Cox: We usually have had a memo. Typically, I have an associate with me and he or she does the memo.

Mr. Sporkin: The point is that it's important that you limit your representation at the beginning. If you go beyond the beginning moment, your choices have become narrowed and very limited because once you get that little bit of information from the "client," it may well be too late later on to proceed against that person unless you've *first* done what Mr. Cox and I have indicated. Thank you.

Prof. Shipman: Thank you very much, Stan. I should now like to ask Paul Gonson, who is a recognized expert on, *inter alia*, the professional responsibility duties and liabilities of securities lawyers, to comment on these conflict of interest issues.

Mr. Gonson: Thanks, Morgan. It is my lot in life to follow Stanley Sporkin, who gives the great war stories, and I give the section numbers.

A number of years ago a law professor at Yale, Geoffrey Hazard, wrote a very interesting little book called *Ethics in the Practice of Law.*[13] He noted that we lawyers tend to identify the universe of persons in two categories: clients and non-clients. He suggests that there is a third category he calls quasi-clients. These are persons who have certain expectations as to what relationships they might have with a lawyer, and I think these are the kind of persons that Stanley has been talking about and Marshall Cox has also mentioned. These are the employees or the other persons you're talking to when you as a lawyer are making an investigation. The Model Code of Professional Responsibility of the American Bar Association, which has been adopted in almost all the states, isn't very helpful on the question of who is the client. Ethical Consideration 5–18 expresses the so-called entity theory.[14] The client is the corporation and *not* any of its stockholders, officers, directors, employees, or so on.

For several years an ABA group has been working toward revision of that Code, and in August 1983 the American Bar Association adopted a new model code, the Model Rules of Professional Conduct.[15] Of course, the Model Rules do not become effective until they are adopted by individual states. The Model Rules are now being considered by several states. Last February, at the ABA's New Orleans meeting, there was a proposed revision to the concept of who is a client, and then-proposed Rule 1.13(a) stated that a lawyer employed or retained by an organization represents the organization, *including* its directors, officers, employees, members, shareholders, or other constituents as a group, except where the interests of any one or more of the group may be adverse to the organization's interests. That caused a big hullabaloo. Nobody could figure out what that meant. This August, when the ABA finally adopted the entire Model Rules, they changed that. Rule 1.13, as finally adopted, now reads that a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents. What does "constituents" mean? The commentary says that officers, directors, employees, and shareholders are constituents, but then it goes on to say that if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the corporate client's employees or other constituents are covered by Rule 1.6. That rule provides that the lawyer may not reveal information relating to representation of a client except under severely limited circumstances. This all means that constituents of an organizational client are not also the clients of the lawyer and the lawyer cannot disclose to those constituents information that he or she receives from other constituents. Model Rule 1.13(e) says that a lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to Model Rule 1.7, which is the conflict of interest rule. In other words, it says yes, professional ethics will permit a lawyer to represent multiple defendants, provided that there is no conflict of interest. Stan has identified areas where there may be a conflict of interest.

13. G. Hazard, Ethics in the Practice of Law (1978).
14. Model Code of Professional Responsibility EC 5–18 (1980).
15. Model Rules of Professional Conduct (1983).

Rule 2.3 speaks to who retains the lawyer and where the lawyer's duties run. If the lawyer is retained by the corporation, all duties of loyalty run to that corporation. If a lawyer is retained by a court, for example, pursuant to its order for a special investigation leading to a report to the court, then those loyalties do not run to the corporation but rather they run to the court or possibly even to the SEC representing the public interest in a larger way.

Rule 4.3 covers dealing with unrepresented persons. That rule suggests that if a lawyer is dealing with someone who is unrepresented, the lawyer must explain what is necessary to avoid being misleading to that person.

From all this, I tentatively conclude that where the lawyer who represents the corporation seeks to interview employees and officials of that company in an investigation and those persons are not represented by counsel, the lawyer probably does have to give the *Miranda*/Cox kind of warning. Keep in mind that from a practical standpoint, the employee is almost required to cooperate, because the lawyer will usually have with her or him a letter from the Chairman of the Board or some other high corporate official directing all employees to cooperate with the lawyer.

