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HANDLING A CORPORATE CRISIS: THE TEN COMMANDMENTS OF CRISIS MANAGEMENT

In today's climate, securities and financial firms are likely to face some enforcement proceeding that creates a situation fraught with potential pitfalls. The author discusses ten prescriptions for handling these situations well, including the importance of detailed advance planning, management of public statements, cooperation with the government, resisting the urge to discipline early, and, when the smoke clears, learning from the crisis.

By John F. Savarese *

The financial crisis and economic downturn that began in 2008 and is, in some respects, still unfolding, prompted virtually every federal government regulator (and many state authorities) to launch inquiries, issue subpoenas, and look for answers (or scapegoats, depending on your perspective). The consequences of this wave of investigations have been dramatic: in fiscal year 2010 alone, the Department of Justice (DOJ) collected over $3 billion in judgments and penalties in criminal matters;[1] the Securities Exchange Commission (SEC) obtained over $1 billion in penalties and commenced 681 enforcement actions;[2] and Congress, not to be outdone, created the Financial Crisis Inquiry Commission, which held 19 days of hearings on the subject.[3] Separately, at least seven congressional committees and subcommittees held hearings generally focused on the financial crisis during the past year.[4]

Each of these kinds of inquiries, if aimed at your company, represents a potential corporate crisis, and, at least for those inclined to look for silver linings within storm clouds, an opportunity. If handled well, your

[1] Press Release, Dep't of Justice, Department of Justice Secures More than $2 Billion in Judgments and Settlements as a Result of Enforcement Actions Led by the Criminal Division (Jan. 21, 2011).

[2] *Select SEC and Market Data*, Fiscal 2010, *available at* www.sec.gov/about/secstats2010.pdf

[3] Press Release, FCIC, Financial Crisis Inquiry Commission Releases Additional Material and Concludes Work (Feb. 10, 2011).

[4] Press Release, U.S. Senate Committee on Homeland Security and Government Affairs, Senate Subcommittee Launches Series of Hearings on Wall Street and the Financial Crisis (April 12, 2010); Equipping Financial Regulators with the Tools Necessary to Monitor Systemic Risk: Hearing Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (2010); Investigating and Prosecuting Financial Fraud after the Fraud Enforcement and Recovery Act: Hearing Before the U.S. Senate Committee on the Judiciary (2010); Stock Market Plunge: What Happened and What is Next?: Hearing Before the U.S. House Committee on Financial Services (2010).

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company can emerge in one piece, with any flawed procedures and systems corrected, a corporate reputation on the mend, and operations still intact. But, if handled badly, a company can teeter on the brink of failure, lose important customers and personnel, and suffer enormous financial costs as well as reputational harm.

This article identifies 10 prescriptions that, if implemented effectively, will contribute to a corporation's winding up at the better end of this range of outcomes.

1. THE BOYS SCOUTS KNOW IT: BE PREPARED

There are two levels of preparation necessary in order for a firm to successfully weather a crisis. The first level might better be described as crisis prevention. This involves, among other things, a general review of the adequacy of the firm's compliance and information and control systems. When they function effectively, they should reduce the occurrence of unplanned disasters and facilitate the mitigation of the effects of those that can't be prevented.

As is well known, every firm should have in place established standards of conduct, and control and information reporting processes that allow management reasonably to conclude that the firm is operating within the law and under management control.[5] Under the landmark *Caremark* decision, directors have an obligation to satisfy themselves that the risk management processes designed and implemented by the company's managers are consistent with the company's corporate strategy and are functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision-making throughout the organization. Setting the appropriate "tone at the top" and instilling a culture of compliance and "no surprises" are the keys to fostering ethical and controlled behavior and minimizing crises brought about by improper or poorly controlled conduct. In a recent speech, the United States Attorney for the Southern District of New York emphasized that "the best-conceived compliance programs, and practices and policies in the world will be too weak to stave off scandal if the core principles are not internalized, if there is not from the top a daily drumbeat for integrity."[6]

Communicating a true commitment to compliance with policies, procedures, and training, and establishing ways for employees to report issues and concerns (*e.g.,* through an employee hot line) can also help prevent a crisis. Often, crises are not really surprises but are a product of longstanding unethical behavior that has been tolerated by the business leadership and accompanied by rationalizations, such as "everyone does it this way." Proper supervision and having a mechanism in place for employees (or even members of the public) to raise concerns about wrongful or questionable conduct can help surface potential problems early and avoid serious problems.[7] In this rapidly changing economic and

[5] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A. 2d 959, 970 (Del. Ch. 1996) (board of directors has a duty to attempt in good faith to "assure that a corporate information and reporting system, which the board concludes is adequate, exists."); *Stone ex. Rel. AmSouth Bancorporation v. Ritter,* 911 A. 2d 362, 364 (Del. 2006) (confirming that *Caremark* set forth the appropriate standard for director liability concerning compliance issues: directors will be liable if there is "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists.").

