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Planning for When Things Go Wrong: Are You Ready To Investigate Allegations of Board Member Misconduct?

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Let us start our discussion with an area of broad consensus: A company's board of directors has a duty of care to respond to and investigate allegations of wrongdoing by officers and/or employees of the company. But what happens when a board member is the one in the investigatory hot seat? Do the same investigative rules and techniques apply when, for instance, a director has been accused of insider trading or leaking confidential information? And what are the best practices companies should consider *proactively* implementing so that they are best-positioned to effectively investigate alleged board member misconduct if and when it occurs? We will try to provide some time-tested, common sense—but oft-overlooked—guidance to help you prepare for these not-so-uncommon eventualities.

1. The Basics: Hire Outside Counsel Carefully, Task Specifically

Once grounds justifying an investigation have been identified, the company (typically through a special committee of the board headed by uninvolved board members) should, in the board resolution creating the committee and counsel's engagement letter, clearly define the scope of the investigation and the investigatory objectives so as to avoid any ambiguity concerning what is within the outside investigators' charter. Companies, moreover, are also well-advised to retain experienced (and probably independent) outside counsel; being able to demonstrate little prior involvement with the company or board members can be a plus. Tasking outside counsel with the job of conducting a full and independent investigation will not only help give counsel's ultimate investigative findings additional credibility with company stakeholders, but it will also be a factor considered if and when the authorities (such as the Securities and Exchange Commission or the U.S. Department of Justice) step in and review the investigative findings.

2. The First Step to Securing Board Member Cooperation: Service Agreements and Corporate Bylaw Language

The easiest way to ensure board member cooperation in an internal investigation is to explicitly include a duty to cooperate in board member service agreements (consider in this vein also the employee's duty to cooperate in an employment contract or handbook).[1] In the spirit of belt and suspenders, moreover, cooperation can additionally, and perhaps with less push back from the board, be required through the corporate bylaws. The agreement should include simple, direct language requiring a director to fully cooperate in any internal or external investigation, and should specify that cooperation includes expeditiously turning over potentially probative documents and communica-

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[1] Consider in a similar vein insurance agreements that require the insured to cooperate in investigations. *See, e.g.*, Stewart Sleep Ctr., Inc. v. Atl. Mut. Ins. Co., 860 F. Supp. 1514, 1519 (M.D. Fla. 1993); Liberty Mut. Ins. Co. v. Precisionaire, Inc., 8:00-CV-1971-T-17EAJ, 2006 WL 905389 (M.D. Fla. Apr. 7, 2006).

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tions within the director's professional or personal custody or control. Note, however, that such a broad request may encounter resistance; companies must, therefore, carefully tailor such language to their specific circumstances.[2] The company may also want to specify that the duty to cooperate remains even after a director resigns or is terminated.[3]

As touched on above, one drawback to including this language in the agreement is potential pushback from the prospective board member. This can be managed, in part, by including a reciprocal duty by the company to cooperate.[4] Thus, the company is not asking more from the board member than it is willing to provide.

3. The Duty to Cooperate—What Does It Mean?

Clear service agreement and corporate bylaw language mandating cooperation is, of course, great, but what if you do not have it in place? To make matters worse, what do you do when a board member accused of being involved in the alleged misconduct simply refuses to cooperate with the investigation?

Tasking outside counsel with the job of conducting a full and independent investigation will not only help give counsel's ultimate investigative findings additional credibility with company stakeholders, it will also be a factor considered if and when the authorities step in and review the investigative findings.

In the face of such a refusal (which is, in fact, fairly common), it can be helpful to politely point out that board members owe a fiduciary duty to their companies, including a duty of care and a duty of loyalty.[5] These duties, in turn, include a duty to cooperate with an internal investigation [6] (note, however, that such a duty to cooperate is not explicit in the Model Business Corporation Act, nor is it entirely settled as a matter of law).

The reasonable expectation of cooperation is animated by an understanding that officers and corporate directors have a fiduciary duty of care to respond to allegations of corporate wrongdoing by fully and independently investigating the accusations, and by considering all pertinent information bearing on the issue. Once a director or officer is put on notice regarding a claim of serious wrongdoing, he or she must put forth a reasonable effort to discover all relevant information to fulfill the duty of care, including making him or herself available for reasonable questioning calculated to determine whether any wrongdoing occurred.[7]

This position is also reflected in Section 302 of the Sarbanes-Oxley Act,[8] which imposes upon officers a responsibility to ensure that they have accurately reported to the company's auditors and to the company's audit committee any fraud, whether or not material, that involves directors, management, or other employees who have a significant role in the issuer's internal controls. These provisions incentivize CEOs and CFOs to diligently investigate any known or suspected wrongdoing brought to their attention; a failure to do so may subject them to liability.

That said, SOX does not provide a mechanism for removal for failure to cooperate. In fact, Delaware General Corporate Law Section 225 specifies the very narrow circumstances pursuant to which the company can seek the removal of a director. In general terms, the Delaware Court of Chancery, upon application by the corporation, can only remove a director following (1) a felony conviction in connection with the duties of such director to the corporation; or (2) a prior court judgment on the merits finding that the director committed a breach of the duty of loyalty.

