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Handling Internal Investigations in the Executive Compensation Area

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Introduction

As the domestic and global economies continue to struggle, it's no surprise that there has been an increasing focus on how (and how much) public company executives are paid. Whether through focus on the ''Occupy Wall Street'' demonstrations, complaints about large ''golden parachutes'' for departing executives, or allegations of undisclosed executive perquisites, or ''perks,'' scrutiny has increased from all sides – including the media, the government, and the plaintiffs' bar – on payments and other benefits provided to company executives and whether those payments and benefits violate corporate governance standards, disclosure rules, or other legal obligations. As a result, the ability to address and resolve allegations of misconduct in the executive compensation area with efficient, targeted internal investigations is becoming increasingly important.

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This article seeks to provide guidance on ways to approach internal investigations that are focused on executive compensation issues. Whether handled internally or with the aid of outside counsel, these investigations implicate sensitive corporate governance issues and must be conducted appropriately and with due care. Further, because such investigations often relate to how the most senior members of company management are paid and how corporate boards make compensation decisions, they need to be handled thoroughly, efficiently, and fairly to enable boards and corporate officers to discharge their fiduciary obligations to their companies. Most importantly, such investigations should provide a company and its board with assurance that all material matters have been diligently investigated so that the company can adequately resolve any regulatory issues that may be presented by the findings.

The article begins by providing a short overview of some of the issues that have recently spawned internal investigations relating to executive compensation in some high-profile cases. The article then provides guidance on the investigative steps that companies may take in order to address allegations or evidence of improper conduct relating to compensation matters.

Allegations Relating to Executive Compensation

Allegations of improper executive compensation practices have the potential to trigger civil and criminal litigation, investigations, and damaging public disclosures that can affect a company's stock value and prompt shareholder rebukes. As one striking example, allegations over the last six years that compensation committees or executives at public companies had ''backdated'' or ''spring-loaded'' the issuance of executive stock option grants so as to use hindsight to take advantage of favorable strike prices for top-level management prompted a myriad of expensive investigations and ensuing Department of Justice and Securities and Exchange Commission prosecutions, as well as class action and derivative litigation.[1] Companies like Brocade, Comverse, Broadcom, Apple, and others underwent significant internal investigations to respond to allegations of improper executive compensation practices. Subsequent DOJ criminal enforcement actions targeted CEOs and other senior executives at those companies, and the SEC pursued civil settlements with executives at companies like United Health, Apple, Monster Worldwide, and Take-Two Interactive Software, Inc.[2]

Another area of executive compensation that has drawn scrutiny from regulators and shareholders relates to company reimbursements of executive expenses, and the reporting of executive perquisite or personal benefits in company proxy statements. In 2006, the SEC adopted new rules regarding Executive Compensation and Related Person Disclosures. The SEC's adopting release issued in connection with these new rules included guidance regarding the determination of whether a benefit provided to an executive qualifies as a perk or personal benefit.[3] The guidance suggested that benefits not ''integrally and directly'' related to the performance of the executive's duties that confer a ''direct or indirect benefit that has a personal aspect'' would be considered a perk unless provided on a nondiscriminatory basis to all employees.[4] Where the aggregate incremental expense to a company of perks provided to one or more of the executives named in the company's annual proxy statement in a particular year exceeds $10,000, the total value of such perks must be disclosed in the summary compensation tables in that proxy statement and, at a minimum, described by type in a footnote disclosure.[5] In addition, individual perks valued at the greater of $25,000 or 10 percent of total perquisites must be separately identified and quantified in a footnote. In addition, companies must disclose in a footnote an explanation of the methodology used to compute the value thereof based on the incremental cost to the company of providing these perks.[6]

Findings that company executives have improperly received undisclosed compensation in the form of perks or other benefits have prompted SEC investigations and board action in several cases. In January 2011, for example, the SEC sued Kansas-based NIC Inc., a manager of government websites, as well as its former and current CEOs and CFO, for failure to disclose more than $1.18 million in perks paid to its former CEO between 2002 and 2007.[7] The SEC alleged that the company had paid for the CEO's lodging at a Wyoming ski lodge, private aircraft flights to and from work, daily expenses for tobacco, liquor, and numerous other benefits that were deemed personal.[8] NIC agreed to settle the SEC charges by paying a $500,000 civil penalty and hiring an independent consultant to recommend improvement to NIC's compliance policies and controls governing payment of expenses and handling of whistle-blower complaints. NIC's former CEO settled the action with an agreement to pay $1,184,246 in disgorgement, $358,844 in prejudgment interest, a $500,000 civil penalty, and a bar from serving as an officer or director of a public company.[9]