[6] Jaclyn Jaeger, *CW 2011: Enforcers Talk Ethics, and Talk Details*, Compliance Week (June 1, 2011); *see also* Benjamin W. Heineman, Jr., *Goldman Sachs: Being "Legal" Doesn't Make it "Right,*" HLS Forum on Corporate Governance and Financial Regulation (April 27, 2010) ("Great companies have to distinguish between what is legal and what is right.").

[7] Under the Federal Sentencing Guidelines for Organizations, companies that have an "effective compliance and ethics program" may qualify for a reduction in their culpability score. §8C2.5(f). Among the requirements identified in the Guidelines is "to have and publicize a system whereby the Company's employees and agents may report … potential or actual criminal conduct without fear of retaliation." §8B2.1. Similarly, the Principles of Federal Prosecution of Business Organizations (§ 9-28.800 of the U.S. Attorneys' Manual) identify, as a factor prosecutors should consider, whether the directors have established "an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law."

The SEC also considers whether a company has established a mechanism for employee reporting in its evaluation of

enforcement environment, all firms should consider whether any enhancements to their policies, procedures, and controls are appropriate.

As is discussed more fully below, the second level of preparation involves getting ready to deal effectively with a crisis when it arises. In today's business environment, a crisis – particularly for securities and financial firms – may seem almost inevitable. But, there are many different kinds of crises, and, as noted above, some can pose a serious threat to a firm's reputation and even survival. Investing the time and resources in detailed advance planning can make a real difference with respect to how a company weathers a crisis. The considerations set forth below should be helpful, but, of course, any advice must be applied thoughtfully, in light of the specific issues raised by the particular matter.

2. WHILE EVERY CRISIS IS UNIQUE, ADVANCE PLANNINGCAN MAKE A HUGE DIFFERENCE

All crises are unique and inevitably raise complex and often unforeseen issues. Thus, there is no single template for a crisis response that will assure that injury will be avoided or minimized. Custom tailoring, not off-the-rack efficiency, is the best prescription. However, there are certain similarities and predictable patterns in the way most crises unfold. Advance planning may give a firm more time to maneuver when a crisis erupts, and more time to focus on the wholly unexpected details.

Preplanning and the exercise of sound judgment are critical.[8] Many crises can be anticipated, at least generally. Rules and strategies should be thought through ahead of time, to the extent possible, for each kind of anticipatable crisis, including, for example: financial fraud or serious accounting problems; criminal or regulatory investigations; significant lawsuits or judgments – *e.g.,* punitive damage awards; discrimination judgments; failures to comply with legal regulations and/or fiduciary duties; or accidents or natural disasters.

The first critical step is to establish core crisis teams for each foreseeable type of crisis. The team should include corporate leadership and high-level representatives from operations and technology, the finance department, media relations, investor relations, the risk and compliance function, and the legal department. Project-specific specialists should also be included, such as accountants. The company should also have outside counsel who have experience and credibility with regulators and/or prosecutors, to handle internal investigations that must be conducted.

The crisis teams should stay prepared and alert. Once teams are identified, they should meet periodically to assess their readiness to react. The goal is to have a plan in place that assigns specific roles to each team member in case a crisis occurs. Advisors must be senior enough and experienced enough to deal with the CEO and board effectively. An up-to-date "war list" should be created, with contact information for all key participants.

Firms should take the opportunity to consult with outside counsel and other advisors during "peacetime." It is important to keep an eye on relevant legal and business trends in an effort to anticipate areas of likely crisis. While it may be impossible to predict the actual nature or timing of a crisis, a firm may still be able to be better prepared by keeping tabs on applicable legal developments affecting competitors.

For example, from time to time, both the SEC and DOJ initiate industry-wide investigations. Most recently, the SEC has reportedly begun investigating accounting firms concerning their audits of Chinese companies whose shares trade in the United States.[9] Also, very recently, it was reported that the SEC has been seeking information from numerous financial institutions with respect to their relationships with sovereign wealth funds; as part of this inquiry, the SEC is examining whether such firms made improper payments in soliciting investments from those funds in violation of the Foreign Corrupt Practices Act.[10] In February 2011, DOJ announced that the Medicare Strike Force had charged over 100 defendants in the largest-

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cooperation. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions,* SEC Rel. No. 34-44969 (Oct. 23, 2001); *see also* Jaclyn Jaeger*, Fraud Reporting Near Record Levels,* Compliance Week (May 24, 2011) (rise of fraud reporting highlights need for companies to develop mechanisms such as an anonymous reporting channel, allowing fraud to be detected earlier).

[8] *See generally,* Martin Lipton, Steven A. Rosenblum and Karessa L. Cain, *Some Thoughts for Boards of Directors in 2010*, Bank and Corporate Governance Law Reporter (April 2010).

[9] Michael Rapoport, *Auditors Facing 'Reverse' Inquiry*, Wall St. J. (June 3, 2011).