Morgan and Stanley Sporkin also asked whether the warning should be written. John Fedders, who has written a number of articles on corporate investigations, recommends the use of a form letter and also published the form of a letter used by him in an investigation.[16]

There are a great many articles that are cited in footnotes to Art's excellent paper. A very good one is not there, an article written by Kathleen Gallagher[17] dealing with the situation post-*Upjohn*.[18] In *Upjohn*, the United States Supreme Court held that the corporation's attorney-client privilege will cover interviews by the corporate lawyer even with low level employees. Gallagher's article examines the question of what happens to the low level employee who has given information to the lawyer if the corporation decides for one reason or another to waive its privilege. Does that low level employee have any privilege? The answer seems to be no. There is no attorney-client relationship between the low level employee (or even the high level employee) and the investigating lawyer. So, Gallagher concludes, the employee is then left, in her words, "naked."[19] If the corporation wants to sacrifice up some of its people, then there's no attorney-client protection that that employee has. Gallagher recommends a system of warnings. She also suggests a modification of the privilege that would cover that person in some circumstances and makes other recommendations which she thinks would cause equity in the circumstances.

Prof. Shipman: Paul, I think the old *E.F. Hutton* case[20] from the Southern District of Texas should be mentioned as a relevant caveat to what you say. What you

16. Fedders, *Corporate Criminal Responsibility—Conducting an Internal Corporate Investigation*, 3 CRIM. DEF. TECHS. (MB) § 62.06[4] & n.33 (1979).

17. Gallagher, *Legal and Professional Responsibility of Corporate Counsel to Employees During an Internal Investigation for Corporate Misconduct*, 6 CORP. L. REV. 3 (1983).

18. Upjohn Co. v. United States, 449 U.S. 383 (1981).

19. Gallagher, *supra* note 17, at 6.

20. E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969).

say is absolutely right if you follow the Cox/*Miranda* procedure. If, however, that careful procedure is not followed and the employee reasonably believes that he is being represented along with the company, I would think the lawyer for the company probably also has the employee for a client and the employee (though not the lawyer necessarily) is fully clothed.[21]

Mr. Gonson: *E.F. Hutton* did hold that. An employee of E.F. Hutton was represented by Hutton's lawyers and reasonably thought the lawyer was representing him.

Let me indicate that Art is right in saying that in some circumstances, it's advantageous for the lawyer to represent both the corporation and several employees specifically to preserve the privilege *if*—and this is a major if—there is no conflict of interest or significant possibility of such a conflict developing.

Two other points and I shall conclude. First, something should be done about the waiver problem. It would be a splendid idea from the point of view of corporate governance principles generally if a corporation could investigate itself in good faith and then be able to go to the government (to the SEC or IRS, for example) and say: "We made an investigation and wish to reveal to you what we have found. We're willing to correct whatever we have to correct and make whatever amends we have to do." A corporation should be able to do that without waiving its confidentiality. At present, on these facts, grand juries and class action plaintiffs in many circuits can get the results of the investigation. In *Diversified Industries*,[22] discussed in Art's paper, confidentiality was given, but subsequent cases in other circuits (also discussed by Art)[23] have held, on similar facts, that if you give the results of the information to the government to show that you have cleaned up your act, you have waived for all time and all purposes. These harmful new developments also seem contrary to *Sells Engineering*,[24] which held that Rule 6(e) of the Federal Rules of Criminal Procedure requires that United States Attorneys presenting information to grand juries may not, generally speaking, give that information to civil attorneys in the federal government, even though the federal government may clearly have civil remedies in court. The situation today is thus quite odd and harmful: information developed in the grand jury investigation cannot, generally speaking, be turned over to the civil attorneys in government, but information generated voluntarily by a private corporation and turned over to the civil side of government can easily become available to the grand jury and everyone else. Legislative or other corrective action is needed to protect the usefulness of internal corporate investigations.

Second, the business judgment rule we discussed with reference to directors[25] should, in my opinion, be applied to lawyers who make internal corporate investigations. These lawyers make very difficult judgments. They ought not to be

21. However, a corporate officer seeking a personal attorney-client privilege for consultation with the corporation's counsel has a heavy burden. *See, e.g., In re* Grand Jury Proceedings, 434 F. Supp. 648 (E.D. Mich. 1977), *aff'd per curiam*, 570 F.2d 562 (6th Cir. 1978).