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[1] Michael Farhang, *Stock Option Backdating and the Independent Director: An Analysis of Litigation Trends* (174 Pens. & Ben. Daily (BNA), 9/9/08; 35 Pens. & Ben. Rep. (BNA) 2123, 9/16/08); *see also* Raquel Meyer Alexander et al., *Backdating Employee Stock Options: Accounting and Legal Implications*, The CPA Journal, Vol. 77, No. 10 (October 2007). For some prominent lawsuits from this wave of litigation, see *In re Comverse Tech., Inc. Sec. Litig.*, 543 F. Supp. 2d 134, 142-43 (E.D.N.Y. 2008) (upholding § 10(b) claims against compensation committee directors in a backdating case where the stock plan in question required fair-market value pricing for options); *Ryan v. Gifford*, 918 A.2d 341, 356-58, 44 EBC 2907 (Del. Ch. 2007) (involving derivative claims stemming from alleged breach of fiduciary duties by corporate directors).

[2] *See* Farhang, *Stock Option Backdating, supra*. *See also* Jesse M. Fried, *Options Backdating and its Implications*, 65 Wash & Lee L. Rev 853 (2008). For prominent examples of DOJ options backdating criminal enforcement actions, see Department of Justice Release, http://www.justice.gov/usao/can/press/2010/2010_06_24_reyes.sentenced.press.html (June 24, 2010) (announcing the sentencing of a former Brocade CEO to 18 months in prison); Department of Justice Release, http://www.justice.gov/usao/cac/pressroom/pr2007/151.html (Nov. 29, 2007) (announcing a plea deal with a former Broadcom VP of Human Resources); Department of Justice Release, http://www.justice.gov/opa/pr/2006/August/06_odag_517.html (Aug. 9, 2006) (announcing charges filed against three former Comverse officials) (all last visited on Oct. 30, 2011). For an exhaustive catalogue of all recent press releases relating to SEC options backdating enforcement actions, see http://www.sec.gov/spotlight/optionsbackdating.htm (last visited on Oct. 30, 2011).

[3] *See* Executive Compensation and Related Person Disclosure Orders, Exchange Act Release Nos. 33-8732a, 34-54302a (Aug. 29, 2006), *available at* http://www.sec.gov/rules/final/2006/33-8732a.pdf (last visited Oct. 30, 2011).

[4] *See id.*

[5] *See id.*

[6] *See* Instruction 4 to Item 402(c)(2)(ix) of Regulation S-K.

[7] *See* U.S. Securities and Exchange Commission Litigation Release 21809 (Jan. 12, 2011) *available at* http://www.sec.gov/litigation/litreleases/2011/lr21809.htm (last visited Oct. 30, 2011).

[8] *See id.*

[9] *See SEC v. NIC, Inc., Jeffrey S. Fraser, Harry H. Herington, and Eric J. Bur*, Civil Action No. 2:11-CV-02016 (EFM) (D. Kansas Jan. 12, 2011) *available at* http://www.sec.gov/litigation/complaints/2011/comp21809-nic.pdf; *see also Form of Final Judgment as to NIC Inc., Jeffery S. Fraser, Harry H. Herington, and Eric J. Bur*, *available at* http://www.sec.gov/Archives/edgar/data/1065332/000101410811000003/ex992toform8k_jan122011.htm, *Consent of Defendant NIC Inc.*, *available at* http://www.sec.gov/Archives/edgar/data/1065332/000101410811000003/ex991toform8k_jan122011.htm (all last visited on Oct. 30, 2011).

In another high-profile example, in 2005, the SEC charged the former CEO of Tyson Foods with securities violations related to allegations that the company failed to disclose executive perks including payment for items like housekeeping and lawn and automobile maintenance.[10] Beyond executive perks, decisions conferring benefits to executives through related party transactions may also draw regulatory scrutiny and shareholder protest.[11] In all of these areas, board decisions authorizing executive benefits or proxy statements reflecting compensation may themselves be challenged and may become the focus of investigations or litigation.

