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Peter J. Henning
Wayne State University

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BOARD DYSFUNCTION: DEALING WITH THE THREAT OF CORPORATE CRIMINAL LIABILITY

Peter J. Henning*

INTRODUCTION

There is probably no worse moment for a corporation than when it receives word of potential criminal wrongdoing in its ranks. Whether a subpoena arrives, FBI agents show up with a search warrant, or an employee calls a whistleblower hotline, the question is how the corporation will respond to the report of wrongdoing and, if it proves true, deal with the fallout.

Dealing with a crisis that could threaten the company's ability to remain in business is always difficult, and there is no firm set of rules for how a board should respond because the threat will often raise unique issues. Directors have to be concerned with the viability of the enterprise while also dealing with their own potential liability. Demands from the government for cooperation under a threat of criminal prosecution, which could have serious collateral consequences for a business, do not make the board's job any easier when so much is unknown.

There are some obvious responses to the threat of criminal and civil liability: first, start an internal investigation to figure out what happened; next, if the alleged misconduct is serious enough, have the board—usually by way of a special committee comprised of untainted independent members—determine how the company should respond to allegations of wrongdoing. Once formed, the special committee usually

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* Professor of Law, Wayne State University Law School. I appreciate the comments and suggestions of Professors Steven M. Davidoff and John F. Dolan, the assistance of Olive A. Hyman, and the opportunity to participate in the Center for Corporate Law's Symposium on The Dysfunctional Board: Causes and Cures.

1. For example, on March 5, 2008, FBI agents executed a search warrant at the corporate offices of Reddy Ice Holdings, Inc., a publicly-traded company. The company issued a press release the following day stating that it "is cooperating with the authorities." Press Release, Reddy Ice Holdings, Inc. (March 6, 2008), available at http://www.reddyice.com/press-current.php. The FBI agents arrived unannounced, and the company had no idea that it was the subject matter of an investigation or whether it would be charged with a crime. A company with over $150 million in annual revenue faced one of the most important events in its history, and it all came about without warning. The effect of the search was felt almost immediately by the Reddy Ice shareholders, who saw the value of their shares drop over 20% in one day. See Reddy Ice Plunges 23% After Federal Officials Executed Search Warrant at Co.'s Corporate Office on Wednesday, MIDNIGHT TRADER, Mar. 6, 2008 available at 2008 WLNR 4471019.
hires an outside law firm and other advisors to conduct a more thorough internal investigation. The lawyers will write up an extensive report that identifies the wrongdoer(s)—perhaps exonerating others along the way—and recommend a course of action to cure the problem.

At this point, some crucial decisions have to be made: Will the company turn over the results of its investigation to government investigators and negotiate a settlement with prosecutors and the Securities & Exchange Commission (SEC) regarding any potential violations, perhaps waiving the attorney-client privilege along the way that can aid private plaintiffs suing for damages? If so, what changes to its operations is it willing to accept to demonstrate its good faith? Will the special committee, or the full board, make the fateful decision to demand that the CEO take the fall for the problems, either because of that person’s involvement in the conduct or because it occurred on the CEO’s watch—“the buck stops here” approach? Most importantly, will the company have to change its business practices to prevent future wrongdoing, and perhaps even change its culture to avoid future problems?

There are no easy answers to such questions, and the decision on them must be made quickly, sometimes without complete information. How a board responds to the threat of criminal and civil prosecution says much about whether it will acquire the label “dysfunctional” and what effect the case will have on the company’s future operations and reputation. A dysfunctional board is not simply one that creates problems, as in the Hewlett-Packard scenario where it employed the highly questionable tactic of spying on employees and journalists to ferret out a leaker. A board can also be dysfunctional when its knee-jerk response to reported problems is nothing more than the quick jettisoning of the CEO or other executives accompanied by the usual pledge of cooperation in the resulting government investigations. Simply ousting the CEO is not always the best solution, even if it is the quickest and easiest route for a board to show its ostensible good faith, especially when the new leader is just more of the same.

The thrust of the Sarbanes-Oxley Act and the Federal Sentencing

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2. See Regina F. Burch, "Unfit to Serve" Post-Enron, 42 VAL. U. L. REV. 1081, 1126 n.215 (2008) ("Hewlett-Packard has become the 'poster child' to illustrate pretexting—an investigative practice involving gathering confidential information through the use of invented stories. Hewlett-Packard’s former board chair, Patricia Dunn, former general counsel Ann Baskins, and former chief ethics officer Kevin Hunsacker resigned after it was revealed that they had used pretexting to determine the source of a board leak of confidential information regarding Hewlett-Packard’s long-term strategic plans.") (citations omitted).

Guidelines for Sentencing of Organizations has been to empower boards to prevent misconduct by the corporation and its employees. Delaware law recognizes an oversight duty for board members to ensure compliance with the law; but simply enhancing the obligation to detect and prevent wrongdoing says nothing about how to respond when it occurs, which is often the point at which corporate dysfunction raises its ugly head. A board, or more properly a committee of truly independent directors, will have to make decisions with potentially far-reaching ramifications for the corporation. While the law does a good job telling companies how to set up a compliance system, it says little about what to do when that system reveals misconduct that can put the enterprise in serious jeopardy. What standard should the corporation follow in responding to misconduct and dealing with the inevitable government threat of civil and criminal liability?

Perhaps even more importantly, the issue of how the corporation’s culture should be changed to keep such misconduct from happening again needs to be considered in responding to a government investigation of significant misconduct. Companies only get so many bites at the apple, and if a culture of corruption exists then a board must address how to change the institution. The corporation under investigation needs to assess whether the wrongdoing was aberrational, or whether it signals a more fundamental problem that must be addressed. Simply dealing with the problem without considering the root cause puts the entire enterprise at risk.

In this Article, I explore issues related to how a board should deal with that next step: When serious corporate misconduct comes to the board’s attention and the focus changes from prevention to formulating the appropriate response to the problem. Prevention can never be perfect, and a board should plan for the day when it must deal with the ramifications of misconduct. Professor Greenwood aptly described how corporate misconduct can arise even when the company has compliance systems in place:

[M]any scandals begin with a small deviation and proceed in small increments, so that at each point the participants can see the next step as

6. For example, the indictment of Arthur Andersen for obstruction of justice was not the first time the company had run afoul of federal regulators. See James Kelly, The Power of an Indictment and the Demise of Arthur Andersen, 48 S. TEX. L. REV. 509, 519 (2006) (“[A]t the time of the Enron debacle, Andersen as a firm had already been in trouble with authorities. The Waste Management case resulted in a court injunction against the firm. The firm was barred from future misdeeds. No doubt the firm’s involvement with Waste Management and other prior SEC cases contributed to the prosecutor’s sense that Andersen was a firm that needed to be reprimanded and reformed.”).
merely an insignificant addition to a commitment already made. They start out with the typical lawyer's rationalization—if "x" is permissible, then "almost x" must also be, since the two are so close as to be indistinguishable. By the point this rationalization no longer works, participants shift to the criminal's commitment: I'm in so deep already that a little more won't hurt.\footnote{Daniel J. H. Greenwood, \textit{Discussing Corporate Misbehavior: The Conflicting Norms of Market, Agency, Profit and Loyalty}, 70 \textit{Brook. L. Rev.} 1213, 1221 (2005).}

The question is how the board should respond to the report of misconduct: By creating a reasonable decision-making process that deals with both the immediate impact of potential criminal violations while at the same time looking at whether there is a longer-term problem in the organization that may require significant—or even radical—internal changes.