[10] Dionne Searcey and Randall Smith, *SEC Probes Banks, Buyout Shops Over Dealings With Sovereign Funds*, Wall St. J. (Jan. 14, 2011).

ever federal health care fraud sweep.[11] Such investigations have also targeted, in the past, gas and oil companies relating to their use of freight forwarders, the use of placement agents in soliciting business with public pension funds, pharmaceutical companies in connection with both illegal payments to health officials overseas and promoting drugs for uses not approved by the FDA, and newspaper publishers concerning their reporting of circulation figures.[12]

The SEC has made clear that more such "sweeps" are on the horizon. For example, when the SEC announced FCPA settlements with Panalpina, Inc. and six other companies in the oil services industry that were alleged to have been engaged in a widespread bribery scheme involving customs officials, the chief of the SEC's FCPA unit noted "the FCPA Unit will continue to focus on industry-wide sweeps, and no industry is immune from investigation."[13]

As part of their readiness preparation, corporate crisis teams should monitor press reports of actual crises that have affected relevant industries to determine whether and to what extent the same issues may apply to their own firm, and to evaluate how the firm would have responded to a similar problem. Recent insider trading prosecutions implicating the use of expert networks by hedge funds, for example, should trigger a review by comparable firms of their reliance, if any, on such networks.[14] Similarly, when pharmaceutical companies were targeted by the government concerning the marketing of off-label use of certain drugs, every firm in the pharmaceutical industry should have been carefully reviewing its own practices.[15]

[11] Press Release, Dep't of Justice, Medicare Fraud Strike Force Charges 111 Individuals for More Than $225 Million in False Billing and Expands Operations to Two Additional Cities (Feb. 17, 2011).

[12] *E.g.*, David B. Wilkerson, *Gannett Confirms SEC Contact*, MarketWatch (Oct. 13, 2004); David Evans, *Big Pharma's Crime Spree,* Bloomberg (Nov. 10, 2009); Gardiner Harris and Natasha Singer, *U.S. Inquiry of Drug Makers is Widened*, N.Y. Times (Aug. 13, 2010).

[13] Press Release, SEC, SEC Charges Seven Oil Services and Freight Forwarding Companies for Widespread Bribery of Customs Officials (Nov. 4, 2010).

[14] *E.g.*, Evelyn M. Rusli, *Hardball Tactics Against Insider Trading: Next Up: A Crackdown on Outside-Expert Firms,* N.Y. Times (May 12, 2011).

[15] *E.g.*, Press Release, Dep't of Justice, Pharmaceutical Companies to Pay $214.5 Million to Resolve Allegations of Off-label Promotion of Zonegran (Dec. 15, 2010); Press Release, Dep't of Justice, Eli Lilly and Company Agrees to Pay

3. BEGINNINGS ARE AS IMPORTANT AS ENDINGS

The outset of a crisis is when proper preparation will pay off. Once a crisis actually occurs, the pertinent crisis team can be assembled immediately without losing valuable time.

It will be critical to get at the facts quickly and find out as much as possible about the situation in a short time frame. Most often, lawyers will be asked to oversee the factual investigation. Senior management's grasp of the relevant facts should be assessed quickly by the investigative team. Often, management's knowledge will be lacking, but with some frequency there is a belief that the facts are clear when they are not. Thus, it will almost always be necessary for the lawyers to interview employees at all levels in the company's hierarchy to understand the facts leading up to the crisis.[16]

The firm should immediately focus on document retention and retrieval programs. With any crisis involving regulators and prosecutors, the universe of relevant documents must be identified and preserved. The failure to properly preserve documents and to timely produce them can result in severe sanctions that may seriously undermine a company's ability to defend itself in court.[17] It will be important for the firm to retrieve

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$1.415 Billion to Resolve Allegations of Off-label Promotion of Zyprexa (Jan. 15, 2009).

[16] *Upjohn Co. v. United States*, 449 U.S. 383, 386 (1981) ("Middle level – and indeed lower-level – employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that these employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties."). Care must be used in conducting such interviews. *See, e.g.*, *U.S. v. Ruehle,* 583 F. 3d 600 (9th Cir. 2009) (outside lawyers criticized for their failure to clarify exactly whom they represented and to document that appropriate warnings were given). Moreover, in a recent speech, SEC Enforcement Director Khuzami noted that the SEC is concerned about "questionable investigative tactics" by defense counsel, including interviewing multiple witnesses at once, and warned that the SEC would use all the tools at its disposal in situations where counsel's conduct "appears to cross the line from aggressive practice to unethical or obstructive behavior." Robert S. Khuzami, Remarks to Criminal Law Group of the UJA-Federation of New York (June 1, 2011).