Allegations relating to improper executive compensation can come from a variety of sources, including sources within a company in the form of internal whistle-blower complaints or audits, as well as external sources like government inquiries and subpoenas, or threats or lawsuits from third parties. Complaints made by corporate insiders or ''whistle-blowers'' relating to executive compensation need to be handled with particular care and attention, especially given the new SEC whistle-blower regulations based on the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act created a whistle-blower ''bounty'' program authorizing the SEC to pay significant monetary awards—10 percent to 30 percent of penalties over $1 million—to persons who provide the SEC with ''original'' information about violations of the securities laws (including those relating to executive compensation), while also affording whistle-blowers anti-retaliation protections.[12] As a result of these regulations, whistle-blowers may perceive a financial incentive in presenting allegations of impropriety regarding compensation directly to the SEC while bypassing internal reporting and compliance mechanisms that companies have traditionally implemented to address such complaints. For these reasons, a robust internal investigation approach is very important for companies seeking to get to the bottom of such issues quickly and effectively.

Guidelines For Conducting Internal Investigations In The Executive Compensation Area

Allegations like those described above regarding improper executive compensation practices need to be investigated immediately and thoroughly to protect the company and its shareholders and to minimize the potential for civil and criminal liability and negative publicity. Such allegations should be investigated in a fashion sufficient to assure the board and its directors that they can adequately fulfill their fiduciary duties to the company and shareholders. At the same time, it is important to keep in mind the sensitivities that may attend to investigations of the compensation of the most senior members of management, and to ensure that investigations are properly scoped so that they do not tread more ground than necessary and become wasteful or disruptive.

Appointing and Overseeing an Independent Investigative Team. Once an allegation or evidence regarding improper executive compensation practices has been received, the company should first seek to constitute a qualified investigative team charged with looking into the allegations and reporting back on its findings. Assuming the allegation implicates the company's public reporting and securities disclosures, one important feature of such a team should be its independence, i.e., that it not be subject to claims of conflicts of interests or dependence upon those accused of the misconduct. In most cases, the decision to initiate an investigation where senior management is at issue will be made by the board of directors, and in some cases the audit committee or a subcommittee of independent directors may be appointed to oversee the investigation and the team conducting it.

While setting up an independent investigative team may be a simple matter in the case of the routine employee misconduct matter (and many compliance programs at public companies have ready-made teams set up for this purpose), creating the same level of independence may be more difficult in practice where executive compensation matters are at issue. In the case of CEO or CFO compensation, for example, those most typically tasked with handling internal investigations (such as chief compliance officers, general counsels, or heads of internal audit) may directly report to those whose compensation may be under scrutiny. In such cases, it may be advisable to protect the integrity of the investigation by utilizing the services of outside experts, e.g., experienced law and forensic accounting firms, who can report either to a member of senior management who is truly independent of the allegations or directly to the board or its designated subcommittee. In some situations, the decisions of the board itself, or a compensation committee of the board, may be at issue. In such cases, it may be advisable to ensure that the board subcommittee overseeing the investigation does not include directors whose decisions may be at issue in the investigation, given the obvious conflict this might create.

In general, it is advisable to have attorneys – whether internal or external – serving as the primary day-to-day managers of such investigations. Attorneys have special expertise in handling investigative strategy, questioning witnesses, and collecting and reviewing evidence, and use of attorneys makes it more likely that the findings and conclusions of the investigation will be protected by the attorney-client privilege and work product protections, an advisable feature of any internal company investigation. Where attorneys direct the investigative activities of non-attorneys (e.g., non-attorney compliance officers or internal auditors), this fact should be made clear to all participating, and relevant communications should always be described orally and in writing as being made at the request of attorneys for the company.[13] In many cases, it may be helpful to have

[10] *See* U.S. Securities and Exchange Commission Press Release, http://www.sec.gov/news/press/2005-68.htm (detailing terms of settlement with the former CEO of Tyson Foods, Inc.) (last visited Oct. 30, 2011).

[11] *See, e.g.*, Proposed Executive Compensation and Related Party Disclosure Order, Exchange Act Release No. 33-8655 (Jan. 27, 2006), *available at* http://www.sec.gov/rules/proposed/33-8655.pdf (last visited Oct. 30, 2011).

[12] *See* Michael Farhang and Susannah Wright, *Dealing with Tipsters Under Dodd Frank*, Recorder, Vol. 134, No. 23 (June 27, 2011).

