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When the Government Comes Knocking



NYLJ PHOTO/RICK KOPSTEIN

BY C. EVAN STEWART

NELSON ALGREN once proffered some profound wisdom: “Never play cards with any man named ‘Doc’. Never eat at any place called ‘Mom’s’. And never, never, no matter what else you do in your whole life ... sleep with anyone whose troubles are worse than your own.” To that, I would not only say “amen,” but would add another: be afraid if you are an in-house lawyer for a regulated company subject to investigation by the New York attorney general. Be very afraid.

*Responding
to investigations
is not
what it used to be.*

To put this admonition in perspective, let us assume the following. During the course of your very busy day as general counsel of the XYZ Securities Company headquartered in New York City, you learn that your firm has just received a subpoena from the New York attorney general with respect to a certain business practice; previously you had asked an outside law firm to opine on the practice — their view was that it comes close to the edge, but does not cross it.

On the heels of the subpoena come several additional items: (i) the media reports that the attorney general intends to charge (under the Martin Act) companies and individuals found to have engaged in the aforementioned practice; (ii) a request comes in from the U.S. Securities and Exchange Commission for documents relating to internal due diligence for public disclosure documents — specifically targeting whether the company considered

disclosing the nature and status of the business practice; (iii) class action lawsuits are being initiated by well-known plaintiff law firms, prompted by the media reports; and (iv) certain of your current and former employees have formally requested the company to advance legal fees to defend themselves with respect to the regulatory investigations and civil litigation relating to the business practice.

Quite a Handful

Going back to bed and pulling the covers up over your head is, unfortunately, not an option. Rather, you must figure out how to deal with this imbroglio, and in a relatively prompt fashion.

Protecting your client is, of course, the main goal; and your only client here is XYZ Securities. As a result, all notions of shielding high-ranking executives (current or former) must be thrust aside. That determination is, in actuality, easier than the

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ultimate job of protecting the company, mainly because effectuating that second objective has changed in recent years.

Not so long ago, corporate counsel would launch an internal investigation, determine the facts, advise the client on how best to proceed, make a (compelling) presentation of the company's defense(s) to regulators, and negotiate various settlements that would be as costless and disruptive as possible. No longer.

The attorney general's modus operandi has basically taken the somewhat orderly process outlined above out of play. As we have seen, first with the securities industry, next in the mutual fund investigation, and most recently with the insurance industry, the attorney general's approach has been to put a company's entire viability at issue from the outset.

Regulatory Tsunami

This tsunami approach leaves little or no room for traditional notions of lawyering. The clearest example of this can be shown by what happened at Marsh & McLennan in November 2004. There, the general counsel of that firm (a former partner at one of the country's venerable law firms) had "sparred" with the attorney general's office, according to press reports, as to various allegations relating to insurance practices; i.e., he had attempted to interpose defenses to the allegations of wrongdoing. Fed up by such "tactics," the attorney general informed Marsh (directly and via the media) that it faced possible indictment and that his office would no longer "negotiate" with current management. The result? The Marsh board of directors quickly exited management (including the general counsel), put in place as the new CEO a former colleague of the attorney general, and promptly (and publicly) sued for peace (which was ultimately achieved by an historic financial payment of \$850 million and a formal "apology" to the company's clients).

What gives the attorney general more "bite" than others (e.g., the SEC) lack? It is the ability to threaten criminal prosecution under New York state law.

SEC enforcement proceedings, which are daunting enough, do not carry with them criminal sanctions. And while no public company wants to endure a lengthy regulatory proceeding (with the negative fallout on the stock price, etc.), conventional wisdom is that no public company can survive a criminal indictment. Even if it is subsequently vindicated by a jury, all that will be left of the company will be the embers fought over by the creditors (e.g., Arthur Andersen, Enron).



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What about the fate of defense lawyers in such circumstances? William McLucas, a former SEC enforcement director, recently told his former colleagues: "It's the bar's duty to resist and fight you." He is right, but remember the potential ramifications to your career of following that advice — just ask Marsh's former general counsel.

The SEC subpoena referenced in the hypothetical poses potential problems not only for XYZ Securities, but also its lawyers. The Sarbanes-Oxley Act substantially changed lawyer obligations in the area of disclosing client confidences. A lawyer now "may" disclose such information: (i) to prevent client fraud with substantial financial injury; (ii) to prevent client fraud on the SEC; or (iii) to rectify client fraud with substantial financial injury which utilized the lawyer's services.

And while these disclosure options are "only" permissive, failure to act appropriately will subject a lawyer to the full panoply of regulatory sanctions available to the commission under the 1934 Securities and Exchange Act.

In this article's hypothetical, the lawyers who worked on XYZ's disclosure documents presumably had no basis for concluding that the business practice was wrong or that its ongoing nature or status needed to be disclosed; after all, the company had an opinion from outside counsel concluding that it was not illegal. Will that constitute a bullet-proof vest? Hardly.