In Part I, I discuss four situations involving a board’s response to reported misconduct to see what lessons can be drawn about how a board should, and should not, respond. These scenarios involve (1) Enron's response to the famed anonymous letter sent by Sherron Watkins before the company's rapid disintegration; (2) Chiquita's actions in dealing with a government investigation in protection payments it made to a terrorist organization in Colombia; (3) UnitedHealth's reaction to media reports that the timing of its options grants was suspicious; and (4) the faulty response of the Staples board to a shareholder demand over mispriced options. These situations illustrate a number of important points for how a board should, and more importantly should not, deal with reported misconduct. In Part II, I review the legal regime governing how directors must create a compliance system for the organization, and how the focus on the "front end" of the process overlooks the need to create a mechanism for dealing with the consequences of corporate misconduct.

Part III looks to the structure set up by the Delaware Supreme Court for dealing with a corporation seeking to dismiss a shareholder derivative suit after the case has been allowed to move forward into discovery. In that situation, there has already been a determination that the complaint has some merit, so an effort by the company to dismiss the claim must meet a higher standard requiring proof that dismissal is truly in the corporation's interest and not merely an attempt to shield fellow directors and officers from liability. Under \textit{Zapata Corporation v. Maldonado},\footnote{430 A.2d 779 (Del. 1981).} Delaware recognizes the ultimate authority of the board to decide on dismissal of derivative claims, but conditions the exercise of that power on proof that the decision was made by a truly independent
group of directors who are, to the extent possible, immune from the pressure of their peers on the board who want a decision accommodating their interests.

When a government investigation poses a significant threat of corporate criminal and civil liability due to the actions of the company’s agents, the response must be more than simply resolve the case as quickly as possible. Companies can appease the government and private plaintiffs, at least for a while, with the payment of fines and damages coupled with the usual mea culpas and promises of future fidelity to the law—anyone can make a problem disappear by throwing money at it. The corporation has to look at itself critically, which requires more than just the rote response of commissioning a quickie investigation and wrapping up a global settlement that costs the company a quarter’s worth of earnings and the termination of a few corporate officers. I believe that in many cases of serious corporate misconduct the proper response to the threat requires companies to effect real change in the organization by changing its culture. Viewing the government investigation as more than a one-time issue that needs to be disposed of as quickly as possible will tell the tale whether a corporate board earns the label “dysfunctional” or acts in a way that protects and enhances the enterprise to allow it to move forward from its brush—or collision—with the law. Without effecting real change in the organization, the company in all likelihood will find itself in the cross-hairs of an investigation again, with the further problem of being a repeat violator.

I. RESPONDING TO REPORTED MISCONDUCT

Prosecutions of corporations and senior management have increased substantially over the past five years, largely in response to the collapse of companies like Enron, WorldCom, and Adelphia Communications for accounting fraud. Shortly before Congress enacted the Sarbanes-Oxley Act in July 2002, the President created the Corporate Fraud Task Force, consisting of senior Department of Justice officials, the Secretaries of Labor and Treasury, and leaders of the major regulatory agencies, such as the SEC and Commodities Futures Trading Commission.9 Since then, corporations such as Bristol-Myers Squibb, Boeing, and Tenet Healthcare have been the target of wide-ranging criminal investigations that resulted in guilty pleas or deferred prosecution agreements.10 In

10. See Brandon L. Garrett, Structural Reform Prosecution, 93 VA. L. REV. 853, 938 (2007) (listing deferred and non-prosecution agreements entered into by corporations with the Department of Justice); Peter Spivack & Sujit Raman, Regulating the “New Regulators”: Current Trends in Deferred
individual prosecutions, the Task Force boasts it has secured the convictions of "214 chief executive officers and presidents; 53 chief financial officers; 23 corporate counsels or attorneys; and 129 vice presidents." After that report, at least three more CEOs, Gregory Reyes from Brocade Communications, Joseph Nacchio from Qwest, and Lord Conrad Black from Hollinger International have been added to the list, and the recent market turmoil will likely add new names.

Principles of corporate criminal liability make an organization potentially liable for the conduct of its agents so long as that person was acting—at least in part—for the benefit of the enterprise and the violation occurred within the employee’s authority. In *New York Central & Hudson R.R. Co. v. United States*, a 1909 decision involving illegal railroad rebates, the Supreme Court held that a corporation could be held liable for any crime by imputing the intent of the employee to the organization. The Court stated that in "[a]pplying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises." Courts have extended the notion of corporate intent to include the collective knowledge of all employees, so that even if no one individual is guilty of the offense, the corporation can be convicted of a crime based on an aggregation of its employees’ intent. Thus, the conduct of executives and employees can make the corporate employer liable for their crimes in most situations.

The Department of Justice also enshrined its policy on charging corporations in a series of memoranda issued under the title *Principles Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 159 (2008) ("Deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs) are proliferating. In the four years between 2002 and 2005, prosecutors and major corporations entered into twice as many of these agreements (also called pretrial diversion agreements) as in the previous ten years combined. The trend appears to be accelerating.").

14. United States v. Black, 530 F.3d 596, 598 (7th Cir. 2008).
16. *Id.* at 494.

No two situations will be the same, and how corporations respond to reports of wrongdoing can be instructive in determining how a board of directors and corporate management fulfill their fiduciary obligation to the organization.

A. Enron

One of the more notorious examples of how a corporation should not respond to reported misconduct occurred at Enron shortly before its collapse. The company relied on its usual outside counsel, Vinson & Elkins, to investigate the then-anonymous complaint sent by Sherron Watkins, a mid-level finance executive, to Kenneth Lay, Enron's CEO, about the use of various financial vehicles and off-book transactions to burnish its quarterly earnings.\footnote{20. Letter from Sharon Watkins, Vice President, Enron Corp., to Kenneth Lay, CEO, Enron Corp. (2001), available at http://news.findlaw.com/hdocs/docs/enron/compltr2lay82001.pdf.} In August 2001, Watkins sent Lay several letters and e-mails expressing her concerns about the propriety of the accounting treatment for certain transactions involving the company's CFO, Andrew Fastow. Watkins wrote that she was "incredibly nervous that we will implode in a wave of accounting scandals" and recommended that the company commission a review by independent counsel and accountants, specifically cautioning that Vinson & Elkins should not be used for an investigation because of the
firm’s involvement in setting up Fastow’s deals.\textsuperscript{21}

After Lay forwarded Watkins’s first letter to Enron’s General Counsel, the company used Vinson & Elkins to investigate Watkins’s allegations. The instructions to the outside attorneys were that Enron’s objective was to ascertain “whether Watkins’s concerns were widely shared among Enron’s senior management group and whether the letter presented new facts that were not understood by those individuals.”\textsuperscript{22}

That is hardly a mandate for a thorough investigation, and while Vinson & Elkins had worked on structuring the transactions identified by Watkins as suspicious, the firm undertook what it viewed as a “fact finding mission” subject to critical limitations imposed by Enron.\textsuperscript{23} For example, the outside lawyers were not to “second guess” the accounting judgments of Arthur Andersen, “dig down” too deeply into the transactions, or analyze the adequacy of disclosure of the transactions.\textsuperscript{24}

After a one-month “investigation” that included interviewing eight Enron executives, two accounting partners at Arthur Andersen, and Watkins—but little else—Vinson & Elkins reached the unsurprising conclusion that Enron had not suffered any harm from Fastow’s transactions despite the conflict of interest and “aggressive accounting.”\textsuperscript{25} The law firm reported that the company’s auditors were comfortable with transactions they had previously approved, the


Watkins’ first letter (i) identified the Raptor vehicles and Condor as being among the most aggressive from an accounting point of view, (ii) questioned how Enron could settle the decline in the value of the stock in Raptors, noting that “it sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future,” which is “a bit like robbing the bank in one year and trying to pay it back 2 years later” and (iii) stated that the author was “incredibly nervous that we will implode in a wave of accounting scandals.” A separate document, entitled “Summary of alleged issues,” described the Raptor structure and the problems embedded in that structure. Watkins noted: “I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day.” In another document, Watkins suggested that independent counsel and accountants be retained to review the transactions. She specifically noted that Vinson & Elkins should not be selected for this purpose. Watkins testified that the purpose of her letters was to focus Lay’s attention on these issues for damage control and to avoid the selection of either Fastow or Causey to replace Skilling. Watkins had intended to raise these issues with Skilling before his departure, but only after she had found new employment.