[17] §802 of the Sarbanes-Oxley Act amended the federal criminal code to add 18 U.S.C. § 1519 (obstruction, alteration, or falsification of records in federal investigations and bankruptcy) and 18 U.S.C. § 1520 (destruction of corporate

documents quickly and efficiently, both to understand the facts and to satisfy external requests for information. It will similarly be important to be able to fully document what steps have been taken.[18] IT specialists should be consulted concerning servers, archives, back-up tapes, hard-drives, etc. Missteps with document retention and gathering can make a crisis substantially more serious and occasionally will cause more problems than whatever precipitated the initial crisis.[19]

Events may require prompt action, but it is important to make an effort to take sufficient time for real deliberations before acting; things are often not as time-sensitive as the smell of smoke makes them seem.

It is also important to communicate effectively with the board of directors, and, in particular, the Audit Committee, which is often given principal responsibility to oversee the handling of these types of crises. The board should be assured that a team is in place and informed about next steps. Interim updates should be provided as the crisis unfolds. Beware of over-engagement by the board, however. Unless the CEO and senior management team are critically compromised by the nature of the crisis, the board (or whichever committee is delegated responsibility by the board) should be kept advised in a timely way but normally should allow management to design and direct a response. On occasion, a committee of the board should be appointed to oversee an investigation and/or "independent counsel" should be brought in.[20] However, boards should be careful about overreacting and losing control of the situation to outside lawyers, accountants, and other experts. The proliferation of independent investigations by special committees, each with its own set of advisors, can be distracting and time-consuming, and, in extreme cases, result in lawyers for the special committee hijacking the company and monopolizing the attention of directors and senior management.

4. SPEAK WITH ONE VOICE

The company should try to avoid communicating mixed or inconsistent messages and every effort should be made to speak with one voice. There will be numerous constituencies who will want to be kept informed (e.g., employees, shareholders, creditors, business partners, government prosecutors and regulators, and the public). Firms should try to assess what issues will be of particular interest to each constituency, and what responses will reasonably satisfy them that the crisis is being managed properly and that their interests are being protected. Planning ahead for how communications will be handled in the event of a crisis is critical.

Speak with a single, trained voice. There should be a predesignated spokesperson or control group authorized to deliver the public message. Public relations professionals, working under the auspices of the lawyers, can be helpful. Consider involving public relations professionals early on to set the right tone.[21]

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audit records). *See generally,* A. Benjamin Spencer, *The Preservation Obligation: Regulating and Sanctioning Prelitigation Spoliation in Federal Court*, 49 Fordham Law Review 2005 (2011); s*ee also* Beryl A. Howell*, The Slippery Slope From Spoliation to Obstruction,* N.Y.L.J. (July 27, 2006).

[18] *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Securities*, 685 F. Supp. 2d 456, 465-66 (S.D.N.Y. 2010) (noting that "the failure to issue a *written* litigation hold constitutes gross negligence because that failure is likely to result in destruction of relevant information" and imposing sanctions where parties' careless collection efforts resulted in loss or destruction of evidence).

[19] *E.g.*, *Arthur Andersen LLP v. U.S.*, 544 U.S. 696 (2005) (prosecution of accounting firm for obstruction of justice while SEC and DOJ were conducting an accounting fraud investigation aimed at an audit client of the firm); *United States v. Frank Quattrone*, 441 F. 3d 153 (2d Cir. 2006) (Quattrone charged with obstruction after documents were destroyed during SEC and regulatory investigations into firm's underwriting of initial public offerings).

[20] *E.g.*, *Zapata Corp. v. Maldonado*, 430 A. 2d 779 (Del. 1981) (Special Litigation Committee composed of disinterested and independent directors can be empowered by the board to evaluate whether the prosecution of derivative claims is in the best interests of the company.); Lawrence J. Fox, *The Special Litigation Committee Investigation: No Undertaking for the Faint of Heart,* Internal Corporate Investigations, McNeil and Brian, eds., 3rd edition (2007).

[21] Communications with public relations professionals, if handled properly, may be protected by the attorney-client privilege. The privilege has been held to protect communications involving third parties when that party is the agent of the client or attorney and is necessary to assist the attorney in the representation. *U.S. v. Kovel*, 296 F. 2d 918 (2d Cir. 1961). This doctrine has been held to apply to public relations specialists, among others. *In re Grand Jury Subpoenas*, 265 F. Supp. 2d 321, 327 (S.D.N.Y. 2003) (holding that the attorney-client privilege covers communications involving public relations consultant assisting lawyer representing target of criminal inquiry); *but see Calvin Klein Trademark Trust v. Wachner,* 198 F.R.D. 53, 55 (S.D.N.Y. 2000)(finding no

Always assess the likely effect of a public statement on all constituencies, but especially on the government prosecutors and regulators involved. In a criminal or regulatory investigation, they will often be the firm's most important audience.

