PANEL DISCUSSION: CORPORATE INVESTIGATIONS AND PARALLEL PROCEEDINGS

Moderated By:
SCOTT O'CONNELL
Nixon Peabody

Special Corporate Investigations: Practical Considerations for Avoiding Traps for the Unwary

Moderator

Scott O'Connell
Nixon Peabody

This panel will explore through the use of a progressive hypothetical—crafted from current events—the many competing and perilous decisions that often need to be made during the life of an internal investigation.

1. The Subject of the Investigation—Initial considerations

    a. Nature of allegation—what conduct is implicated
    b. Whose conduct is implicated—what level of the organization
    c. How extensive is alleged conduct
    d. Is the alleged conduct criminal
    e. Source of the information

        i. Whistleblower? If so, what protections are mandated
        ii. Aggrieved former employee trying to manufacture leverage?
        iii. Allegations made by competitor in litigation?
        iv. Routine discovery of information discovered in the ordinary course of business?
        v. Analyst Report
        vi. Newspaper Article
        vii. Regulatory Inquiry

    f. Public disclosure obligations

2. Initial Actions

    a. Sarbanes Oxley Compliance

        i. Up the ladder reporting
        ii. Chief Legal Officer
        iii. Chief Ethics Officer
        iv. Audit Committee

    b. Decision on whether to conduct an investigation

    c. Decision on who will conduct investigation

        i. In-house legal team
        ii. Outside legal team

d. Determine who the client is for purposes of the investigation

    i. Audit Committee
    ii. Outside directors of the board
    iii. Special Committee of the board
    iv. Company officers

e. Determine Protocol For Investigation

    i. Timeline?
    ii. Talking points concerning investigation
    iii. Written acknowledgement from interviewee that the investigating attorneys are not the interviewee's counsel
    iv. Company counsel permitted to participate in interviews?
    v. Private counsel of interviewee permitted to participate in interviews?
    vi. Union representatives or counsel?
    vii. Form of written product documenting investigation
    viii. Nature of reports to clients

f. Identification of Individuals with Information

g. Identification of Potentially Relevant Records

    i. Electronic data and communications—Preservation obligations?
    ii. Paper records
    iii. Third party information

3. Conducting the Investigation—Best Practice Considerations

    a. Number of participants on interview team
    b. Witness statements—form and content
    c. Acknowledgements--
    d. Confidentiality issues
    e. Form and manner of final presentation to client

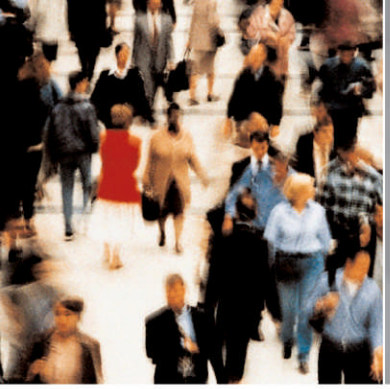
4. Interim Actions During Investigation

    a. Suspension or adverse employment actions of certain individuals
    b. Interim reports to client
    c. Regulatory disclosure considerations
    d. Public disclosure considerations

5. Special Challenges—Dealing with uncooperative employee witnesses

6. Special Challenges—Parallel Proceedings

    a. Derivative actions
    b. Securities class actions
    c. Regulatory proceedings
    d. Criminal investigations



Class Action Alert
Recent developments in class action law

A publication of Nixon Peabody LLP

JULY 2008

Good hygiene for special litigation committees

By Christopher M. Mason, Carolyn G. Nussbaum, and Steven M. Richard

Two recent opinions of the Delaware Chancery Court in *Sutherland v. Sutherland*, No. 2399-VCL, 2008 Del. Ch. LEXIS 49 (May 5, 2008), and 2008 Del. Ch. LEXIS 59 (May 29, 2008), emphasize some practical truths that all Delaware corporations (and corporations organized in most other states as well) should recognize when they use a special litigation committee in response to a shareholder demand or derivative suit.

The *Sutherland* case involved a family-owned timber company and its subsidiary. The plaintiff and another family member together owned 50 percent of the relevant common stock. They opposed family members who owned the other half of the common stock—but who also had absolute voting control through certain preferred stock.

Believing that the family members with voting control were, as officers and directors, improperly using corporate funds for their personal benefit, the plaintiff, in her role as a shareholder, sued derivatively for waste and breach of fiduciary duty. In response, the companies created a special litigation committee.

The special litigation committee consisted of a single outside director who was a partner in a reputable accounting firm. It had full authority to investigate and act for the companies with respect to the plaintiff's claims, retained independent legal counsel, undertook an investigation, and produced a report recommending the dismissal of the plaintiff's claim. When the companies moved to dismiss the plaintiff's claims based on the special litigation committee's recommendation, however, the Chancery Court denied their motion. *See Sutherland*, 2008 Del. Ch. LEXIS 49.

The general legal standard for judicial review of a motion to dismiss based on a special litigation committee's recommendations appears in the well-known opinion in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). As that case and its progeny hold, a Delaware corporation must show the court that a special litigation committee has acted in good faith, made a reasonable investigation, and maintained its independence before the committee's recommendation may be followed as a basis for

dismissal.[1] The Chancery Court in *Sutherland,* however, did not find that the companies had made all three of these showings.