22. Diversified Indus., Inc. v. Meredith, 572 F.2d 606 (8th Cir. 1977) (en banc).

23. Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 668–69 (1984).

24. United States v. Sells Eng'g, Inc., 103 S. Ct. 3133 (1983).

25. *See* Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

judged with hindsight, for with somebody's demanding hindsight an actor is often wrong.

Prof. Shipman: Thank you, Paul. We have worked our way to some pivotal questions. We talked about confidentiality of reports. We talked about discretion of directors, the exercise of business judgment. We talked about the termination of derivative suits as the most controversial exercise of that discretion. This sends us into two cases, both decided in the State of New York, one by the New York Court of Appeals a number of years ago, the *Auerbach*[26] decision, and *Joy v. North*,[27] a recent Second Circuit diversity case ostensibly based on Connecticut law. *Joy v. North* orders the trial court, in at least some cases, to use its business judgment in reviewing a decision by a committee of independent directors of a corporation to recommend termination of derivative actions, and holds that the committee's filings with the court (which may contain a normally-privileged investigative report by special counsel) in support of the motion usually may not be kept under seal.

I want to ask Stu Summit, an ace litigator, his opinion of the effect of *Joy v. North* (and the Delaware decision on which it was partially based) upon the utility of having special counsel conduct an investigation and using counsel's report as a basis for the action of the board or a special committee of independent directors moving to dismiss a derivative suit. If the whole report becomes public and non-privileged, is the game worth the candle?

Mr. Summit: From a practical point of view, *Joy v. North* and the Delaware *Maldonado*[28] decision have the same effect, although their holdings and rationales differ somewhat.

Under these decisions, if you wish to rely on disinterested directors' determination that the particular derivative action then pending before a court should be dismissed because continuation of the action is not in the corporate interest, you must prove to some extent (not yet defined) that the determination itself was disinterested, was the result of full information in the possession of those disinterested persons who made it, *and* that the judgment is in fact correct. These two courts don't use the word "correct"—they take the high road and profess not to be second guessing directors—but the fact is that the moment you get trial lawyers in the courtroom whose goal is to have the court agree with a position or disagree with it, correctness becomes the issue, however the semantics are couched. That is, the court can say, "all I want to do is make sure that it is reasonable," but the lawyers are not going to merely set out to prove it's reasonable. The lawyers are going to set out to prove if it's right or wrong, because that's what we're trained to do. We're going to come in with everything we can, assuming the lawsuit is important. These two cases change the rules of the game. If you choose to rely on such an investigation and a decision by directors not involved in the alleged wrongs, you're going to have a trial, or at least a fact-finding decision of some sort, on whether or not the decision made by those in-

26. Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *see* Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, part VII at 673–78 (1984).

27. Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

28. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

dependent directors was sound, by one test or another. In the case of the Delaware court, they were quite clear that the judge is supposed to exercise his business judgment, which is in stark contrast with the classic rule of *Auerbach*,[29] where the New York Court of Appeals held that directors not affected by the litigation or transactions could, by following the proper procedure, make a business judgment decision with a finality that would not be reviewed on the merits by a court.

As a practical matter, these issues do not come up in baseless cases. If they do, somebody in my judgment is wasting a lot of time. It's really awfully elaborate to go about an internal investigation, which often creates its own problems. Plaintiff sues everybody, including otherwise disinterested directors. So right away, by the mechanistic rules that we use, directors are automatically alleged to be not disinterested even if they weren't really involved in the transaction at issue. You, therefore, have to go to a lot of trouble to get one of these disinterested director decisions. You have to take the high road. You don't use internal counsel. You don't use regular counsel. You use new counsel, who have to learn the names of the players and what the addresses are and the like. All this trouble to do what? To then try to prove to a judge that the disinterested directors were right. You're not going to do that for a baseless case, in my judgment. It's just as easy to prove the case is baseless and be done with it.