Government attorneys can be expected to closely scrutinize all public statements made on behalf of the company once an investigation is underway, and they are likely to be critical of any statements they view as unduly optimistic or that minimize the significance of the investigation. For example, when Lucent Technologies settled an accounting fraud action with the SEC, the agency imposed an additional $25 million penalty for the company's "lack of cooperation." The SEC cited public statements denying the wrongdoing that were made by Lucent's counsel as one of the factors giving rise to the additional penalties. The release explained:

> After reaching an agreement in principle with the staff to settle the case, Lucent's former Chairman/CEO and outside counsel agreed to an interview with Fortune magazine. During the interview, Lucent's counsel characterized Lucent's fraudulent booking of the $125 million software pool agreement between Lucent and Winstar as a "failure of communication" thus denying that an accounting fraud had occurred. Lucent's statements were made after Lucent had agreed in principle to settle this case without admitting or denying the allegations concerning, among other things, the Winstar transaction. Lucent's public statements undermined both the spirit and letter of its agreement in principle with the staff.[22]

While the CEO may wish to appear quickly or immediately knowledgeable and in control, it may be better to leave communications in other hands, at least until all of the facts and plans of action are clear. Any message can include the fact that senior management is being fully informed and is staying closely involved with the investigation and its resolution.

An understanding of the facts will likely evolve over time and may even change dramatically as an internal review progresses. Publicly committing the firm to a definitive position at the outset of an investigation can be treacherous. It is especially risky to deny wrongdoing at an early stage before you are highly confident of the facts supporting your position. Such a denial may not only jeopardize relations with prosecutors and regulators, but can easily undermine the credibility of the firm's internal review and may be viewed by the government as an attempt to mislead the public. The SEC has taken boards of directors to task for public statements that it found to be inadequate in hindsight.[23] The instinctive "apology" can be equally dangerous. Any premature institutional admission of wrongdoing is likely to be immediately accepted as valid by the government, and the firm will find it difficult to backtrack, even if exculpatory facts later emerge. As a result, any ill-considered public statements from the firm about the merits of the matter can seriously threaten the firm's ability to negotiate a favorable disposition with prosecutors and/or regulators.

5. STOP ANY BAD PRACTICES AS SOON AS POSSIBLE

Any illegal activities should be stopped as soon as the firm learns about them. It is important to promptly address whatever problem seems to be precipitating the crisis. It will not get easier to change practice as time goes on. In what may be one of the most extreme examples of the consequences that can follow a company's failure to eliminate the wrongful conduct, Stolt-Nielsen was indicted on antitrust and conspiracy charges two years after entering into an amnesty agreement with DOJ in connection with its role in an

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privilege where PR firm's work simply involved assisting "counsel in assessing the probable public reaction to various strategic alternatives, as opposed to enabling counsel to understand aspects of the client's own communications that could not otherwise be appreciated in the rendering of legal advice"). It is critical in any event to properly document the relationship, and establish that the engaged public relations firm's expertise is necessary to assist the law firm in providing legal advice to a company navigating through such a crisis, in order to preserve the privilege.

[22] Press Release, SEC, Lucent Settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud (May 17, 2004).

[23] *In the Matter of Cooper Companies Inc.*, Exchange Act Rel. No. 35082 (Dec. 12, 1994) (corporate directors have responsibility to safeguard the integrity of a company's public statements); *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.,* Exchange Act Rel. No. 39157 (Sept. 30, 1997) ("If an officer or director knows or should know that his or her company's statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure.").

international parcel tanker shipping cartel. DOJ revoked the agreement and indicted the company after it learned from other sources that top Stolt-Nielson executives had continued to participate in the conspiracy for months after the scheme's discovery.[24] The company's leniency had been predicated on a number of representations, including that it "took prompt and effective action to terminate its part in the anticompetitive activity."

6. TRY TO MAKE GOVERNMENT REGULATORS YOUR FRIEND – BUT BE CAREFUL OF THE FIRST DATE

Maintaining credibility with regulators and prosecutors is critical. The firm's relationship with regulators will not begin with the onset of a crisis. Long-term investment in a reputation for integrity and compliance should provide a reservoir of good will which may help at a critical time.

Under the current enforcement regime, in which demonstrations of extraordinary cooperation may be rewarded, consideration must be given to contacting the regulators at an early stage. This is essential if the matter will become public, but it is a sound step in many circumstances in any event. The government generally rewards firms for self-reporting and cooperation and may penalize firms for failure to do so.[25] Assistant Attorney General Lanny Breuer has noted that DOJ wants "companies that uncover illegal conduct to come forward voluntarily . . . if you come forward and fully cooperate with our investigation, you will receive meaningful credit."[26]

For example, the SEC recently recognized the cooperative efforts of two companies under investigation by agreeing to enter into the SEC's first non-prosecution agreement[27] and its first deferred prosecution agreement.[28] The SEC explained that the company in the *Tenaris* case was an "appropriate candidate" for the agency's first deferred prosecution agreement because of its "immediate self-reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training." The SEC noted that the "company's response demonstrated high levels of corporate accountability and cooperation."[29]