The reason for this clearly had something to do with the single-member nature of the special litigation committee in *Sutherland.* As students of shareholder derivative suit history will recall, one of the few cases in which a Delaware court has ever rejected the recommendation of a special litigation committee was *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985)—a case in which the "committee" also consisted of a single director. The first of the *Sutherland* opinions cited the *Lewis* decision for the proposition that single-member committees may be "closely scrutinized." 2008 Del. Ch. LEXIS 49, at *9 & n.20. The second *Sutherland* opinion, becoming much more emphatic about how much closer this scrutiny should be, quoted the *Lewis* decision for the proposition that, "in a case involving a one-person SLC [special litigation committee], the moving party must prove that the SLC was 'like Caesar's wife … above reproach.'" 2008 Del. Ch. LEXIS 59, at *4 & n.7.

The single-member committee in *Sutherland* could not meet the standards of "Caesar's wife." While the Chancery Court found the record sufficient to show that the committee was independent, 2008 Del. Ch. LEXIS 49, at *9-16, the companies did not adequately establish the committee's good faith or the reasonableness of its investigation, *see generally id.* at *17-26, even though the investigation "was, in many respects, exhaustive and time consuming," *id.* at *16-17. The Chancery Court therefore denied the motion to dismiss.

The companies filed a motion to reargue this decision. As to the procedural issue of reargument, the Chancery Court held that the companies did not make the necessary showing that the denial of the motion to dismiss involved "a misunderstanding of a material fact or misapplication of the law…." 2008 Del. Ch. LEXIS 59, at *2. But the Chancery Court also took the opportunity to expand at length on *why* its earlier decision was correct (including emphasizing the higher, "Caesar's wife," standard for one-person special litigation committees. *Id.* at *4).[2]

The Chancery Court was especially critical of the special litigation committee's omission in its report of any reference to certain payments made for the benefit of one of the defendants—payments constituting the very sort of questionable transaction that had led the plaintiff to file her action. *Id.* at *5-6. The committee not only failed to mention these payments, but wrote its report in such a way to suggest that there were no such payments. *Id.* at *6. Only hotly contested discovery proceedings by the plaintiff to gain access to documents detailing the transactions overlooked by the committee uncovered those payments. *Id.* at *6-7. While the special litigation committee may have been right that strong statute-of-limitations defenses would have defeated any claims relating to those payments, the Chancery Court still held that "a good faith effort to deal with [the payments] necessarily required that the report *both* disclose the facts relating to the payments *and* present the analysis of [the defendants'] defense." *Id.* at *7 (emphasis added). Thus, while the committee in *Sutherland* was not required to conduct a forensic investigation, it was required to investigate not only the specific

---

[1] A motion to dismiss based on a special litigation committee's recommendation is a "hybrid" motion that has elements both of a motion to dismiss and a motion for summary judgment. *See, e.g., Sutherland,* 2008 Del. Ch. LEXIS 49, at *7 & n. 6. As such, the moving party must show, not merely allege, these criteria.

[2] In contrast, Nixon Peabody has successfully defended a single-member special litigation committee's recommendation in *Hartman v. Thoman*, Index No. 2001/02645 (N.Y. Sup. Ct. Monroe Co. Jan. 21, 2002).

transactions pled in the plaintiff's complaint, but the *types* of claims and transactions that the complaint attacked. *See id.* at *8-9.

The Chancery Court also found that the special litigation committee's destruction of original interview notes, after using them to prepare what the court considered to be cursory and incomplete interview summaries, undermined the good faith and reasonableness of the committee's investigation in *Sutherland*: "[T]he touchstone of good faith in the context of a special litigation committee report is its demonstrated willingness to deal openly and honestly with *all* relevant and material information. Where, instead, the record shows that material information is consciously omitted …., the court must wonder what other information was omitted or what other information might have been uncovered by a more diligent inquiry." *Id.* at *7-8 (emphasis added).

The basic "function of judicial scrutiny of a special litigation committee's recommendation is to determine independently whether the action is likely to harm the corporation rather than help it." *Joy v. North*, 692 F.2d 880, 891 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983). The Chancery Court's opinions in *Sutherland* are timely reminders of some basic elements of good "corporate hygiene" in preparing a special litigation committee to make this independent recommendation. Based upon our experience with such committees, we would recommend:

- Wherever feasible, create a special litigation committee of more than one director.
- Provide the committee with the funds and authority to retain its own independent counsel.
- Use minutes, rather than individual notes of committee members, to record committee meeting work.
- Produce a thorough committee report that addresses all material relevant evidence that came to the committee's attention, even if it was not specifically identified or referenced in the complaint.
- Keep all back-up materials and work product until after completion of the litigation.
- Address the factual strengths and weaknesses of all claims, even if the committee or counsel believes that the corporation has strong legal defenses to them.