Where the question arises is in other kinds of cases, those that arguably have merit to them. A violation of law may have occurred, or maybe there is no argument about it: the facts *will* ultimately demonstrate that a violation of law has occurred. Now, remember, we're talking about derivative actions, and that's a special breed of case because they purport to be in the name of and for the benefit of the corporation. The business judgment issue in those cases—and it is a question of policy and judgment—is whether the present value of the possible judgment in favor of the corporation (discounted by time value of money, risks of failure or non-collection) exceeds the detrimental costs to the corporation in continuing the case. That is a value judgment. In my opinion, it cannot be quantified as *Joy v. North* suggests. If it looks like the corporation might recover $2,000,000 and the case is only going to cost $300,000 to try, well that initially appears to be a terrific bargain. If, however, you continue the litigation, the harm to the company and its current business may exceed $2,000,000 by reason of matters unrelated to the transaction in the lawsuit. Now, who can scientifically determine that? Well, we now know for sure that in the Second Circuit (under Connecticut or other law not clearly to the contrary) or in Delaware, it's the judges who will make such a determination. Why should they? They're not business people. They may have no way of appraising these intangibles, but there we are. I personally cannot envision the circumstance where I would recommend, under a *Joy v. North* rule of law, doing the internal investigation, having the disinterested directors make a business judgment, and then litigating about the correctness of the judgment. The baseless case can be handled on its substantive merits. In other cases, if you conduct an internal investigation *and* try to use it to back up a decision by

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29. Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

disinterested directors to terminate the litigation, you have only aided the plaintiffs. According to the Second Circuit, if you wish to rely on the report to try to dismiss the case, you must put the report forward with all supporting data and justify it with everything you can. After all that trouble and aid to the plaintiff, you then run the risk of having the court disagree with the recommendation of the report. How can you ask a judicial officer, whose whole being is directed toward curing violations of law and imposing retribution for violations of law, to approve a pragmatic decision to forego retribution for a violation of law as a sound result on the merits? Once judicial review goes beyond verifying the procedures used and testing the disinterestedness of directors, the result is most dicey.

But despite the problems Paul Gonson has mentioned and despite the problems of a *Joy v. North* rule, there will be times when an internal corporate investigation is clearly indicated. One of the reasons is because of the differing interests within the corporate constituency. We've talked of the corporation as if it were a single person. Typically, the reason internal corporate investigations take place, and should take place, is because there is a very great difference of interest between independent and other directors. Notwithstanding some of the academic skepticism of independent directors expressed this morning, we all have seen that when trouble starts or looks like it might, the independent directors (either through self-interest or simply being good people) do take the reins and do insist on finding out what the story is. And all of the problems aside, if an independent director wants to know what's happened over a period of time in a complicated fact picture, the internal corporate investigation is the way to go about it. Assuming an internal investigation is to be had, one of the major problems that has led to untoward consequences, in my judgment, is not having decided, early in the game, on a clear purpose for the corporate investigation or not sticking with that purpose. Typically, some people will decide at the beginning of an investigation that they do not want the result to be publicly available. They don't want to have to hand it over to SEC Enforcement. They don't want to publish the report. So they take every feasible step to ground the investigation in one or more privileges. And when you set out to do that, the odds are pretty good, if you do it right, of retaining the privilege. For example, instead of worrying about the interviewee being protected by a privilege, you give it to her: you have her counsel there; you say that everyone knows we're going to get sued about all this, but not to worry about conflict of interest because each of us has separate lawyers present; and you point to the joint defense privilege, which is recognized when there are two or more lawyers and two or more clients, all of whom could face litigation. So there are ways of going far to protect some kind of privilege. There are even ways of dealing with the auditors on the subject without delivering the report that has been prepared. Where the special counsel has to get involved with the audit and has to sign off on the audit, special counsel may sign off without delivering any specific information.

Prof. Shipman: How's that done, Stu? That is a very practical point.