In explaining the decision to accept a non-prosecution agreement from Carter's Inc., rather than bring an enforcement action against the company, the SEC identified the following factors: (1) the "relatively isolated nature" of the unlawful conduct; (2) the company's "prompt and complete" self-reporting of the misconduct to the SEC; and (3) the company's "exemplary and extensive" cooperation in the inquiry, including undertaking a "thorough and comprehensive" internal investigation.[30]

The factors and considerations that the SEC staff will rely upon in determining whether to enter into a non-prosecution agreement, a deferred prosecution agreement, or a conventional settled enforcement action are not clear-cut at this point, but, based upon the Commission's actions to date, it is apparent that the breadth of any misconduct, the involvement of more senior corporate officers, and a willingness to disgorge all profits from the alleged misconduct will likely be relevant factors beyond those specifically highlighted by the staff in the *Carter*'s and *Tenaris* cases.

The SEC has also recently adopted new rules creating financial incentives for whistleblower employees to report suspected securities law violations directly to the SEC, which could result in the issuance of subpoenas

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[24] Press Release, DOJ, Stolt-Nielsen S.A. Indicted on Customer Allocation, Price Fixing, and Bid Rigging Charges for its Role in an International Parcel Tanker Shipping Cartel (Sept. 6, 2006). The company ultimately succeeded in getting the indictment dismissed. *See U.S. v. Stolt-Neilsen S.A.*, 524 F. Supp. 2d 609 (E.D. Pa. 2007).

[25] U.S. Attorneys' Manual § 9-28.700 (The Value of Cooperation); SEC Enforcement Manual §6 (Fostering Cooperation); Robert S. Khuzami, Director, Div. of Enforcement, Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders (Jan. 13, 2010) ("For those thinking about cooperating, you should seriously consider contacting the SEC quickly, because the benefits of cooperation will be reserved for those whose assistance is both timely and necessary . . . Latecomers rarely will qualify for cooperation credit."). The New York District Attorney's Office and FINRA also give companies credit for cooperation. Memorandum from Daniel R. Alonso on Considerations in Charging Organizations to All Assistant District Attorneys (May 27, 2010) (based largely on Principles of Federal Prosecution of Business Organizations); and FINRA Regulatory Notice 08-70, FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation (Nov. 2008).

[26] Lanny A. Breuer, Ass't Attorney General, Criminal Division, Keynote Address at Money Laundering Enforcement Conference (Oct. 19, 2010).

[27] Press Release, SEC, SEC Charges Former Carter's Executive with Fraud and Insider Trading (Dec. 20, 2010).

[28] Press Release, SEC, Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011).

[29] *Id.*

[30] Press Release, SEC, *supra* note 27.

and thus prompt a potential corporate crisis.[31] Because these rules may encourage employees to circumvent company compliance programs, they may also change the dynamics of handling such crises and companies may feel some pressure to move faster to report possible instances of wrongdoing to the SEC. In addition, the rules create heightened penalties for any retaliation against whistleblowers and possible problems for a company's internal compliance function.

As noted above, detailed factual explanations should not be given to the government, however, until the firm is confident that it has a grasp of the relevant facts. The goal in preliminary dealings with the government is a demonstration that the firm and regulator are on the same side: both want to stop any wrongdoing, and take corrective steps and engage in appropriate remediation. Both the government and the firm should be interested in achieving these results on a reasonable timetable and on a reasonable budget.

7. YOU MAY BE ABLE TO PROTECT THE ATTORNEY-CLIENT PRIVILEGE BUT YOU STILL HAVE TO SHARE THE KEY FACTS

Under the DOJ's Principles of Federal Prosecution of Business Organizations, credit for cooperation will *not* depend on whether a corporation has waived attorney-client privilege or work-product protection, or produced materials covered by attorney-client or work-product protections.[32] In August 2008, DOJ revised the Principles, making several significant changes concerning cooperation credit. Section 9-28.300 of the U.S. Attorney's Manual continues to provide that prosecutors "should" consider nine factors "in reaching a decision as to the proper treatment of a corporate target," including the corporation's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents." However, the prerequisites for cooperation credit were changed.

The Principles now state that credit for cooperation will not depend on whether a corporation has waived attorney-client privilege or work-product protection, or produced materials covered by attorney-client or work-product protections.[33] It will depend on the disclosure of pertinent facts. Corporations that timely disclose relevant facts to the government may receive credit for cooperation regardless of whether they waive privilege in the process. The policy forbids prosecutors from even asking for non-factual privileged information.[34] Under the prior version, known as the McNulty Memo, prosecutors were permitted to request, under certain circumstances, that a corporation produce non-factual attorney-client privilege communications and work product.[35]

The Principles also now specify that federal prosecutors are not to consider whether a corporation has advanced attorneys' fees to its employees, officers, or directors when evaluating cooperation.[36] Under the earlier guidance in the McNulty Memo, DOJ reserved the right to consider such payments negatively in deciding whether to assign cooperation credit to a corporation.[37] Nor may federal prosecutors consider whether the corporation has entered into a joint defense agreement in evaluating whether to give the corporation credit for cooperating.[38] However, the government has the right to ask that a company refrain from sharing

[31] SEC Rel. No. 34-64545 (May 25, 2011).