\textit{Id.}

\textsuperscript{22} \textit{Id.} at *60.
\textsuperscript{23} \textit{Id.} at *61.
\textsuperscript{24} \textit{Id.}
\textsuperscript{25} \textit{Id.}
expected response of anyone asked about their professional services. The only fault the law firm could find with the transactions was that they represented "bad cosmetics"—as if accounting and related-party transactions were simply a matter of appearances and spin.26

The law firm gave the company a "clean bill of health" on the issues raised by Ms. Watkins, despite the limitations Enron placed on Vinson & Elkins's ability to conduct an effective investigation of the allegations and the firm's own possible conflicts from their prior involvement in the transactions.27 Whether or not Vinson & Elkins protected the interest of its client, the first mistake in any investigation is to use lawyers with any connection to the transaction or with a stake in the outcome of the inquiry. There is an omnipresent danger that attorneys will turn a blind eye to what their clients are doing, and acquiesce in transactions or conduct that, step by step, takes the corporation across the line into illegality. Using that law firm to investigate a claim of misconduct arising from those very transactions is the height of folly, as Enron's shareholders and stakeholders learned to their great detriment.

B. Chiquita

International fruit company Chiquita Brands International, Inc. (Chiquita) entered a guilty plea that included paying a $25 million fine for making illegal payments from 1997 through 2004 to a terrorist organization in Colombia to protect its operations there.28 More than just the $1.7 million paid to right-wing paramilitary group Autodefensas

26. Id.

27. See Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 BUS. LAW. 143, 164 (2002) ("The investigation required V&E to assess objectively, as if it had not been there at all, the soundness and propriety of its prior representation. Thus, the situation presented a serious conflict between Enron's presumed interest in an objective investigation and V&E's own interests."); Robert W. Gordon, A New Role for Lawyers?: The Corporate Counselor after Enron, 35 CONN. L. REV. 1185, 1201 (2003) ("[A]lthough lawyers may take on an assignment that limits the scope of their representation or asks them to accept some facts as given, they may not agree to such limits as will preclude them from competent and ethical representation."); Susan P. Koniak, Corporate Fraud: See Lawyers, 26 HARV. J.L. & PUB. POL'y 195, 209 (2003) ("Vinson should not have accepted this assignment. To say that the matters raised by Watkins were serious problems that warranted a full-fledged, all-out, independent investigation of potential wrongdoing related to Enron's financial shenanigans would have required it to criticize its own previous advice to the company and to open itself up to lawsuits and further scrutiny. The idea is ridiculous that an investigation conducted by Vinson, under these circumstances, would count to establish that Enron's management had fulfilled its fiduciary duty to investigate allegations of wrongdoing by the company and its agents made by a credible employee.").

28. See Robert Clifton Burns, Going Bananas: Chiquita Tried to Protect Its Workers—And Got Mashed by Prosecutors, LEGAL TIMES, Apr. 2, 2007 ("Chiquita Brands agreed in mid-March to pay a $25 million criminal fine over payments to a paramilitary group in Colombia made to protect the company's employees from threatened violence.").
Unidas de Colombia (United Self-Defense Forces of Colombia or AUC) caused problems for Chiquita and its board. In the eyes of the federal prosecutors, worse than just making the payments was the fact that they continued after Chiquita disclosed the misconduct to federal prosecutors and in-house counsel warned that the illegal payments must stop. Yet, directors and management decided that it was better to continue the payments than risk incurring the wrath of AUC, which could have harmed company workers in Colombia.

The government’s Sentencing Memorandum in the case provides a detailed summary from the government’s point of view of how Chiquita came to make the payments to AUC that nearly led to the indictment of one or more members of its board because they did not take action to stop the company’s illegal conduct. It had paid protection money to two left-wing terrorist organizations from 1989 to 1997, and then in 1997 switched to making monthly payments to AUC after its emergence as a counterweight to the other groups. The protection money came through Chiquita’s Colombian subsidiary, Banadex, with a private security company known as a convivir acting as the conduit for the funds. This allowed Chiquita to record the payments on its books as “security payments” or “security services.”

In September 2000, in-house attorneys at Chiquita conducted an internal investigation of the payments and sent a memorandum to management and the board’s audit committee outlining the payments and identifying AUC as a “widely-known, illegal vigilante organization.” In April 2002, the audit committee reviewed a new means for getting the money to AUC that involved paying additional income to a Banadex employee, who then gave cash to AUC monthly; that change was implemented two months later.

In February 2003, a senior Chiquita officer learned that AUC had been designated a terrorist organization in September 2001, and Chiquita’s outside counsel warned that the payments should be stopped because they were in violation of the material support statute. In a


31. Id. at 2.

32. Id. at 5.

33. Id. at 6.

34. Id. at 8.

A series of meetings and memoranda, the lawyers warned the company that it was violating the law by making the payments and would have to stop them immediately. One memorandum summarizing a meeting stated, “Bottom Line: CANNOT MAKE THE PAYMENT.”

On April 4, 2003, the full board received information about the AUC payments, and the decision was made to disclose the misconduct to the Department of Justice. The apparent suggestion of one board member at the meeting to terminate the payments and withdraw from Colombia was not acted upon. Three weeks later, Chiquita officials met with federal prosecutors and asked for forebearance in order to protect the Banadex workers. Not surprisingly, the Department of Justice did not give its explicit blessing to continued violations of the law, although it may be that Chiquita thought it might get such a waiver at a later date. Regardless, it continued to make the payments until January 2004, when a new CEO ordered them discontinued.

Chiquita pleaded guilty to Engaging in Transactions with a Specially Designated Global Terrorist in violation of 50 U.S.C. § 1705(b), and was sentenced to pay a $25 million fine and five year probation. The government noted in its Sentencing Memorandum that the Colombian operation generated almost $50 million in profits after the designation of AUC as a terrorist organization, and in 2003 it was Chiquita’s most profitable division. More ominously, the Department of Justice gave serious consideration to charging senior officers and directors for allowing the payments to continue after receiving information from counsel—both in-house and outside lawyers—that the payments were illegal and needed to stop. In the Sentencing Memorandum, prosecutors obliquely acknowledged that they “gave serious consideration to bringing additional charges in this matter. In an exercise of prosecutorial

Whoever knowingly provides material support or resources to a foreign terrorist organization, or attempts or conspires to do so, shall be fined under this title or imprisoned not more than 15 years, or both, and, if the death of any person results, shall be imprisoned for any term of years or for life. To violate this paragraph, a person must have knowledge that the organization is a designated terrorist organization (as defined in subsection (g)(6)), that the organization has engaged or engages in terrorist activity (as defined in section 212(a)(3)(B) of the Immigration and Nationality Act), or that the organization has engaged or engages in terrorism (as defined in section 140(d) (2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989).

Id.

36. Chiquita Sentencing Memorandum, supra note 30, at 9. The government described five different items reflecting outside counsel’s position that the payments should be terminated. Id.

37. Id. at 10–11.

38. Id. at 12.

39. See Reisinger, supra note 29.

discretion, the United States decided not to do so." 41

Despite Chiquita's claims that the payments were altruistic, designed to protect its workers, the government was suspicious that this was a case of "business as usual" to protect an important source of income for the company. 42 The conduct of the board, more specifically its audit committee, in allowing the payments to continue when it was clear they were not being properly accounted for, can be viewed in one way as an example of directors who chose to maintain a profitable business at a rather small—and easily hidden—cost. Once appraised of the matter, the response of the board was viewed by prosecutors as an instance of the directors ignoring the advice of their lawyers. At the same time, Chiquita's directors faced a difficult moral dilemma because simply terminating the payments to AUC would put its workers at significant personal risk.