Mr. Summit: In the one case I can mention, this was done: We sat in the room with the auditors and we went through, line by line, questions they had asked us. This was a highly sensitive situation; the company was obviously heading toward bankruptcy in the near future (which in fact came to pass), and the auditors raised sensitive

issues with us. We (speaking very generally) asked them if they had looked at certain areas. "Did you talk to so-and-so about such and such?" Without giving away the sensitive nature of a precise topic, we just kept talking. Both sides were very tentative and careful until both were satisfied that a thorough job had been done by the auditors. Even so, there was a notation by the auditors that the investigation was underway but it wasn't taken as an exception to the opinion.

Prof. Shipman: O.K. And you don't think there was a waiver? The auditors did note it in the footnotes?

Mr. Summit: Well, it was couched in a way that did not disclose our participation and no substantive information was conveyed to them. We recognized we were on difficult ground, and that someone might challenge the conclusion that the privilege was not waived, but we felt that we had to do what we did. We had to have the investigation going on on the one hand, and they had to get an audit out on the other.

To return to my major point, what you do not dare do, once you have decided to have a fully privileged investigation, is to change horses, because then you may have created at least a claim of privilege for interviewees. It's damn difficult to then decide, "All right, we're just voluntarily going to turn the report over lock, stock and barrel." A truly involuntary turnover is another matter, but I think some of the problems have come from people setting out down a privileged road and then ultimately realizing that they are in so much trouble that they had better go the other way and disgorge the information, leaving a very confused situation.

In any event, I think there are instances where internal corporate investigations are desirable, and with good attention to what you're doing and why, they can sometimes serve a useful result, at least for the uninvolved directors.

Prof. Shipman: Thank you very much. I did want someone who litigated a lot to speak. We've got to remember that many of these questions are tied into litigation.

Let's now focus on sensitive transactions. Suppose you as an independent counsel conduct an investigation and find that certain sensitive transactions have taken place; they are rather old and cold, and they are not material financially. I want to ask Art Mathews and the panel what the SEC *CitiCorp* Release[30] means in that context. Is the old doctrine—anything that touched on integrity of management was per se material—relegated to the history books?

Mr. Mathews: Let me not answer it just in the context of *CitiCorp*. Also, let me first comment on what Stu said. I agree with Stu on the efficacy of having interviewees represented by counsel and then having a joint defense privilege. I also might say that it often may be appropriate that the corporation pay the counsel fees for employees and officers, subject to whatever the state indemnification statutes and the corporate charter and bylaws provide. But one problem that you have to flag on the joint defense doctrine is that in most cirumstances either client can waive the privilege over the objection of the other. So don't go into a joint defense doctrine situation and think you've got guaranteed privilege, for whenever the two clients get at odds with each other, either client can waive.

30. *SEC CitiCorp Release*, SEC Exchange Act Release No. 82-19 (Mar. 5, 1982), discussed in Mathews, *Corporate Internal Investigations*, 45 Ohio St. L.J. 655, 698-99 (1984).

Mr. Summit: Actually, most cases agree with Art, but there are a few that go the totally opposite way—that *neither* client can disclose without the consent of the other, but both rules pose the equivalent practical problem, that is, you'd damn well better know what you're doing when you get into it.

I don't want to be misunderstood. I would never claim, and never have claimed, that the *information* a witness or party has is subject to a privilege that a lawyer for someone else controls. It is that the *particular communication* of the information that (depending on which way the cases go and what each party wants to do) may be subject to the joint defense privilege. What the person witnessed and was part of some years before is never itself subject to that privilege. Sometimes that aspect of the joint defense privilege gets misinterpreted by people.