[32] U.S. Attorneys' Manual §9-28.710-20 (Attorney-Client and Work-Product Protections; Cooperation: Disclosing the Relevant Facts); *see also* SEC Enforcement Manual § 4.3 (Waiver of Privilege) ("Voluntary disclosure of information need not include a waiver of privilege to be an effective form of cooperation and a party's decision to assert a legitimate privilege will not negatively affect their claim to credit for cooperation.").

[33] U.S. Attorneys' Manual §9-28.720. The August 2008 revisions represented a significant change in DOJ policy, as compared with the policies reflected in the Thompson Memo, issued in January 2003. *See* Memorandum from Larry D. Thompson, Deputy Att'y General, on Principles of Federal Prosecution of Business Organizations to Heads of Department Components and United States Attorneys (Jan. 20, 2003). This change was prompted, at least in part, by the decision in *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006), *aff'd* 541 F.3d 156 (2d Cir. 2008), which held that the Thompson Memo's policy, as implemented by the U.S. Attorney's Office in the Southern District of New York in its investigation of KPMG tax-shelter practices, violated the Fifth and Sixth Amendments. The Thompson Memo was then superseded by the "McNulty Memo," *see* Memorandum from Paul J. McNulty, Deputy Att'y General, on Principles of Federal Prosecution of Business Organizations to Heads of Department Components (Dec. 12, 2006), which was replaced by the current Principles now set forth for the first time in the U.S. Attorneys' Manual.

[34] U.S. Attorneys' Manual §28.720(b).

[35] McNulty Memo §VII B(2).

[36] U.S. Attorneys' Manual §9-28.730 (Obstructing the Investigation) ("In evaluating cooperation, however, prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees or providing counsel to employees, officers, or directors under investigation or indictment.").

[37] McNulty Memo §VII B (3).

[38] U.S. Attorneys' Manual §9-28.730.

information the government has provided to the company with third parties.

Federal prosecutors should not be considering whether a corporation has disciplined or terminated employees for the purpose of evaluating cooperation;[39] they may only consider whether a corporation has disciplined employees whom the corporation identifies as culpable, and then only for the purpose of evaluating the corporations' remedial measures or compliance program.[40]

The SEC's Enforcement Manual similarly provides that the SEC staff "should not ask a party to waive the attorney-client or work-product protection without prior approval of the Director or Deputy Director."[41] The Manual makes clear that a party's decision to assert a legitimate claim of privilege should not negatively affect a claim of cooperation credit.

Although the DOJ's and SEC's policies may take waiver of privilege or work-product protection off the table in negotiations, firms facing criminal and regulatory investigations will continue to have significant incentives to cooperate fully with government investigators.[42] It will generally be in the firm's best interest to seek cooperation credit by providing relevant business records, identifying relevant personnel and evidence, and conveying other pertinent information to government investigators.

8. NOT EVERY STONE NEEDS TO BE TURNED OVER

Internal investigations should be designed to uncover the facts relevant to the crisis. Management needs to know its cause and effects in order to implement appropriate preventative steps. But, while the firm needs to know the relevant facts, not every stone needs to be turned over. The nature of the investigation and who should conduct and oversee it are highly fact-specific questions; good management practices suggest that limits to the investigation should be carefully set and carefully reset, if necessary. The need to move quickly may require limiting the scope of the investigation initially. It is important to stay focused and solve the immediate problem causing the crisis without creating additional problems. After the immediate crisis has been contained, consideration can then be given to a broader-scale compliance audit.

9. RESIST THE URGE TO DISCIPLINE TOO EARLY

The need to take action against employees involved in the crisis may pose difficult choices. The impulse to discipline reflexively should be resisted. Often there will be pressure to punish someone seen as responsible for dragging the firm into a mess. That pressure may come from the press, the public, or the board. Fairness to employees and officers counsels caution here, and may – indeed, usually – coincide with the firm's best interest.

Discipline is often more wisely one of the last steps in an investigation rather than the first. A key concern is to ensure that firms do not act prematurely, without full information. Strong discipline may also alienate other employees who possess important information and can be otherwise helpful in the investigation. Any cooperation needed from the employee will be much more difficult to obtain after disciplinary action is taken. Thus, efforts to obtain information should generally be made before any action is taken. The loyalty of a firm to its employees, and vice versa, is a valuable asset that the firm should not squander. Thoughtful judgment is necessary; it is often wise to measure twice or thrice before cutting. The exception is deliberate wrongdoing where the individual personally benefited. The government will understand if the company's thought process is explained and is not likely to pressure the company into severing all ties with an employee early on. The exception may be when the wrongdoing relates to integrity or misleading the public.