A dysfunctional board may be one that ignores the advice of its lawyers when told to take steps to discontinue a course of conduct that is illegal, perhaps because the board thinks it has a better way of handling the situation. At least to the government, it appeared that the response of Chiquita's directors to reported misconduct was to acquiesce in its continuance for nearly another year. Chiquita's board was in a difficult position, albeit one of its own making, and chose to respond by relying on the very directors who had acquiesced in the illegal payments. Whether or not the decision was right, and it may well have been correct, the lack of independence in the decision-making process caused the government to view the company's response as disingenuous. Even when compliance works and the information reaches the highest levels of a company, that does not mean the response will be effective.

C. UnitedHealth

The stock option backdating imbroglio involves internal investigations at over 100 companies, with criminal charges filed against CEOs and other corporate executives from companies like Comverse Technology, Brocade Communications, and McAfee. 43 The initial

41. Id. at 21.
42. See id. at 14-16. The Sentencing Memorandum quotes from the notes of outside counsel a day after the board meeting on April 4, 2003, that took up the issue of the AUC payments, about a conversation with a senior officer who said, "His and [a director's] opinion is just let them sue us, come after us. This is also [a senior officer's] opinion." Id. at 10 (alterations in original). This conversation only heightens the suspicions of prosecutors that the first response to a report of illegality is to see whether it can be swept under a rug or ignored until the government discovers it, which it may never do.
43. See Barbara Grady, The Game of Options, ALAMEDA TIMES-STAR, May 13, 2007; Steven N. Machtinger & Kenneth I. Schacter, Targeting GCs in Options Backdating Actions, N.Y. L.J., Oct. 18,
trigger for the internal investigations was an article in the *Wall Street Journal* on March 18, 2006, entitled *The Perfect Payday*, that discussed the statistical improbability of companies awarding stock options with strike prices that matched the low for month, quarter, or even year. If a date at which the stock price was at a low point was picked with hindsight to determine the exercise price of the options, then it effectively grants a bonus to recipients. Backdating options is not illegal in itself, but it must be disclosed and the use of hindsight to price the option exercise price has important accounting and tax implications.

The options grants identified by the *Wall Street Journal* involved Dr. William W. McGuire, the chairman and CEO of UnitedHealth Group, Inc. Grants in 1997, 1999, and 2000 were at the low price for the year, while a 2001 grant "came near the bottom of a sharp stock dip." According to the article, "[T]he odds of such a favorable pattern occurring by chance would be one in 200 million or greater." The odds of winning the multistate Powerball lottery with a single ticket are one in 146 million. In response to the article, UnitedHealth's board created a Special Committee of three "disinterested" board members, which in turn hired an outside law firm and forensic accountants to examine the company's options grants from 1994 to 2006.

Even the first step of creating the special committee shows how difficult it can be for a board to investigate possible misconduct within the organization. One of the three members of the Special Committee served on the compensation committee, although after the period of question options, and all three members had participated in approving the options grants. While the law firm retained by the Special Committee determined that none of the grants to its members involved backdating, that was not necessarily apparent from the outset. Moreover, two of the three directors had served on the company's board for over twenty years, and one was UnitedHealth's former CEO. While

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45. *Id.*
46. *Id.*
47. See Welcome to Powerball—Prizes, http://www.powerball.com/powerball/pb_prizes.asp (last visited Aug. 22, 2008). The actual odds calculated by the Powerball lottery are one in 146,107,962.00. *Id.* The odds of being struck and killed by lightning are estimated at one in 350,000.
49. *Id.* at 1.
50. *Id.*
51. A review of UnitedHealth's public filings discloses the roles of the directors of the company.
technically independent under the New York Stock Exchange’s rules, these directors clearly had close ties to management that called into question the degree to which they could review potential management misconduct and recommend significant changes in the corporation’s culture.

Once the law firm undertook its investigation, it discovered problems with more than just the options grants. The head of UnitedHealth’s compensation committee who helped negotiate the employment agreement with Dr. McGuire also managed assets for the CEO in amounts ranging from $1.5 million to over $55 million. In turn, Dr. McGuire invested $500,000 in 1999 in a venture of the director to buy back his investment management firm. While the company’s general counsel was aware of some “conflict” involving the two, the report notes that “there are no minutes or other documentation to confirm that” there was any disclosure to the board about the relationship. The law firm determined that “[a]ll directors believed that they first learned of the investment that Dr. McGuire made in [the director]’s firm after the commencement of this investigation.”

Finding an unexpected conflict of interest is not uncommon, but the greater problem an internal investigation faces is dealing with a corporate officer—especially a CEO—who may not be fully cooperative in the investigation. Dr. McGuire was long the driving force behind

52. The Corporate Governance Standards of the New York Stock Exchange (NYSE) require a majority of “independent” directors on the board of a company whose shares are traded on the Exchange. The NYSE asserts that “[r]equiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.” NYSE, Inc., Listed Company Manual § 303A.01 cmt. (2003). The Exchange defined an independent director in this way: “No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination.” Id. § 303A.02(a) (2004). The Standard goes on to list different tests to establish directorial independence, including whether the person (or a family member) was an employee of the company within the past three years, whether the person received over $100,000 in compensation over the prior three years apart from director’s fees, whether there is any connection with the company’s outside auditor, or whether the director’s current employer “has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company’s consolidated gross revenues.” Id. § 303A.02(b)(v) (2004).

While the NYSE standards create a modicum of distance between a director and the company, financial and employment ties are hardly the only basis on which independence can (or should) be assessed. A former executive who is four years removed from the company on whose board he or she sits will likely have very strong ties to the organization, and while that person would be “independent” under the NYSE Corporate Governance Standards, those connections would make it difficult to conclude the person has the requisite distance to exercise truly dispassionate judgment about the corporation or its management.


54. Id.
UnitedHealth’s growth, and richly rewarded for it. Prior to the options backdating investigation, the total value of the former CEO’s unexercised options was estimated at over $1 billion. In looking at the options grants in which Dr. McGuire was a recipient and key participant in setting their value, the law firm found “certain facts run contrary” to his assertion that the grant dates were not selected with the benefit of hindsight. In other words, the former CEO may not have been fully truthful in responding to the investigation, one in which he had a significant stake in the outcome.

Any internal investigation is a delicate affair because the results are likely to be turned over to the government if misconduct is found. While the authority of the board to conduct an investigation is clear, the will to undertake a thorough review may not always be there. Using current board members to lead the investigation can be problematic because of ties they have to current management, which is often the focal point of an investigation. Even relying on so-called independent directors is not a surefire method to assure that the investigation will be thorough.

As the UnitedHealth investigation shows, turning over a company’s rocks can reveal some rather unseemly conduct, and any committee must be prepared to deal with the consequences of what its lawyers find. The investigation led to Dr. McGuire’s resignation, and the ability of the company’s special committee to conduct a probing internal investigation that focused on its leader was commendable because it was able to stand up to one so powerful within the organization. But there are obvious risks in selecting directors with long-standing ties to the organization to conduct the investigation, and it remains an open question whether simply selecting a few directors from among those who qualify as independent is sufficient to protect the company. How many times can a committee of the board stand up to an entrenched CEO unless it has extraordinary authority to act on behalf of the corporation to investigate wrongdoing and, if necessary, remove those who have engaged in misconduct.