The mutual fund investigation is highly (and disturbingly) instructive. There, the conduct at issue relates to "market trading" and "late trading." The former is not illegal, and was known for years to be a widespread practice; the latter had never been judged, determined or interpreted to be illegal prior to the attorney general's investigation, and a number of prominent law firms had advised clients that "late trading" (a term that did not exist previously) was not illegal. [The author represents former Bank of America Corp. broker Theodore Sihpol, who was indicted last year on charges he stole from mutual funds by performing late trading. A trial is scheduled for April.]

In February 2004, the head of New York's Investment Protection Bureau stated in press reports, "we are living in a completely new regulatory world," and announced that the attorney general "would not hesitate" to go after law firms that were aware of, and approved, "improper" trading in the mutual fund industry. More recently, the head of the SEC's Enforcement Division publicly announced that "you can expect to see one or more actions against lawyers who, we believe, assisted their clients in engaging in illegal late trading or market timing arrangements that harmed mutual fund investors," and that the commission is looking at suing both inside and outside counsel who helped clients conceal mutual fund trading practices or who "prepared, or signed off on, misleading disclosures regarding [their clients'] conditions."

Barbarians Inside the City Walls

The current regulatory landscape makes clear that “cooperating” with regulatory investigations is the only way to ensure that your client survives (not to mention you!). Such “cooperation” comes at a price, however, both literally and figuratively. Again, the mutual fund industry investigation is instructive.

To curry favor with the New York attorney general (and other regulators), mutual fund companies promptly fired scores of individuals (regardless of whether there was evidence they were responsible); the companies also agreed to pay fines which had no correlation to the monetary injury that was alleged. Certain funds further agreed to reconstitute their fee structures. As a matter of public policy, this last feature should cause the most concern — who is to say that the new fee structures are, in fact, better than the old ones? The normal process for addressing such an issue has traditionally been through administrative proposal, subject to public comment, with thereafter possible adoption, revision, amendment, or rejection. Now, the mutual fund industry’s fee structure has been determined by, in essence, one person via threatened criminal prosecution, without any public input. What if he is wrong?

And there is another consequence of such “cooperation.” Regulators have consistently made clear that waiving attorney-client privilege and work product are part and parcel of judging a company’s good faith. Whatever benefit might accrue from such a waiver(s) has a price, however. In the civil litigation that follows (just as night follows day), the plaintiffs’ law firms are entitled to the waived materials — materials which constitute what some lawyers have called a “silver platter” (i.e., evidence which renders your ability to defend the client a nullity).

Thus, remember, whatever “cooperation” you engineer for the client will have at least two costs: the regulatory fines and settlements, and the checks written to resolve civil litigation which your client’s own privileged communications and your own work product have rendered indefensible.¹

Delaware Law, Corporate Bylaws

One other “cooperation” component, which regulators have flagged, needs to be highlighted. As set forth in this article’s hypothetical, the issue of corporate targets advancing legal fees to current and/or former employees under their indemnification policies has become a hot topic for regulators. Why this is so is fairly clear — it allows the individual targets to defend themselves against the vast prosecutorial arsenal of the government. The government does not like this state of affairs because sometimes individuals, unlike companies, will put the government to its proof, having nothing to lose in going to trial, and everything to gain (e.g., Richard Grasso in his current litigation with the New York Attorney General).

In one sense, this should not be a controversial matter. Companies (most of which are incorporated in Delaware) are mandated by their corporate bylaws and under Delaware law to advance legal fees. Yet, at the same time such requests are coming over the corporate transom, a government prosecutor/regulator is making a life or death decision about that corporation’s future and factoring in whether it is being fully “cooperative,” or not.

Early in 2004, the SEC settled an enforcement case with Lucent Technologies, Inc. which suggested (opaquely) that the SEC’s anger at the company was based, in part, because Lucent “without being required to do so by state law or its corporate charter, had “expanded” the

numbers of employees that could be covered under Lucent’s indemnification policies; the commission also stated that the company had failed to disclose a “key issue” concerning employee indemnification, without identifying the issue.

The SEC’s opaque complaints vis-à-vis Lucent were recently “clarified,” but in truth they represent the tip of the iceberg of regulators’ concern about companies complying with their own bylaws and Delaware law. In at least one case, an individual has had to sue in Delaware to compel compliance by a company reluctant to raise the attorney general’s ire by voluntary compliance. Lawyers with corporate clients facing the 800-pound government gorilla thus need to be sensitive about this issue. Blithely following clear legal obligations may have some unhappy consequences for your corporate client.

Conclusion

Corporate crises put lawyers front and center. That may sound like good news, but it brings a fair amount of unpleasant baggage and problematic risks. The current regulatory environment gives new meaning to that old aphorism: be careful what you wish for.

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1. There is one U.S. Circuit Court of Appeals (the Eighth Circuit) that has embraced the concept of “selective waiver” — waiver to regulatory authorities but not to third parties; the other circuits have not. The SEC has tried to argue in various amicus briefs for such a doctrine, with little success (most recently in California state court). The commission has also supported congressional legislation to permit selective waiver; that proposed legislation shows no momentum at present.

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