4. Board Member Resolutions

In the absence of a duty to cooperate in the service agreement and/or bylaws, the board can also require cooperation from its directors and officers as part of its resolution authorizing the investigation.[9] The only downside to this course of action is that the board adopting the resolution is the same board subject to investigation, and, thus, may not, of its own accord, want to include the duty to cooperate. The lesson, thus, is that it is always preferable to include duty-to-cooperate language in the service agreement and bylaws before any allegations of misconduct arise.

[2] In terms of sample language, consider: ''The director agrees to cooperate with [company] and its in-house and/or outside attorneys, both during and after the termination of the director's board membership with [company], in connection with any litigation, internal investigation/review, or other proceeding arising out of, or relating to, matters of which the director can reasonably be said to have been directly or indirectly involved prior to the termination of the director's service, or about which the director has knowledge. The director's cooperation shall include, without limitation, providing assistance to company's counsel, experts, and consultants; submitting to interviews with company or outside counsel; turning over any and all documents, communications, and other items of potentially relevant evidence in the director's custody or control; and providing truthful testimony in any court proceedings. In the event that the director's cooperation is requested after the termination of his or her service to [company], [company] will seek to minimize interruptions to the director's schedule to the extent consistent with its interests in the matter, and will reimburse the director for all reasonable and appropriate out-of-pocket expenses actually incurred by the director in connection with such cooperation upon reasonable substantiation of such expenses.''

[3] *Cf.* Lindquist v. Linxian, 11-23876-CIV, 2012 WL 3811800 (S.D. Fla. Sept. 4, 2012) (holding that, after resignation, board member had no fiduciary duty to voluntarily disclose information to the audit committee or turn over documents).

[4] *Cf.* Service Agreement between Richard Alden and Skull Candy, § 6 (requiring Skull Candy to cooperate with the Director in any investigation and provide information and documents), *available at* http://www.sec.gov/Archives/edgar/data/1423542/000119312511115588/dex1020.htm (last visited April 30, 2013).

[5] *See, e.g.*, MODEL BUS. CORP. ACT § 8.30.

[6] *Cf.* Neb. Legislature *ex rel.* State v. Hergert, 720 N.W.2d 372, 399 (2006) (holding that a public officer, in this case a university regent, has a ''duty to cooperate with investigators'').

[7] *See generally In re* Abbott Lab. Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2003); McCall v. Scott, 250 F.3d 997 (6th Cir. 2001); *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996); *see also Hergert*, 720 N.W.2d at 399.

[8] Codified at 15 U.S.C. § 7241.

[9] *See, e.g.*, Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 607 (8th Cir. 1977).

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5. Communication Devices

Companies should also consider whether to issue communication devices to board members and require members to use these devices for company business. This requirement can be included in the service agreement and would potentially give the company unfettered access to relevant communications in the event of an internal investigation. This requirement could also prevent the inadvertent waiver of privilege.

For instance, if a board member is not provided with an email account and is communicating with an attorney using a different company's email account (that is known to be monitored by the other company), then there is the risk that the otherwise applicable attorney-client privilege for those communications may be deemed waived.[10] Conversely, if the board member fails to follow company instructions about using these devices, then that may provide an independent ground for potential removal.

A muted word of caution: Although requiring the use of company-issued communication devices or email accounts may be helpful when investigating a recalcitrant board member, it also puts a greater burden on the company in the event of an external investigation. Specifically, the company will be required to maintain and preserve the information and may be subject to sanctions if, for instance, it doesn't take steps to preserve text messages once litigation is reasonably anticipated.[11] Additionally, and as noted above, board members may well reject any service agreement that allows the company unfettered access to their communications and can be expected not to use them if they are knowingly engaging in improper conduct.

6. Conclusion

Companies have a duty to investigate allegations of board member misconduct. In discharging that duty, companies should:

- Seek independent outside counsel to conduct investigations into credible allegations of wrongdoing.
- Proactively include a duty to cooperate with internal investigations in all board member service agreements and in the corporate bylaws.
- Include the duty to cooperate in any board resolution authorizing the investigation.
- Maintain confidentiality, move quickly to determine if there are any actions needed to protect the workforce, hold and preserve appropriate records, review relevant corporate policies, and provide the investigator with access to records and individuals.
- Consider requiring directors to use company phones and computers for all company business.

As those who have gone through investigations into allegations of board member wrongdoing can attest, the process can be exceptionally costly both financially, as well as emotionally. Business disruption and damage to employee morale due to virtually inevitable infighting are common side effects, as are claims that the special committee is exceeding its authorization or otherwise engaging in a ''witch hunt.'' Nobody wants to be in the middle of this type of an internal investigation, but with a bit of foresight and preparation the duration and toxicity of the experience can de drastically limited, and the ultimate reliability of the resulting findings and recommendations notably enhanced.

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[10] *See* Holmes v. Petrovich Dev. Co., LLC, 191 Cal. App. 4th 1047 (Cal. Ct. App. 2011). In contrast, at least one court has held that using a password protected personal email on a company laptop to send emails to an attorney does not waive the attorney-client privilege. *See* Stengart v. LovingCare Agency, Inc., 990 A.2d 650 (N.J. 2010).

[11] *See, e.g.*, Regas Christou v. Beatport, No. 10-cv-02912, 2013 WL 248058, at *13–14 (D. Col. Jan. 23, 2013) (sanction for failure to preserve text messages).