Mr. Mathews: Let me, if I may, answer Morgan's question on how you determine whether you have to disclose what you found. I think that the *CitiCorp* Release, which is summarized in my paper, is probably of no help at all. I think it ought not to be relied on. I think that that was one of those cases that was stale and was a hot potato within the agency, and I don't think the release actually stands for anything. When you have to go for guidance (and it's not definitive guidance, but it gives direction), go to John Fedders' speech that he gave to the ABA in November, 1982.[31] He took a substantial step back from some of the things that I think Stanley was pushing (when Stanley was running the enforcement program) in the areas of "integrity theories" of materiality for disclosure purposes. According to Fedders, there are four areas in which something may be material. One is the traditional quantitative financial materiality. That has been traditional for fifty years. Two is self-dealing; even if it's not quantitatively material, if the managers are dipping into the cookie jar and getting kickbacks or the like, self-dealing has to be disclosed. Three, if there is a particular SEC form that requires an item response—either under the proxy rules, 8–K's, 10–K's, 10–Q's, or anything else—if the Commission has asked for a particular line item disclosure, you must respond and disclose even though it's not financially material. Four, a false statement in filings is material. When you do say something in a filing, it's got to be correct and you cannot fail to disclose something that would make whatever you said merely a half-truth. But the important thing is (and this is the step back from where the law was at least in the enforcement context, I believe, when Stanley left the Commission) that Fedders said that unadjudicated misconduct that does not rise to the level of any of these four points for judging materality is not material. The present Shad-Fedders SEC is taking the viewpoint that they will not require mere unadjudicated conduct (aside from self-dealing) to be disclosed on an integrity of management, integrity of earnings, or integrity of assets theory. And somewhat along that line, Commissioner Bevis Longstreth has written a recent *Business Lawyer* article.[32] If you combine the Longstreth *Business Lawyer* article and the Fedders speech, you get some guidance. However, the Fedders speech is only an enforcement policy speech as to whom the SEC is going

31. Speech by John Fedders on Failure to Disclose Illegal Conduct, 14 SEC. REG. & L. REP. (BNA) 2057 (Nov. 26, 1982).

32. Longstreth, *SEC Disclosure Policy Regarding Management Integrity*, 38 BUS. LAW. 1413 (1983).

to sue. It does not bind a prosecutor or a judge. I'd be interested, Stanley, if you'd have any comment on the fifth element in the Fedders speech, that for unadjudicated violations that don't trigger the first four concepts, the SEC won't bring enforcement actions.

Mr. Sporkin: Well, now that I'm on the other side, I'll take all the crumbs that I can get. But I think the Fedders language is a little too sweeping. If you literally state that an unadjudicated violation is not required to be disclosed, in many instances the SEC will be put out of business. It can't sit around and wait four years until something is adjudicated. Mr. Schwartz mentioned that one of his clients came in and said he had all of these financial disclosure problems. Well, are you going to wait until it becomes adjudicated before you disclose it? Under the securities laws, the corporate issuer has a responsibility to make disclosures. The issuer knows the facts. It knows whether they have assets or they don't have assets. It knows whether there's been a defalcation or there hasn't been a defalcation. And I don't think I can take much comfort if I'm going to be advising a client on a disclosure problem to say, "Well, wait a second; how do we know we must disclose? No court has determined whether it's required and no court has determined whether the financial statements are out of whack." I don't think the Fedders language is realistic. I regret that I must disagree with the Fedders statement if it's meant to be literal, but I don't think it washes.

Prof. Shipman: Stanley Sporkin, a question for you. On the initial investigation, does the attorney have the duty to opine at the end of her or his investigation concerning whether the corrective SEC-IRS filings have to be made? This is a hot potato. You've investigated and established the facts. Is it your duty at that point to say in your opinion that no corrective SEC filings are needed? Or the opposite, if the opposite is true?

Mr. Sporkin: That, of course, Morgan, is very difficult to answer in isolation. Obviously, you want to know what is the retainer arrangement? What were you asked to do? Were you asked to go in and find the facts and to report back the facts and then Mr. Schwartz was going to take over from there as counsel for the company? Then I think your obligations may be a little less broad than they would be otherwise. Now suppose that your retainer isn't so limited. Part of the retainer was to recommend a course of action. You come in at the end and you say the recommendation we make is that you revise your 10–K. Assume that you get to a high level in the corporation and assume that they don't want to accede to your advice. I would not say that you would have an obligation to go to the SEC or the authorities.[33] If, however, you are then retained a month or two later to help prepare a registration statement, then of course you would have a responsibility of making sure there had been full disclosure. It's a difficult thing, Morgan, and I don't know if anybody else has any thoughts.

Prof. Shipman: I agree with everything you've said, Stanley. I think the one thing I want to flag is one part of the *In re John Doe* opinion[34] where the court, in finding a prima facie case of cover-up and conspiracy, found that the lawyer wrote

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33. *See, e.g., In re* Carter and Johnson, Exchange Act Release 17597, FED. SEC. L. REP. (CCH) ¶ 82,847 (1981).