[13] *See Upjohn v. United States*, 449 U.S. 383, 391-92 (1981) (investigative interviews and other evidence protected by

personnel from internal audit or compliance involved as part of the investigation team under the direction of attorneys because their expertise with company resources and hierarchies will help an investigation run more efficiently.

Developing an Investigative Plan. The next step is to develop a comprehensive investigation plan. Thinking through the investigative approach at the outset is of key importance to ensure that scope, expenses, and time remain tailored to the necessary goals of the investigation. The investigation plan should be a simple, straightforward proposal for how to attack the factual questions presented by the allegations at issue, e.g., how company funds were spent or how management or the board arrived at a particular compensation-related decision. The plan should outline the key issues, the sources of information to be consulted (including evidence and witnesses), the timeline for accomplishing the investigation whether in stages or in total, and the assignments of responsibility for each component of diligence.

The plan should incorporate deadlines by which each stage of work should be completed. Managing progress on the investigation requires regularly tracking and updating the accomplishment of critical objectives by the various ''process owners'' on the investigation team. Charting progress at incremental stages will provide assurance that appropriate items are being investigated thoroughly and will give the oversight body (whether the board or management) visibility into the parameters of the investigation and facilitate an informed dialogue regarding keeping the expenses of the investigation under control. Keeping track of progress can also provide a good record for later questions about how comprehensive the investigation was. Assuming a ''process'' document like an investigative plan is kept, it should not be the repository for the *findings* of the investigation – an issue discussed further below – but instead should help the team keep track of what is to be, and has been, accomplished. It is also important to remember that the team should not be totally beholden to the investigation plan. As new issues emerge, the investigation must be flexible to adapt to and accommodate new issues, facts, and witnesses.

Developing an Understanding of the Applicable Law. As the investigation plan is being developed, it is also important that the investigation team develop a good understanding of the applicable law relating to the executive compensation matters at issue. Too often companies begin investigations based on vague allegations or suggestions of misconduct without knowing what exactly they are looking for and what facts might change the analysis under the applicable law. For example, proxy disclosure rules, accounting and tax rules, and even relevant statutes of limitations may influence questions like what types of compensation need to be reported and how, and what period of time a reasonable investigation should cover. Outside counsel can serve as a good resource to assist with this endeavor, especially when specialized expertise is necessary to understand a complicated legislative or regulatory scheme and current agency interpretations. While the applicable law should not necessarily determine the scope of an investigation and the investigative plan, it should certainly provide guideposts.

Preserving, Collecting, and Analyzing Documents. Soon after receiving notice that an allegation of misconduct relating to executive compensation has been raised, the company should issue a document preservation notice to all individuals potentially in possession of relevant materials, including the executive(s) at issue. Although companies may find that doing so presents special challenges given the concern for confidentiality in such matters, it is important to cast the preservation notice as widely as needed both in terms of subject matter and recipients. A broadly distributed notice has certain advantages, in that it may be an effective way to remind employees of the need to avoid misconduct and also provide protection for the company in case its preservation efforts are challenged later in subsequent litigation. To mitigate the risk of unauthorized disclosures, any notices or communications about document preservation efforts should always be made subject to the attorney-client privilege.

The next important step is a determination of what types of materials need to be gathered immediately. In some cases involving executive compensation decisions, the basic relevant material may be limited to hard copy files in the custody of relevant departments, e.g., human resources or other departments. In many situations, however, relevant discussion regarding executive compensation decisions may have occurred over e-mail. Without surrounding discussion, it may be difficult to understand who was involved in certain key decisions and what those decisions were. In such cases, a decision should be made immediately on whether employee self-collection can be reliably accomplished, or whether company IT personnel or an outside vendor need to be engaged to image hard drives and server data. In some cases, the imaging of electronic data helps to prevent a later claim that data was lost or destroyed because the company acted too slowly in collecting information.

The documents collected should be sorted and organized based on relevance, with attention to keeping search terms for any electronic data narrow enough to avoid unnecessary review time. It will often be helpful to create chronological collections of documents on key issues. The review of documents may also help the investigative team identify additional issues that were not anticipated in the original investigative plan, and to identify additional custodians or witnesses who may have helpful information. In the case of executive expense issues, it may be advisable to have the assistance of forensic accountants experienced with the management of large amounts of financial data who can assemble it into a comprehensible format. Such data management may provide the foundation for interviews and the direction of the investigation.