The firm's alternatives for dealing with employees who may be involved in the conduct at issue include: (i) full support for the individual; (ii) suspension until the facts are fully developed and informed judgments can be made, but with continued financial support in the interim; (iii) termination of the individual with fair payment if the misjudgment did not involve a knowing attempt to violate firm policy or the law; or

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[39] Press Release, Dep't of Justice, Justice Department Revises Charging Guidelines for Prosecuting Corporate Fraud (Aug. 28, 2008) ("The new guidance provides that prosecutors may not consider whether a corporation has sanctioned or retained culpable employees in evaluating whether to assign cooperation credit to the corporation.").

[40] U.S. Attorneys' Manual § 9-28.900(B) (Restitution and Remediation) ("Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined wrongdoers, once those employees are identified by the corporation as culpable for the misconduct.").

[41] SEC Enforcement Manual §4.3.

[42] Both Carter's and Tenaris agreed to cooperate in the SEC's continuing investigation as a condition of their settlements. ¶ 2(a) of Carter's Non-Prosecution Agreement and ¶ 3(a) of Tenaris' Deferred Prosecution Agreement define cooperation to include, among other things, "producing, in a responsive and prompt manner, all *non-privileged* documents, information, and other materials to the Commission, as requested by the Division's staff…") (emphasis added).

(iv) termination without any financial support. Severance and indemnification policies must be considered in making this assessment. Generally, under Delaware law, corporations have the authority to indemnify directors, officers, and others against the costs of threatened or pending legal action, including providing advancement of legal fees.[43] This obligation continues until there is a "final disposition – a final non-appealable conclusion of a proceeding."[44]

The company's expenses in advancing fees may be covered by a Directors and Officers Liability Insurance policy. The company should notify its insurance carrier promptly of potential liability to ensure coverage. Counsel for individual directors or for committees of the board might also be well advised to raise the insurance question lest a "notice" issue be created.

10. WHEN THE SMOKE CLEARS, LEARN FROM THE EXPERIENCE

Once the crisis has abated, the firm will often need to take steps to repair its reputation with the regulators and others, and to restore employee morale. It is also the time to start learning from the crisis. The firm's information reporting and control and compliance structures will have been tested and perhaps shown wanting. Therefore, it is prudent for management to review these systems to prevent future problems of this type and for the board to be assured that such a review is being done.

It is important to ensure that the company's compliance infrastructure is adequate to deal with the current regulatory regime. Altered circumstances require reassessment of legal and compliance issues, relevant practices, applicable policies and procedures, and training programs. As discussed above, a crucial aspect of any compliance program is making clear to employees that management believes compliance is of the highest priority. U.S. Attorney Preet Bharara has stated that it is a mistake for executives to assume that all employees understand the importance of integrity and he recently emphasized that the message must be pounded home again and again.[45] He stressed that: "Profound personal integrity, repeatedly demonstrated and openly valued, is absolutely critical."

Periodic risk assessment and re-assessment are also critical. The company must identify where the financial, reputational, and legal risks are in the business and ensure that a workable early warning system is established. As the business changes, these risk assessments must keep pace and be refreshed.[46] Employees must understand that the practices of competitors do not justify problematic business activities.

The Federal Prosecution Principles provide that "Prosecutors may consider a corporation's history of similar conduct, including prior criminal civil and regulatory enforcement actions against it, in determining whether to bring charges and how best to resolve cases."[47] The firm must be able to assure government prosecutors and regulators at the outset of the next crisis that the company has learned from its past mistakes and has made every effort to build an effective compliance infrastructure, set the right tone at the top, has given employees and supervisors adequate tools to understand and comply with applicable rules and regulations, and is committed to following up promptly and vigorously whenever issues surface. ■

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[43] Del. Gen. Corp. Law § 145 (Indemnification of officers, directors, employees and agents; insurance); *see also* John Mark Zeberkiewicz and Blake Rohrbacher, *The Right Protection: More on Advancement and Indemnification,* 41 The Review of Securities & Commodities Regulation, 283 (2008); Richard A. Rossman, Matthew J. Lund and Kathy K. Lochmann, *A Primer on Advancement of Defense Costs: The Rights and Duties of Officers and Corporations,* 85 University of Detroit Mercy Law Review 29 (2007); S. Mark Hurd, *Indemnification of Directors and Officers Under Delaware Law*, 35 The Review of Securities & Commodities Regulation 262 (2002). The Second Circuit held in the *Stein* case that action taken by federal prosecutors to pressure the company into denying the advancement of legal fees to its employees was violative of the Sixth Amendment. 541 F.3d at 136 (2d Cir. 2008).

[44] *Sun-Times Media Group Inc. v. Black*, 954 A.2d 380, 397 (Del. Ch. 2008).

[45] Jaeger, CW 2011, *supra* note 6.

[46] Federal Sentencing Guidelines for Organizations, §8B2.1(c) ("In implementing subsection (b), the organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process.").

[47] § 9-28.600.