57. See, e.g., Del. Code Ann. tit. 8, § 141(a) (2008) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .”).
58. The SEC settled its investigation of Dr. McGuire by using the executive compensation “clawback” power provided by Section 304 of the Sarbanes-Oxley Act. That provision provides:

If an issuer is required to prepare an accounting restatement due to the material
D. Staples

Office supply company Staples, Inc. took a different route than UnitedHealth in disclosing the results of its internal investigation. The company's disclosure of the results of its internal investigation consisted of the following brief statement in a form 10-Q quarterly report:

During the third quarter of 2006, the Company and its Audit Committee, assisted by outside counsel, conducted a review of its historical stock option granting practices during the period from 1997 to the present. Based on the results of the review, the Company has recorded a $10.8 million expense ($8.6 million net of taxes) in the third quarter to reflect the cumulative impact of accounting errors due to the use of incorrect measurement dates, without restating any historical financial statements. The Company has concluded that the use of incorrect measurement dates was not the result of intentional wrongdoing and has taken steps to improve the controls over its option granting processes.59

In response to a shareholder derivative suit filed in Delaware alleging a breach of fiduciary duty and waste for allowing options backdating, the company and the directors and officers named as defendants filed a motion to dismiss because, inter alia, the shareholder plaintiffs failed to make the required pre-suit demand.60 Under Delaware law, before a derivative suit can proceed, the shareholders must demand that the board take corrective steps to address the problem, unless making the demand is futile and therefore excused.61 Under Rales v. Blasband,62 the pre-suit

noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—
1. any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
2. any profits realized from the sale of securities of the issuer during that 12-month period.


61. See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) ("where officers and directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct
demand is excused if the allegations of the complaint create a reasonable
doubt that the board can exercise "its independent and disinterested
business judgment in responding to a demand."63 The Delaware
Chancery Court held that demand on the Staples was indeed excused—a
rather uncommon conclusion—because of "certain troubling aspects of
this matter that undermine the court's confidence in the ability of the
board to properly consider a demand."64

In reaching its conclusion, the Chancery Court noted two significant
problems. First, what Staples disclosed as "carefully labeled 'incorrect
measurement dates'" contained no explanation of the source of the
errors or any effort by the board to remedy them, even though officers
and directors profited from the conduct.65 Second, "the company
continued to be represented by the same lawyers who represented the
officers and directors that received those backdated options and the three
directors who approved them," raising questions regarding whether a
conflict of interest tainted the decision that the backdating was not
intentional.66 The court gave little deference to the board's conclusions
because it made no effort to show that an independent committee
conducted the investigation, and its disclosure entailed only "the
grossest generalities" with findings that "have been carefully hidden
from both the stockholders and the court."67

Delaware courts require that corporate boards comply with the rather
minimal procedural standards necessary for an exercise of the business
judgment rule,68 a threshold Staples failed to meet. A board that views
its obligations in response to wrongdoing as "veni, vidi, vici" does not
come close to fulfilling its fiduciary duty to ensure not only that the
misconduct is redressed, but that it does not happen in the future. Staples
said to the world, "Trust us," to which the Delaware Chancery Court
replied, "No, thank you."

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63. Id.
64. Conrad, 940 A.2d at 37.
65. Id.
66. Id.
67. Id.
68. See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) ("Our view is that in determining
demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under
the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and
independent and (2) the challenged transaction was otherwise the product of a valid exercise of business
judgment.").
E. Four Lessons for Responding to Misconduct

No two investigations are alike, and what is appropriate for one company may not be for another. The four situations described above do give some insight, though, into how a board should—and should not—proceed in response to reports of potentially serious misconduct. The four lessons that can be drawn are:

1. Make Sure It’s a Real Investigation, Not a Whitewash

The limitations that Enron imposed on Vinson & Elkins for the so-called investigation of the Watkins allegations virtually guaranteed that no significant wrongdoing would come to light. While it is certainly questionable whether the law firm should have even accepted the assignment, a corporation cannot control the outcome of the investigation by choosing compliant counsel who will do its bidding, unless of course its goal is to avoid learning of possible misconduct. Unfortunately, it is probably impossible to keep serious problems a secret forever, or even for more than a few quarters— as Enron’s board learned—and courts will not take kindly to a law firm acting under a conflict of interest.

2. You Can’t Deal with a Problem when You Have a Dog in the Fight

There is a phrase ascribed to Texans about a person’s neutrality in a dispute, in which one says, “I don’t have a dog in that fight.” People are by nature very protective of their decisions, and it is hardly surprising that someone with a conflict of interest cannot judge the propriety of his or her own conduct, even when he or she acts with the best of intentions. This has been called “stake bias,” which occurs when the director’s personal involvement in the underlying decision or transaction affects the ability to judge the conduct objectively. The Chiquita board

69. See Proverbs 28:13 (King James) (“He who covers his sins will not prosper, but whoever confesses them will have mercy.”).

70. See Stepak v. Addison, 20 F.3d 398, 405 (11th Cir. 1994) (“When a board chooses to entrust its investigation to a law firm—and it is unquestionably the board’s prerogative to do so—the directors must ensure that counsel is capable of independently evaluating the corporation’s interests. Selection of a law firm that has actually represented the alleged wrongdoers in proceedings related to the very subject matter that the law firm is now asked to neutrally investigate reaches, in our opinion, the level of gross negligence and is incompatible with a board’s fiduciary duty to inform itself of all material information reasonably available prior to making a business decision.”).

71. See Kenneth B. Davis, Jr., Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence, 90 Iowa L. Rev. 1305, 1331 (2005) (“What might be termed stakes bias—the bias that derives from a director’s personal stake as a potential defendant in the derivative suit that
learned about a significant problem with paying protection money to a terrorist organization and tried to come up with a solution that would both uphold the initial decision made by the directors and act in a way that exhibited cooperation with the government. It was not until a new CEO arrived that the improper payments stopped. I think it can fairly be asked whether the board’s judgment was affected by its stake in the underlying decision to make and then continue the payments. References to whether a director was “independent” from corporate management are largely meaningless in the context of the internal investigation and response to the wrongdoing when the directors are involved in the misconduct. Even when UnitedHealth’s internal investigation found significant problems with backdated options, the board members responsible for dealing with the problem were long-time directors with close ties to the former CEO, who was found to be perhaps less than accurate.\textsuperscript{72} While the company ultimately recovered some of the gains improperly realized, it took well over a year and Dr. McGuire still retains a significant stake in the company. Real independence means having directors and outside advisers with no dog in the fight.

3. A Thorough Investigation Will Turn Up Something New, so Be Ready for a Shock (or Two)

If the goal is not to learn anything, then it is not a real investigation. If the board empowers its outside advisers and those responsible for oversight of an investigation with real authority to gather information and implement changes, then something unexpected will come to the surface. When UnitedHealth began its investigation, there was only a statistical anomaly about the timing of the options grants. What was then found was a CEO who dissembled at a minimum and perhaps even lied to the law firm conducting the internal investigation. A board cannot simply authorize an investigation and then sit back waiting for the results. It must be ready to deal with the information developed and the consequences of any additional misconduct found.

4. Sweeping the Results Under the Rug Will Only Make Things Worse

An investigation cannot just end with a report to the board and

\textsuperscript{72} See UnitedHealth Report, \textit{supra} note 48, at 6 (In reviewing Dr. McGuire’s statements regarding the selection of the options issuance date, the Report notes that “[c]ertain facts run contrary to this assertion.”).
minimal public disclosure of the results. A corporation has an obligation to inform its constituencies, most importantly the shareholders, about what it found and what it intends to do in the future. Disclosure is not just an obligation, it is an important step in the process of correcting underlying problems and ensuring the misconduct does not occur again. Simply announcing a result, especially when it involves conclusory statements like "no intentional wrongdoing occurred" and "steps have been taken to prevent future violations," does not instill confidence in the thoroughness of the investigation and independence of the directors responsible for the inquiry. The Delaware Chancery Court was rightfully distrustful of the Staples board because its disclosure said almost nothing about a problem that goes to the heart of the board’s oversight responsibilities.

