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Coerced Cooperation Policy Threatens Employee Rights

By Stanley S. Arkin and Howard J. Kaplan

The government's growing emphasis on cooperation in connection with criminal and regulatory investigations of so-called corporate fraud is eroding individual rights and legitimate employment expectations, and is fundamentally altering the traditional relationships among a corporation's various constituencies, including its employees, counsel, and board of directors.

Redolent of recent times and near places where condemning neighbors or even family members is exalted in the cause of social and political virtue, the government is, in effect, turning corporations and their counsel against possibly accusable employees, often forcing companies to mete out punishment before there is even an indictment, lawsuit or other significant determination of wrongdoing. Even where the virtues sought to be protected and nurtured are in the abstract as unquestionable as commercial probity and transparency, that balance of moderation so intrinsic to a system of justice is increasingly at risk.

Witch-Hunt Atmosphere

The government's aggressive enforcement tactics diminish employee loyalty and cooperation, particularly in times of crisis, and breed insecurity and suspicion among employees of companies under government investigation. Such employees will come to expect the witch-hunt atmosphere that now often follows accusations of corporate wrongdoing and may legitimately fear that the company, eager to prove its willingness to cooperate with the government, will sacrifice the careers of those involved with little regard for actual culpability.

In fact, as recently reported by The New York Times, Wall Street firms are sufficiently skittish over the current enforcement and public relations environment that a growing number of employees with previously distinguished careers face termination for perceived ethical breaches, even where the alleged conduct falls short of violating any law or stated company policy.1

Such an environment is not conducive to rooting out actual wrongdoing and, indeed, creates a disincentive for employees (even innocent ones with important information) to come forward and cooperate with an internal investigation.

This article highlights these and other effects of the more aggressive government policies in this area.

The Role of Corporate Counsel

The government now brings immense pressure to bear on companies to investigate, discover and report all instances of suspected wrongdoing, and to waive the attorney-client privilege with respect to counsel's otherwise confidential communications with employees. Thus, at the outset of any internal investigation or before, corporate counsel is immediately pitted against the company's officers and employees. This adversarial posture is reflected in the nature of warnings that now must be given by corporate counsel, including that an employee's statements may be provided to the government and may serve as the basis for a criminal or regulatory prosecution.

The government has made clear that this policing function of corporate counsel is a central tenet of its enforcement policies. Last year, several former executives of Computer Associates were prosecuted on charges of obstruction of justice arising, in part, from allegedly perjurious statements made to outside corporate counsel during the company's internal investigation of alleged misconduct. The government charged the executives with obstruction on the theory that the executives lied to corporate counsel knowing that the information they provided would be turned over to government investigators.2 Similarly, to keep corporate counsel in line, the government has recently pursued several lawyers, including one who had no role in the alleged fraud apart from a failure to report his suspicions of wrongdoing up the corporate ladder.3

Quasi-Governmental Function

Closely related to this new quasi-governmental function of corporate counsel, the government now frequently demands that companies under investigation waive their attorney-client privilege. If a company refuses to waive its privileges, the government then presumes that the company is not cooperating with the investigation (a real threat, given the dire consequences that could flow from such a determination). In its 2001 Seaboard Report,4 the SEC encourages accused corporations to prepare and produce written reports identifying possible misconduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law. While the SEC goes on to say that it considers privilege waiver only as a means where necessary to provide relevant and sometimes critical information, in practical effect, the SEC is signaling that corporations should waive their privileges if they hope to obtain the benefits of cooperation.5

Indeed, in a number of recent enforcement actions, the SEC has praised corporations for waiving their attorney-client and work product privileges, and has made its penalties dependent upon such a waiver. Last year, for example, the SEC settled accounting fraud charges against Royal Ahold arising from alleged accounting irregularities that had inflated the company's reported earnings by about $830 million. Despite this conduct, however, Royal Ahold escaped monetary penalty based in part upon its extensive cooperation, including voluntary reporting of the alleged misconduct, disclosure of the company's investigative reports and supporting information to the SEC, and waiver of the attorney-client and work product privileges with respect to the internal investigation.6

Waiver of Privilege

The DOJ also emphasizes waiver of privilege as a basis for leniency. As memorialized in the Holder and Thompson Memoranda,7 prosecutors evaluating whether to charge a corporation with criminal conduct are instructed to consider the corporation's willingness to disclose the complete results of its internal investigation and to waive its attorney-client and work product privileges, including both with respect to the internal investigation and with respect to communications between specific officers, directors and employees and counsel. According to the DOJ, such waivers permit the government to obtain statements of possible witnesses and targets without having to negotiate individual cooperation or immunity agreements. For a more detailed discussion of the government's growing reliance on privilege waiver and its dangerous effects, see Corporate Attorney-Client Privilege and Work Product, New York Law Journal, May 4, 2004 (by Stanley S. Arkin & Charles Sullivan).