34. *In re* John Doe Corp., 675 F.2d 482 (2d Cir. 1982), discussed in Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 680–92 (1984).

the report, covered everything he investigated, and called it the way he saw it except for the one crucial item that didn't show up in the final copy of the report. The court continued by saying that the client used the report to its advantage by showing it to the underwriter and to the auditor and the fact that the client gave it to somebody else and had them rely on it connoted that it was an entire job. So I guess what I come back to, Stanley, is that it may well be that if only some things are disclosed in the report and if the corporation tries to use the report to its advantage for only the things that were disclosed, the lawyer and the company are going to be in trouble.

Mr. Summit: In which case, you darn well better say what's happened. Which can be done. You can have a section saying we investigated claims involving thus and so (no names, no dates, no nothing) and that because we were unable to unearth evidence sufficient to justify mentioning them in this report, they are omitted. We could spend the whole day on how to write the report. What was done by the lawyer in *In re John Doe* was a terribly dangerous thing to do.

Mr. Gonson: Stu, there's a difficulty with that too. The *Sealed Case* opinion[35] that Art has referred to a number of times is interesting, because there the grand jury was not looking into, as I understand it, alleged substantive violations. It was looking into what are essentially alleged obstruction of justice violations. The report that was filed there said that the lawyers were aware of a $400,000 payment to a Mr. *X* and could not find sufficient evidentiary basis to understand why it was made. And then the prosecutor shows up with an affidavit from Mr. *X*, saying, "Well, I paid the money . . . and the chairman was with me when I did it." The chairman had said that he didn't know of any attempted bribes overseas. And so the D.C. Circuit held that the prosecutor had shown a sufficient prima facie justification to get that report, because the report fudged and didn't show what the payment was about and because there was some evidence to indicate that in fact there may have been a crime. But the fascination to me still is that, at least as articulated in the opinion, what the grand jury was looking into was not the substantive violation but rather the alleged obstruction of justice aspect of it.

Mr. Mathews: Paul, the other thing that the court relied upon was that the special counsel never tried to interview *X* and did not disclose that fact. The report said that they couldn't prove that it was an illegal payment, but they never said that they didn't interview the one person who allegedly would have told them it was an illegal payment.

Mr. Gonson: I wish to comment on Morgan's question whether the lawyer should opine on legally required remedial steps. The three-judge panel in *Diversified Industries*[36] held that the attorney-client privilege would not apply to the investigation there conducted because the lawyers were not engaging in legal activity: they were merely factfinders, and anybody can investigate. The en banc opinion in *Diversified Industries*[37] disagreed with that. They said that the skills of a lawyer are brought to a

35. *In re* Sealed Case, 676 F.2d 793 (D.C. Cir. 1982), discussed in Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 692–98 (1984).

36. Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977), *rev'd*, 572 F.2d 606 (8th Cir. 1977) (en banc).

37. Diversified Indus., Inc. v. Meredith, 572 F.2d 606 (8th Cir. 1977) (en banc).

factual investigation. However, it then became standard practice for the lawyer who makes the investigation to give legal advice because it adds to the aura, if you will, of lawyers' work. And so, lawyers customarily do give legal advice. The Fedders article draws the line between legal advice and business advice. And sometimes that shades pretty much. In the SEC area we talk about materiality—that's really legal advice, I guess; but in some other areas of the law (antitrust, food and drug, pollution) you shade into business judgments and every lawyer should be awfully careful not to cross that line and give business advice rather than legal advice.

Mr. Mathews: Morgan, may I make one comment? I have recently been involved in reading all of the cases on the attorney-client and work product privilege in internal investigations, not only for this paper, but also for a separate paper on those specific issues.[38] I'm not a hundred percent sure where I am coming out, but I'm almost sure that, based on reading all the cases mentioned in my paper delivered here, that it's impossible in my tough case to preserve the confidentiality of the investigative work product by either the attorney-client privilege or the work product privilege, and it's too great a risk. And I think where I'm coming out is that at present, I don't think there will ever be any way to have one hundred percent assurance that you can protect the investigative work product. By legislation or by ad hoc judicial development, an internal investigation self-evaluative privilege[39] may be developed along the lines Paul advocated, but that would be apart from the attorney-client and work product privileges.