II. THE COMPLIANCE THICKET

There is no such thing as "too much compliance" with the law, but there can be too much law on compliance. While we may not have reached that state yet, there is certainly plenty of law telling corporations how to set up programs to ensure compliance with the vast array of legal and regulatory rules under which all public companies must operate. Perhaps even too much emphasis on creating compliance systems: "Layer upon layer of information gathering and reporting systems were created that merely drove up transaction costs and had little impact on reducing the incidence of fraud." 73

In 1991, the United States Sentencing Commission adopted the Sentencing Guidelines for Organizations that allows a corporation that has an effective compliance program to mitigate up to 95% of a potential criminal fine. 74 With that carrot, corporations began to adopt systems to ensure there was a means for management to learn about problems within the organization. Organizational Guidelines set forth the basic requirements for a compliance program that should be "reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct." 75 The detection of a violation, however, does not necessarily show that the program is ineffective. 76

76. Id. § 8B2.1(a)(2).
It is not enough to simply set up a compliance program, so the Organizational Guidelines require continual monitoring of the compliance procedures. That burden is placed squarely on the "governing authority" of the corporation to "be knowledgeable about the content and operation of the compliance and ethics program and... exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program." The program should entail regular training within the organization, and the creation and dissemination of "a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation." Telephone hotlines are the most common means of allowing for such anonymous reporting, and are now a standard feature at most companies.

State corporate law has imposed a similar duty on corporate boards, led by the Delaware courts. The seminal decision of the Delaware Chancery Court in *In re Caremark International Inc. Derivative Litigation* established the basic fiduciary standard for directors—to keep themselves informed about compliance with applicable legal requirements. In connection with a settlement of shareholder claims against the board related to the company's healthcare fraud violations, Chancellor William Allen wrote

I am of the view that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

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77. Id. § 8B2.1(b)(2)(A).
78. Section 8B2.1(b)(4)(A) of the Sentencing Guidelines Manual provides that "[t]he organization shall take reasonable steps to communicate periodically and in a practical manner its standards and procedures, and other aspects of the compliance and ethics program, to the individuals referred to in subdivision (B) by conducting effective training programs and otherwise disseminating information appropriate to such individuals' respective roles and responsibilities." Id. § 8B2.1(b)(4)(A).
79. Id. § 8B2.1(b)(5)(C).
80. 698 A.2d 959 (Del. Ch. 1996).
81. Id. at 970. Chancellor Allen's discussion of the fiduciary obligation of the board of directors is pure dicta because it was wholly unrelated to the issue being decided in the case, which was whether the settlement of the derivative action was fair. Id. Moreover, his statements on the duty appear to contradict the analysis of the Delaware Supreme Court in *Graham v. Allis-Chalmers Manufacturing Company*, 188 A.2d 125 (Del. 1963), which rejected a claim for director liability for failure to monitor the company's activities because "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." Id. at 130. Despite these seemingly formidable obstacles, Chancellor Allen's discussion in *Caremark* of the board's oversight obligation was accepted by the Delaware Supreme Court, perhaps in no small part because it is clearly a correct statement of what the law should be.
This oversight obligation is a component of the board’s duty of good faith, and any claim of directorial liability would require proof of “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—will establish the lack of good faith that is a necessary condition to liability.”

The Delaware Supreme Court refined the Caremark analysis in Stone ex. rel AmSouth Bancorporation v. Ritter, where the court reviewed the dismissal of a shareholder derivative claim alleging that the board failed to ensure compliance with the reporting requirements of the Bank Secrecy Act. For a successful claim, a shareholder would have to show either a complete failure to create a reporting system or internal controls, or “having implemented such a system or controls, [directors] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of the risks or problems requiring their attention.” The first type of fiduciary breach is unlikely to occur if the company has moderately competent counsel—who has attended a CLE conference in the past decade or read about Enron. The second type of breach is the more likely source of claims against the board, it focuses less on what was done structurally and more about how the board operates after creation of the compliance program that fails to prevent misconduct.

The Sarbanes-Oxley Act of 2002, adopted in the wake of the collapse of major public companies like Enron, WorldCom, and Adelphia Communications, added to the compliance regime for publicly-traded corporations. Section 307 of the Sarbanes-Oxley Act requires the Securities and Exchange Commission (SEC) to adopt rules “requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof).” The SEC adopted rules to implement this provision that allow a company to create a Qualified Legal Compliance Committee (QLCC) consisting of at least one member of a company’s audit committee and two or more independent board members who would have the responsibility, inter alia, to recommend how a corporation can implement any appropriate response

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82. In re Caremark Int'l Inc., 698 A.2d at 971.
83. 911 A.2d 362 (Del. 2006).
84. Id. at 370.
to evidence of a reported material violation. A lawyer representing the company could report a violation to the QLCC to fulfill the reporting requirement imposed by § 307.

While a QLCC might appear to be the best means to deal with not just reports of wrongdoing but also taking action to remedy any problems, in fact its role is more of a hortatory one. After completing an investigation, a QLCC is empowered to report internally and, perhaps as a last resort, disclose problems to the SEC if no action is taken. It cannot, however, initiate changes on its own, unless the board delegates that authority.87 Like the compliance programs mandated by the Organizational Sentencing Guidelines and Caremark, the QLCC’s primary focus is on gathering information and investigating, not crafting a remedy for violations or enforcing change on the organization.88 It is not clear whether a QLCC would be the best method of achieving that result because it might not be equipped to deal with the particular issue facing a company that could require a quite different approach than using current directors who may have close ties to incumbent managers.89

Among the more important—and controversial—provisions of the Sarbanes-Oxley Act is § 404, which requires companies and their

87. Rule 205.2(k) outlines the responsibilities of a QLCC after it concludes an investigation of wrongdoing by the corporation and its employees:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.


88. See Jill E. Fisch & Caroline M. Gentile, The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors, 55 DUKE L.J. 517, 540 (2003) ("The issuer’s decision to create a QLCC might arguably modify its culture, serving to alter norms for reporting and responding to evidence of misconduct, but the extent of likely modification seems limited at best.").

89. A small percentage of public companies have created a QLCC. A study by Professor Robert Rosen found that as of September 30, 2005, 456 companies had formed a QLCC, representing approximately 2.5% of securities issuers subject to the SEC rules, and the number adopting this approach was declining. See Robert Eli Rosen, Resistance to Reforming Corporate Governance: The Diffusion of QLCCs, 74 FORDHAM L. REV. 1251, 1252 (2005). One reason for the aversion to QLCCs may be the concern of board members that those appointed to serve will face greater potential liability. Professor Rosen notes that corporate counsel "reported that they did not recommend QLCCs because directors would be concerned with their liability." Id. at 1302. Professors Fisch and Gentile reached a similar conclusion, stating that "service on the committee may increase the liability exposure of QLCC members relative to other members of the board of directors." Fisch & Gentile, supra note 88, at 542.
outside auditors to provide an annual assessment of "the effectiveness of the internal control structure and procedures of the issuer for financial reporting." The Committee on Capital Markets Regulation estimates that the cost of complying with the internal controls reporting requirement was over $4 million in the first year after enactment, "a stiff price for most public companies and a significant burden for small ones, particularly first time market entrants." A key focus in any review of a corporation's internal controls will be its system for preventing and detecting potentially illegal conduct.

While enhanced internal controls may give management greater comfort that misconduct and criminal violations are less likely to occur, they certainly are no guarantee that a problem will not occur. As the SEC noted in a study of § 404's effects, "[I]nternal controls cannot prevent or detect every instance of fraud. Controls are susceptible to manipulation, especially in instances of fraud caused by the collusion of two or more people including senior management." Greater emphasis on developing adequate internal controls again focuses on the front end of the equation—prevention and detection—instead of the back end, the appropriate response once misconduct comes to light.