These policies essentially transform the chief legal officers of public companies into quasi-governmental investigators. Although they may lessen the burden on investigating government officials, these policies in fact ultimately risk undermining the government's presumed long-term goal of achieving greater compliance with federal securities and other laws. Recently, the U.S. Court of Appeals for the Second Circuit affirmed the sanctity and value of the attorney-client privilege--and the public's interest in preserving that privilege--in upholding the privilege as applied to governmental entities: Upholding the privilege furthers a culture in which consultation with government lawyers is accepted as normal, desirable, and even indispensable part of conducting public business. Abrogating the privilege undermines that culture and thereby impairs the public interest.8 As the Second Circuit also recognized, it is sheer fantasy to suggest that forced disclosure of privileged communications will not make internal investigations more difficult to the point of being impossible.9

No doubt the privileges sought to be waived belong to the company, not the employee and, ultimately, company counsel's loyalty need be to the shareholders, not management. Yet, the notion of going to a lawyer for advice and direction--a company lawyer on premises for that purpose--has a profound social utility, which seems not to be weighed in the wholesale policy of requesting waivers. Lawyers are not there to simply listen to complaints or confessions, but with the basic mission of telling people how to be law-abiding. Encouraging a reluctance by corporate employees to confide in a corporate lawyer risks losing that core benefit of the profession.

Individual Ability to Defend

The Government's Efforts to Diminish an Individual's Ability to Defend. The government's aggressive enforcement policies also encourage companies to disadvantage accused or even potential subjects of an investigation, not necessarily on a careful and thoughtful consideration of all the evidence, but in an effort to demonstrate cooperation with the government. Companies now routinely fire possible subject or target individuals before the investigation is even

complete (or in many cases at its beginning), and thereafter seek to deprive them of critical information and indemnification.

In other words, with increasingly rare exception, companies will no longer support employees who may be accused of wrongdoing, regardless of what the facts may ultimately show. Indeed, as previously noted, a growing number of companies have fired senior executives at risk of being accused of perceived wrongdoing as a preemptive step to carry a more favorable view by government agencies. It is simply indisputable that policies which produce such harsh results will negatively impact the employer-employee relationship and, in particular, will seriously compromise employee loyalty, a singular factor in economic productivity.

The government's policies in this regard are quite clearly stated. For example, both the SEC and the DOJ have made clear in recent pronouncements that they expect a corporation to terminate individuals responsible for possible alleged misconduct. As explained by the SEC's director of enforcement last year, appropriate disciplinary action against culpable individuals will mitigate any potential penalty. Likewise, the DOJ commends efforts to replace responsible management and to discipline or terminate wrongdoers.10 In practice, these policies encourage companies to terminate suspected executives or employees immediately, during the very early heat of an investigation, before any official determination of misconduct either by corporate counsel or by the government.

Recent communications from the SEC also indicate that a corporation's payment of its employees' attorney's fees will be considered a black mark against the corporation. For example, in assessing a $25 million penalty against Lucent last year for its failure to cooperate, the SEC explained that the penalty resulted partly from the fact that without being required to do so by state law or its corporate charter, Lucent expanded the scope of employees that could be indemnified against the consequences of this SEC enforcement action, conduct the SEC deemed contrary to the public interest.11 The company reportedly had agreed to cover legal costs, fines and penalties incurred by the employees in connection with the government's investigation.12 The Enforcement Division has since commented that the SEC may well ask a company not to indemnify employees who have incurred legal costs and penalties.13

Beginning with the 1999 Holder Memorandum, it also has been the DOJ's stated policy that a corporation's support of culpable employees, including by the advancement of legal fees or entry into joint defense agreements, will be viewed as a factor weighing in favor of criminal charges and more onerous penalties. The 2003 Thompson Memorandum further condemns overly broad assertions of corporate representation of employees or former employees.14

Attack on Indemnification

Given the government's patent hostility to advancement of fees and indemnification of corporate officers, companies will necessarily feel pressured into resisting their obligations in this area.15 The government's attack on indemnification undermines the settled and, we believe, justifiable expectations of corporate officers, as well as the complex indemnification architecture established under Delaware and like laws, the purpose of which is to enable corporations to attract and retain qualified officers, directors and employees. But more importantly, it turns the presumption of innocence on its head, encouraging corporations to deny their employees the means to protect their legal rights before there has been any sort of adjudication that the employee has engaged in unlawful conduct.