We welcome your questions and comments. If you need assistance on any matter, please call or e-mail Christopher M. Mason (cmason@nixonpeabody.com 212-940-3017) or Paul J. Hall (phall@nixonpeabody.com 415-984-8266) as the coordinating heads of our class action defense practice across our substantive litigation teams, or contact any of our partners listed below.

Attorney	E-mail	Phone
Philip M. Berkowitz (NYC)	pberkowitz@nixonpeabody.com	212-940-3128
Bruce E. Copeland (SF)	bcopeland@nixonpeabody.com	415-984-8253
Roger R. Crane (NYC)	rcrane@nixonpeabody.com	212-940-3190
Brian Dalrymple (SF)	bdalrymple@nixonpeabody.com	415-984-8275
Dennis M. Duggan, Jr. (BOS)	dduggan@nixonpeabody.com	617-345-1340
Samuel Goldblatt (BUF)	sgoldblatt@nixonpeabody.com	716-853-8121
Andrew J. Hachey (BOS)	ahachey@nixonpeabody.com	617-345-1034
Paul J. Hall (SF)	phall@nixonpeabody.com	415-984-8266
Stephen C. Johnson (SF)	scjohnson@nixonpeabody.com	415-984-8222
Fred A. Kelly, Jr. (BOS)	fkelly@nixonpeabody.com	617-345-1319
Hugh R. Koss (SF)	hkoss@nixonpeabody.com	415-984-8414
Joseph J. Leghorn (BOS)	jleghorn@nixonpeabody.com	617-345-1114
Christopher M. Mason (NYC)	cmason@nixonpeabody.com	212-940-3017
Louise M. McCabe (SF)	lmccabe@nixonpeabody.com	415-984-8258
Richard A. McGuirk (ROC)	rmcguirk@nixonpeabody.com	585-263-1644
Carolyn G. Nussbaum (ROC)	cnussbaum@nixonpeabody.com	585-263-1558
W. Scott O'Connell (BOS)	soconnell@nixonpeabody.com	617-345-1150
Joseph J. Ortego (NY)	jortego@nixonpeabody.com	516-832-7564
Frank H. Penski (NYC)	fpenski@nixonpeabody.com	212-940-3124
Vivian M. Quinn (BUF)	vquinn@nixonpeabody.com	716-853-8134
Robert Reklaitis (DC)	rreklaitis@nixonpeabody.com	202-585-8375
Stephen G. Schrey (SF)	sschrey@nixonpeabody.com	415-984-8228
George J. Skelly (BOS)	gskelly@nixonpeabody.com	617-345-1220
Melissa B. Tearney (BOS)	mtearney@nixonpeabody.com	617-345-1323
David H. Tennant (ROC)	dtennant@nixonpeabody.com	585-263-1021
Deborah L. Thaxter (BOS)	dthaxter@nixonpeabody.com	617-345-1326
Eugene D. Ulterino (ROC)	eulterino@nixonpeabody.com	585-263-1580
James W. Weller (NY)	jweller@nixonpeabody.com	516-832-7543

If you are not currently on our mailing list and would like to receive future issues of *Class Action Alerts,* or if you would like to unsubscribe from this mailing list, please send your contact information, including your name and e-mail address, to yjones@nixonpeabody.com with the words "Class Action Alert" in the subject line. Previous issues of *Class Action Alerts* are available at our website at www.nixonpeabody.com.

NIXON PEABODY LLP
ATTORNEYS AT LAW

Scott O'Connell

Partner
Practice Group Leader, Financial Services and Securities Litigation

soconnell@nixonpeabody.com
617-345-1150
Fax: 866-947-1393

Practice Areas

Consumer Class Actions
Corporate Governance & Regulatory
Securities & Governance Litigation
Government Investigations & White Collar Defense
Financial Services Litigation
Hedge Funds & Alternative Investments Litigation
Subprime & Leveraged Finance Disputes

Scott O'Connell is the leader of the firm's Financial Services and Securities Litigation Practice Group. He represents integrated financial service companies—including banks, securities firms, insurance companies, and regulated subsidiaries of nonfinancial parents—in federal and state court litigation and before regulatory agencies.

Mr. O'Connell has extensive experience defending financial institutions in class actions concerning lender liability, breach of contract, breach of fiduciary duty, breach of good faith, unfair and deceptive trade practices, fraud, misrepresentation, fair debt collection practices, and civil RICO. He has particular trial experience litigating complex financial relationships between parties. His trial experience includes disputes between majority/minority shareholders in closely held businesses, partners, joint venturers, and co-developers. He has also successfully defended companies and their professional advisors sued under various theories of securities fraud.

While at law school, Mr. O'Connell served as an editor of the *Cornell Law Review* and as chancellor of the Moot Court Board. He was also an instructor in the Cornell undergraduate government course, "Law: Its Nature and Function."

Mr. O'Connell has been recognized for exceptional standing in the legal community in *Chambers USA: America's Leading Lawyers for Business 2008* for his Securities Litigation work. He has also been recognized as a "New England Super Lawyer" in Securities Litigation based on a peer-review survey by *Boston Magazine* (2007). Mr. O'Connell has earned an AV rating from Martindale Hubbell.