III. RESPONDING TO SERIOUS MISCONDUCT

A. When Has It "Hit the Fan"

Not every report of misconduct requires that a company call in outside counsel to investigate or gear up for a major review of its operations. Indeed, many reports to hotlines and corporate counsel are for minor transgressions and problems that hardly rate the concern of the board. In any larger organization, there will be transactions and incidents that can be handled as a matter of routine, such as small-scale expense account abuses or missed administrative filings. Some issues, however, may be harbingers of greater corporate compliance issues, such as payments to foreign officials to obtain contracts. While the amounts


91. COMMITTEE ON CAPITAL MARKETS REGULATION, REDUCING REGULATION AND LITIGATION WHILE ENHANCING SHAREHOLDER RIGHTS WILL IMPROVE THE COMPETITIVENESS OF U.S. CAPITAL MARKETS 3 (Nov. 2006), available at http://www.capmktsreg.org/pdfs/Summary_11.30 interimreport.pdf. The Committee called for "a more reasonable materiality standard" for assessing internal controls under Section 404, and recommends that smaller issuers be exempt from the rules issued under that provision. Id. at 5.

involved in overseas bribes are often trivial in comparison to the size or revenues of the business, federal prosecutors are paying significantly greater attention to such cases and are more likely to bring criminal charges. Robert Bennett, one of the leading white collar criminal defense lawyers, recommends that "[a]s a general matter, as soon as a company has reason to believe a problem may exist, an internal investigation should be initiated."93

At some point, a company’s legal counsel or audit committee has to recommend to the board that a reported problem or government investigation poses a significant threat to the organization. The degree of the threat will depend on the type of organization involved and its particular business. For example, an accounting firm convicted of a felony would probably lose its license to practice in most states, and would be barred from auditing publicly-traded companies—the fate that befell Arthur Andersen. In the insurance and financial industries, a securities fraud conviction could have a similar effect on a company, while a hospital or pharmaceutical company would be automatically barred from Medicaid and Medicare programs if it were convicted of a healthcare fraud offense.94 Potential criminal fines and civil penalties can have a material effect on a corporation’s quarterly and annual financial statements, and any criminal conviction has a negative effect on the public’s perception of the company.

While there is no clear line to say when misconduct poses a significant threat to the company, corporate counsel and the board should be able to reach a reasonable conclusion that the company needs to undertake a higher-level response. Ultimately, it is only the board of directors, described by Professor Bainbridge as, "Platonic guardians of a sui generis entity,"95 that can address the misconduct and ensure the corporate enterprise undertakes the change necessary to prevent future wrongdoing. No two cases will be the same, but the judgment that serious misconduct within the corporation has occurred means the company must respond with more than just routine monitoring of the

94. See 42 U.S.C. § 1320a-7(a)(3) (2006) ("The Secretary shall exclude the following individuals and entities from participation in any Federal health care program . . . (3) Any individual or entity that has been convicted for an offense which occurred after August 21, 1996, under Federal or State law, in connection with the delivery of a health care item or service or with respect to any act or omission in a health care program (other than those specifically described in paragraph (1)) operated by or financed in whole or in part by any Federal, State, or local government agency, of a criminal offense consisting of a felony relating to fraud, theft, embezzlement, breach of fiduciary responsibility, or other financial misconduct.").
situation and a perfunctory pledge of cooperation—it is now an "all hands on deck" situation that requires immediate attention from the corporation's highest authority, the board of directors. A corporate investigation gone awry like Hewlett-Packard's, or reports of options backdating allegations like those that afflicted nearly 200 companies, require a response different in kind from the usual mode of corporate decision-making.\footnote{See Howart Mintz, How the Brocade Verdict Will Affect the Valley, SAN JOSE MERCURY-NEWS, Aug. 8, 2007, at 1A (discussing the potential effect of the conviction of the former CEO of Brocade Communications on over 200 companies that disclosed options backdating).}

\section*{B. Assessing the Impact}

The challenge the board faces is not just determining the underlying facts involved and seeking a swift resolution to the government inquiries. The board must consider the need to \textit{change} the organization both to address the problems that occurred in the past and to ensure that future violations of that type do not happen again. Prosecutors and regulators will demand no less, and the board's responsibility is to ensure that more than mere lip service is paid to notions of corporate accountability and a culture of compliance. The matter may be complicated by the involvement of senior managers and current board members in the underlying misconduct and the maintenance of a corporate culture resistant to change. The board must deal not only with the government, but also the organization that may need to be changed, perhaps radically. As Professor O'Connor noted, "[M]any boards have learned to go through the motions of good corporate procedures, but nevertheless continue to fail to challenge managers when necessary."\footnote{Marleen A. O'Connor, The Enron Board: The Perils of Groupthink, 71 U. CIN. L. REV. 1233, 1238 (2003).}

Ceding authority to the CEO to respond to the problem may raise significant concerns if the misconduct reaches inside the executive suite. If that is the case, then the board will have to take charge, although even there individual directors may be implicated, such as the Chiquita board's decision to continue the illegal payments. So the first decision may well be the hardest: Who will manage the crisis?\footnote{See Martin Lipton, Some Thoughts for Boards of Directors in 2008 (Dec. 6, 2007) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1090970 ("The first decision a board must make during a crisis is to decide whether the CEO should lead the corporation through the crisis. If the CEO is part of the problem or is otherwise compromised or conflicted, someone else—often one of the other directors—should take a leadership role.")} A board must consider whether there is a conflict of interest between management, and even current members of the board, and the best interests of the
company in redressing the internal failures and changing the corporate culture. Resolving the investigation may require that employees be terminated, internal controls be enhanced, and perhaps even a fundamental change in how the business operates to prevent the misconduct from recurring. Current management may resist such changes, arguing that the government investigation is misguided, or that the problem is a minor one that does not require any significant reformation of the organization. 99

Assuming the investigation uncovers significant wrongdoing that implicates current managers, what model should the board follow when confronted with reported misconduct or even a full-scale government investigation that poses a serious threat of criminal charges and regulatory sanctions against the corporation? What is not needed is another shareholder lawsuit, but a response that may well require significant changes in how the company operates and the culture it will imbue. 100

C. Responding to Misconduct

The closest analogy to the situation faced by a company that is a target of a significant criminal investigation is the situation faced by a board of directors when it seeks to dismiss a shareholder derivative lawsuit after the complaint has already advanced past the initial demand stage. The governing case for this scenario is Zapata Corp. v. Maldonado, 101 from the Delaware Supreme Court, which set a high bar for an independent board committee to dismiss a shareholder derivative suit in some instances. The Delaware court authorized a corporation to appoint what is now known as a Zapata Committee to take a second look at whether the continuation of the derivative suit is in the company's best interest, even after the case has proceeded into discovery. 102 While allowing the board to appoint a special committee to act on its behalf, the Delaware court was wary of the pressure on the board members who would decide whether the suit against their confreres would continue. The court stated,

99. Judge Posner's pithy statement about board resistance to a hostile takeover comes to mind: "No one likes to be fired, whether he is just a director or is also an officer." Dynamics Corp. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), rev'd on other grounds, 481 U.S. 69 (1987).

100. See Elson & Gyves, supra note 73, at 702 ("The solution lies not in using the threat of legal liability to force compliance, but in creating an environment where a board and the entire organization find it vital for corporate success to demand ethical and appropriate conduct.").


102. Id.
We must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role.\textsuperscript{103}

The linchpin of the Zapata procedure is that the board or designated committee be truly independent and disinterested, not just in the sense of having no direct ties to the corporation or its management but also be free of any taint from the underlying decision at issue. The Zapata Committee must have the authority to make decisions on behalf of the corporation, not merely to make recommendations to the full board.\textsuperscript{104} Anything less means that directors tainted by the challenged decision will ultimately decide the company’s course of action. There is no real independence without the power to act by effecting real change in a corporation. The lessons learned from the responses to misconduct by Enron, Chiquita, UnitedHealth, and Staples can be applied by truly independent directors given the type of mandate that a Zapata Committee has to conduct a complete investigation and implement what is best for the corporation.