Conducting Witness Interviews. The witness interview is perhaps the most critical stage of any investigation because it can help the company to determine quickly whether it is dealing with a serious issue or not. In the case of whistle-blower complaints, it is common (and advisable) to begin with an interview of the whistle-blower in order to gain an adequate understanding of all of the allegations at issue. It is often not as helpful to start interviewing the target(s) of a whistle-blower complaint right away, however, in part because at the out-

attorney-client privilege and attorney work product protections).

set not all the relevant facts are known and the potential for gaps, misstatements, or inaccurate recollection of relevant events is greater. Instead, it may be better to review relevant documents and information from other sources first, to ensure that the discussion can be as efficient and informed as possible.

In the case of interviews of company employees conducted on behalf of a company investigation, it is good practice to administer to the witness the admonition commonly known by its origins in the Supreme Court's decision in *Upjohn v. United States*[14] regarding the attorney-client privilege. Such admonitions usually inform the witness that the interviewer (who should generally be an attorney) represents the company, not the employee individually; that the interview is being conducted to assist the attorney in providing legal advice to the company; that the company controls the attorney-client privilege that covers the contents of the interview, not the employee; that any information revealed during the interview will be shared with the appropriate persons at the company and possibly with third parties, including government agencies, at the company's sole discretion; and that the witness should keep the information confidential in order to maintain the company's privilege. It is also helpful to remind the witness of the importance of complete and accurate answers.

In addition to *Upjohn* warnings, it is generally advisable to have at least two interviewers present (either telephonically or in person) with respect to any witness interview. Having a second interviewer present helps to maintain accuracy of any notes taken. In addition, having a second person present for the interview may help to resolve any allegations of pressure or disputes over what was said. This is especially important in the case of whistle-blower witnesses, who may be concerned for their position and may fear retaliation from company representatives.

Assuming a written memorandum of the interview is created, it should be created relatively close in time to the interview, and should always be designated with an attorney-client privilege and attorney work product legend to highlight the need for confidentiality.

Providing a Report to the Company and Counseling Remedial Action. Following the conclusion of the investigation, the investigative team will need to synthesize the evidence gathered and provide a report to those responsible for overseeing the investigation, which in many cases will include the board or a subcommittee thereof. An oral report may be suitable in many cases, as relevant witness statements, documents, and findings in many investigations may be capable of adequate summarization during the course of a single board or management meeting. If a written report is created, care should be given to language used in order to ensure accurate and fair characterization of all evidence (including evidence that might undermine the investigation's findings) and the basis for the investigative conclusions should be clearly stated in the report. Further, definitive statements about the evidence should be qualified to account for the possibility that additional sources of information not yet reviewed could conceivably affect certain conclusions. A written report should be drafted with a full awareness of the possibility that its contents may be sought in the future by regulators and civil litigants hoping to bolster efforts to take action against the company or its management.

Assuming the investigative conclusions involve a finding that company policies were not adhered to, the company may need to take remedial action. This action could range from discipline of responsible employees, to termination, or even amended public disclosures or efforts to rescind agreements found to be obtained through fraud. In some cases, board action may be appropriate to strengthen internal controls that are affected by the investigation's findings. Assuming that a whistle-blower has raised the initial allegations, the company should also consider whether it has developed sufficient information within the 120-day period permitted under the Dodd Frank whistle-blower rules[15] to determine whether a voluntary disclosure to the SEC or other regulatory authorities is appropriate. Where media coverage is an issue, the company should also consider what statements, if any, it will make to the press regarding the investigation, keeping in mind the effect that any admissions might have in subsequent civil or regulatory actions.

Conclusion

While public scrutiny of executive compensation is unlikely to subside anytime soon, companies can effectively address allegations of improper compensation-related practices by implementing effective investigation and remediation procedures. Picking the right team with proper oversight, planning out the scope of fact finding, prioritizing the gathering of evidence, and maintaining a record of the investigative process are reliable ways to keep a company investigation properly focused and effective. While getting to the bottom of alleged misconduct should be the primary goal of any investigation, doing so in a targeted way that is efficient and cost-effective will contribute greatly to the overall goal of safeguarding the company's interests.

[14] 449 U.S. 383 (1981).

[15] Under the Dodd Frank whistle-blower rules, a whistle-blower who raises an allegation of misconduct through a company's compliance program may wait 120 days to report the same allegation to the SEC without losing priority for a subsequent whistle-blower bounty based on the date of the original complaint. *See* 17 C.F.R. § 240.21F-4(b)(7).