Prof. Buxbaum:[40] I perceive a shift in focus over time. The internal corporate investigation originally resulted from a deal with the SEC wherein the special counsel was, directly or indirectly, doing the SEC's job of a public housecleaning. Now, the focus seems to be upon an internal corporate investigation to avoid governmental scrutiny or a derivative action—to avoid, if you will, public housecleaning. Has such a shift happened and is it healthy?

Mr. Summit: You're quite right, to the extent to which you are addressing that question to some points I made. Your points are entirely correct and I tried to be clear about that at the time. If you set out to do a confidential investigation for the benefit of the board and/or the independent directors in their conduct of the business affairs of the company (who should stay, who should go, what lawsuits they may have, or the like) and the report is clothed that way, you can't reasonably expect to forestall the SEC or anybody else. You are not doing their job and you are not helping them specifically.

Prof. Shipman: What about where you contract with the SEC? Does the nature of that change?

Mr. Summit: I don't think so. No. And the in between is where you are conducting the investigation. You know the SEC will want you to do it (hoping you have

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38. *See* Crisman and Mathews, *Limited Waiver of Attorney-Client Privilege and Work-Product Doctrine In Internal Corporate Investigations: An Emerging Corporate "Self-Evaluative" Privilege*, 21 AM. CRIM. L. REV. 123 (1983).

39. *See, e.g.*, Comment, *The Attorney-Client Privilege, The Self-Evaluative Report Privilege, and* Diversified Indus., Inc. v. Meredith, 40 OHIO ST. L.J. 699 (1979) and other authorities cited in Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 669 nn. 76–77 (1984).

40. Richard M. Buxbaum, Professor of Law, University of California, Berkeley.

done it well); and you take the report to them, hoping that with their limited resources, the SEC will say the report will do, even if it is not exactly what the SEC would have done.

Mr. Mathews: The problem arises because most of the circuits have rejected the limited waiver of privilege theory.[41] Thus, the company can't do the investigation and share it with the SEC the way they're usually willing to do if there were a universal limited waiver rule. As it is, when the company shares the report with the SEC, the company risks giving the report to its adversary in class and derivative actions. And the lack of any general self-evaluative privilege has aggravated that problem. That's the dilemma.

If anyone thinks that they're going to do a less than adequate investigation, just review the *Textron*[42] case. An inadequate, quick investigation can cause more problems than it cures.

Mr. Gonson: This is a corporate governance program. It's interesting to see the parallel development between internal corporate investigations and peer review in the accounting profession. In the early 1970's, sort of in tandem with the development of the internal investigations by corporate America, the SEC was bringing a fairly large number of disciplinary proceedings against large accounting firms. In the past, the SEC had invoked discipline such as suspension upon individual accountants, or in some cases, firms for a limited period of time. It shifted gears dramatically in the early 1970's and entered into settlements whereby the accountants would in effect investigate themselves—try to clean up their act and try to identify the kinds of practices that got them into difficulty with the Commission. That became known as peer review, because the way that was done was accounting firm A would hire accounting firm B to review its practices and procedures. Eventually, that became institutionalized. The AICPA restructured itself and set up a public company group. Peer review is now a recognized institution in major accounting firm practices. And that I think, is an interesting illustration of how informal ad hoc practices become institutions.

Prof. Shipman: Any other questions from the audience? Hearing no questions, I want to thank all of you very much for attending, and I declare the Conference over, one minute early.

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41. *See* Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 669 (1984); *see also* Crisman & Mathews, *Limited Waiver of Attorney-Client Privilege and Work-Product Doctrine in Internal Corporate Investigations: An Emerging Corporate "Self-Evaluative" Privilege*, 21 AM. CRIM. L. REV. 123 (1983).

42. *See Textron Settles SEC Antifraud, Reporting Charges Based on Foreign, Domestic Questionable Payments*, [Jan.-June] SEC. REG. & L. REP. (BNA) No. 539, at A-2 (Feb. 6, 1980).