Even if the committee is given sufficient authority to direct the corporation, those directors given the authority must engage in one of the hardest decisions that can be made: Whether or not to sue fellow board members or officers for violating their fiduciary duty. Vice-Chancellor Strine summarized quite well the difficulty facing the Zapata Committee in \textit{In re Oracle Corporation Derivative Litigation}:

\begin{quote}
It is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (\textit{e.g.}, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person.\ldots Denying a fellow director the ability to proceed on a matter important to him may not be easy, but it must, as a general matter, be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him.\textsuperscript{106}
\end{quote}

A board confronting an investigation of serious corporate misconduct is in largely the same position as a Zapata Committee because it usually

\textsuperscript{103} Id. at 787.

\textsuperscript{104} See Ryan v. Gifford, Civ. No. 2213-CC, 2007 WL 4259557, at *3 n.2 (Del.Ch. Nov. 30, 2007) ("It is worthwhile to note that the Special Committee formed here to investigate the stock option backdating appears to lack power to assert claims on behalf of Maxim and so is not one formed under the framework of Zapata v. Maldonado, 430 A.2d 779 (Del. 1981). Such a committee would certainly possess its own independent privilege.").

\textsuperscript{105} 824 A.2d 917 (Del.Ch. 2003).

\textsuperscript{106} Id. at 940.
must pass judgment on current management and even fellow board members in deciding whether they should be terminated or disciplined. Perhaps even more importantly for the company, the government may seek significant changes in the corporate governance structure that will affect how management and the board will operate in the future. For example, the deferred prosecution agreement entered into by Bristol-Myers Squibb required the company to separate the CEO position from chairmanship of the board and to change its internal budgeting process. The committee may be called upon to adopt far-reaching changes to the organization that will often pit it against entrenched interests in the corporation. Absent a committee with real authority to implement those changes, the response to the investigation may be inadequate.

The Delaware Supreme Court laid out the following steps a Zapata Committee should take before making its decision: (1) "an objective and thorough investigation" of the issues underlying the shareholder complaint, and (2) "a thorough written record of the investigation and its findings and recommendations." It is standard procedure, and crucial, for such a committee to retain independent legal counsel who has no significant business relationship with the corporation, so the integrity of its internal investigation and subsequent report to the committee is not subject to challenge. As Professors Hazard and Rock noted, "When a company launches an internal investigation in the wake of a scandal, the credibility of the investigation depends in no small measure on the perception that the law firm conducting the investigation is independent of the potential wrong doers."

The use or, if necessary, appointment of truly independent directors, who are given the type of authority that a Zapata Committee must have, is crucial in dealing with a government investigation and avoiding the dysfunction that can infect corporate decision-making. The Chiquita situation highlights an important step a board should consider when it cannot separate itself from the subject matter of the government's investigation: Bring in new board members with no connection to the corporation, and hence no stake in the outcome of the investigation. The

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109. Geoffrey C. Hazard, Jr. & Edward B. Rock, A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel, 59 BUS. LAW. 1389, 1392 (2004); see also James D. Cox, Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel, 48 VILL. L. REV. 1077, 1085 (2003) ("[I]ndependence of counsel is a desideratum and is best achieved when the committee's counsel has not previously represented the corporation.")
decision may come out exactly the same, and perhaps new directors added to Chiquita’s board would have recommended the same course of action. But the outcome is not the issue; it is the process of having directors who can exercise a truly independent review that is important in dealing with the government and facing the issue of how to institute change in the organization. The Chiquita board members who supported continuing the payments made a decision that may have appeared to be tainted by their involvement in the initial determination to maintain the Colombian subsidiary and protect the company workers there.110

In the same way, the conduct of the Staples board when confronted with the shareholder derivative suit was to treat it as a minor annoyance to be swept under the rug. It is clear that backdating presents a significant problem due to potential legal entanglements with the SEC and federal prosecutors, and the problem with of lack of internal controls that allowed for such alterations in corporate documentation. Absent a committee with real authority to effect change, the response may well be perfunctory at best and a cover-up of more widespread corporate misconduct in a worst-case scenario.

The need for real independence is highlighted by the response of Enron to Sherron Watkins’s missive to then-CEO Ken Lay highlighting significant problems in the company’s accounting. Using its long-time outside counsel and placing significant restrictions on the lawyers looking into the allegations virtually guaranteed a whitewash. As the Delaware Supreme Court emphasized in Zapata, it is the independence of the committee that is the key to allowing it to exercise its business judgment regarding a derivative suit. A committee appointed to investigate significant wrongdoing inside the corporation must be just as strong in conducting its inquiry as it is in dealing with the consequences.

The knee-jerk reaction of many boards seems to be “shoot first, ask questions later” when the CEO and other senior executives are cut loose to show who is in charge; that is hardly better than having conflicted directors soft-pedal a problem and do their best to ignore it, as the Staples board did. A government investigation requires a measured response involving a thorough internal assessment so that, if necessary,

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110. It is natural for directors to defend their independence, and few would acknowledge any conscious bias or problems in the decision making process. I suspect the boards at Enron, Chiquita, UnitedHealth, and Staples include members who are widely admired for their business acumen and high ethical standards. None of that prevents mistakes from being made, or from the process of responding to potential corporate misconduct having at least the appearance of being biased in favor of protecting management from having to institute significant changes. Any claim of bias will be treated skeptically by members of corporate boards, but the government appears to put great stock in the independence of the directors and corporate counsel with whom it deals when there is an investigation of serious wrongdoing.
all the facts can be presented to the prosecutors when deciding whether or not to file charges against the company. A Zapata-style committee would by its nature be an ad hoc entity dealing with the issues raised by the investigation, and so it would be better to create it as an independent body rather than relying on a QLCC or the audit committee, which may not have the necessary independence. Such a committee would have the credibility to negotiate with the government, should a settlement be in the corporation’s best interest. Furthermore, the committee should have the power, granted at the outset, to effectuate real change in the corporation, which may require terminating executives and changing the reporting duties of others to ensure the problem does not occur in the future.

IV. CONCLUSION

In a speech to corporate managers in 2005, the general counsel for Boeing addressed the company’s need to respond to a range of government investigations of significant corporate misconduct:

My overall message is fairly simple: We as the leaders of the Boeing Company get to choose what kind of culture we are going to have. And we make these choices every day by what we do and frankly what we choose not to do. But the consequences of all those choices are our collective responsibility. 111

At the time, the company was in the process of settling a number of criminal and civil investigations that ranged from the theft of documents from a competitor to an improper offer of employment to a government procurement official. As the general counsel noted, a significant portion of Boeing’s continuing business with the federal government was at risk because of how the company acted, and it needed to make fundamental changes in how it operated. But the greater question was whether the company could effectuate real change: “The cultural question we need to ask, of course, is are we going to model the leadership values? And are we going to hold accountable those of us in this room, our subordinates and even our superiors?” 112

Boeing survived, and has even thrived, since it resolved a series of government investigations in 2006. Whether it has truly changed its culture remains to be seen. Nevertheless, the board of directors of a company should understand that it does not get many second chances to

112. Id.
correct the way it operates and to alter a culture that allows, or even encourages, doing business on the edge of legality. Affecting the type of cultural change described by the Boeing general counsel is one of the hardest things any board can ever undertake.

When serious wrongdoing is reported to management and the board, the first response is likely one of shock, and a desire to find someone to blame. The next step is crucial: Creating a mechanism by which the company can address past misconduct and move forward to ensure it does not occur again. The approach in Zapata is a workable model for companies to follow because it places authority in those who do not have the kind of stake in past practices that will encourage them to look for excuses or engage in hand-wringing without confronting the true issues the company faces. While there have been very few Enron-like collapses since 2002, the danger posed by a government investigation of criminal conduct may threaten the continued existence of an enterprise. A functional board of directors will recognize the need to take action that will, if necessary, alter the way a company conducts its business. Getting to that point will require a willingness to adopt a mechanism for effecting change in the organization that may well threaten the continued tenure of management and the board. Anything less would be a sure sign of a dysfunctional board.