In addition, accused employees face the threat that their employer, struggling to gain favor with the SEC, will withhold compensation and other entitlements. In a recent example, the SEC exerted pressure on new management of Gemstar-TV Guide International Inc. to withhold severance and other moneys from the company's former CEO and CFO. The SEC sought to deprive the former officers of these entitlements by invoking 1103 of the Sarbanes-Oxley Act, which authorizes the SEC to freeze extraordinary payments that are about to be made by corporations under investigation. Although 1103 requires the SEC to obtain a court order to freeze funds, the SEC originally exerted pressure on Gemstar to cooperate by withholding payments before the government's investigation was completed and before it could show any entitlement to freeze the money under the statute.16 The company later cited its cooperation in this regard when seeking--and obtaining--lenient treatment from the SEC. In announcing a $10 million penalty against Gemstar for alleged accounting fraud, the SEC specifically credited Gemstar for voluntarily agreeing not to make the payments.17 Whether the SEC is proved to be right in the future or not, the point is that the company's cooperation enabled the SEC to avoid all process.

Recently, too, the accounting giant KPMG LLP, in the early midst of a grand jury investigation over the lawfulness of certain tax shelters it previously purveyed, and which up until the investigation it together with its partners staunchly supported, later switched strategies, forced those partners to resign and refused to pay legal costs unless [those partners] agreed to cooperate with the prosecutors, where anything...said could be used against [them].18

As David Boies in his recent commentary in the Wall Street Journal, The Case of Hank Greenberg, cogently observed, [t]he right of citizens to refuse to testify is increasingly under attack by regulators and others despite the fact that the right of citizens to refuse to testify serves important public purposes, and often times is motivated by reasons other than being guilty of something.19

Conclusion

Undeniably, the slew of corporate scandals in recent years has demanded a reevaluation of our government's approach to enforcement of the securities laws and other laws to protect investors and consumers. But in the rush to reform, we may have created a system that encourages an at-risk corporation to arbitrarily and callously throw its employees to the wolves. The consequences of this growing policy on the employer-employee relationship are now becoming apparent, and are extremely unsettling.

1. Landon Thomas, Jr., On Wall Street, a Rise in Dismissals Over Ethics, The New York Times (March 29, 2005).

2. U.S. v. Kumar and Richards, Indictment (E.D.N.Y. Sept. 17, 2004) 53-55, 58-59.

3. SEC Litigation Release No. 18896 (September 24, 2004).

4. Seaboard Report (Securities Exchange Act of 1934, Release No. 44969 (October 23, 2001)).

5. Stephen Cutler, the SEC's Director of Enforcement, has commented publicly that a company's willingness to cooperate with the SEC's requests will often prove decisive in determining the penalty to be assessed upon a corporation. Stephen M. Cutler, Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (April 29, 2004). In this connection, Cutler has instructed the SEC staff to keep an ongoing log of each party's cooperation, or lack thereof, throughout the course of each SEC investigation. Stephen M. Cutler, Remarks Before the District of Columbia Bar Association (February 11, 2004).

6. SEC Litigation Release No. 18929 (Oct. 13, 2004).

7. Memorandum from U.S. Deputy Attorney General Eric Holder, Federal Prosecution of Corporations (June 16, 1999); Memorandum from U.S. Deputy Attorney General Larry Thompson, Federal Prosecution of Business Organizations (Jan. 20, 2003).

8. In Re: Grand Jury Investigation, 399 F.3d 527, 534 (2d Cir. 2005).

9. Id. (citing 1 Paul R. Rice, Attorney-Client Privilege in the United States 4:28, at 4 (2d ed. 1999).

10. Stephen M. Cutler, Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (April 29, 2004).

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

12. Deborah Solomon and Dennis K. Berman, SEC Gets Tough With Settlement in Lucent Case, The Wall Street Journal, May 17, 2004.

13. Bureau of National Affairs, SEC Enforcement: SEC Demand for 'Cooperation' Seen Raising Due Process Concerns (June 14, 2004). In a recent unpublished and relatively unpublicized speech to the American Bar Association's Committee on Federal Securities Law Regulation, Joan McKown, chief counsel for the SEC's enforcement division, distinguished between indemnification for penalties and indemnification for an employee's legal fees. These comments do not appear to have been embraced as official policy of the Enforcement Division. Bureau of National Affairs Securities Regulation and Law Report, SEC Enforcement: Acceleration Clauses for Payment Now a Part of SEC Settlement Agreements (December 6, 2004).

14. Supra note 7 at VI(B).

15. In a decision last year, a Delaware court specifically noted the recent increase in disputes over fee advancement rights. See Tafeen v. Homestore, 2004 WL 556733, at *1 (March 22, 2004).

16. Arkin Kaplan represents Dr. Henry C. Yuen and Elsie M. Leung, Gemstar's former CEO and CFO.

17. SEC Press Release, Gemstar-TV Guide International Agrees to Settle SEC Enforcement Action Charging the Company with Overstating its Revenues (June 23, 2004), available at http://www.sec.gov/news/press/2004-86.htm.

18. Laurie P. Cohen, Prosecutors' Tough New Tactics Turns Firm Against Employees, The Wall Street Journal (June 4, 2004).

19. David Boies, The Case of Hank Greenberg, The Wall Street Journal (April 12, 2005).