Now what? Strategic considerations for managing civil litigation after a criminal investigation has concluded

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The 2008 Wall Street meltdown has uncovered a number of financial frauds and will no doubt lead to an increase in investigations initiated by federal prosecutors into the conduct of financial institutions and other businesses. If recent history is any guide in the new administration, the Department of Justice will resolve many of these investigations by the company entering into a deferred prosecution agreement (DPA) or non-prosecution agreement (NPA).

Much has been written about the significance to a company of resolving an investigation through a DPA or NPA—and rightly so, when compared with the alternative of an indictment. It is often tempting, however, for members of a company's board of directors to view the DPA or NPA as the conclusion to a bad chapter in the company's history, and thereafter shift their focus to compliance with the terms of the agreement. In fact, a whole new phase is often about to begin: civil litigation resulting from the conduct uncovered during the criminal investigation and any parallel investigation by the company's audit committee.

If they did not already commence litigation during the investigations, activist shareholders will race to the courthouse to file derivative actions against current and former company executives implicated in any wrongdoing—and possibly against members of the board for allegedly failing to adequately oversee the company. Plaintiffs commonly advance a broad array of claims, ranging from alleged violations of the federal securities laws to common law claims of corporate mismanagement and unjust enrichment.

If a shareholder beats the company to the courthouse, the company can expect an increase in litigation costs and a fight concerning the directors' suitability to prosecute the company's claims. Although derivative actions are filed on behalf of the company, plaintiff shareholders are often unwilling to stand back and permit the company and its lawyers to prosecute the actions. Plaintiffs may even use the company's own words to argue that the company is unsuited to prosecute its own claims, as prosecutors typically require the company to make detailed factual admissions in DPAs and NPAs—admissions that generally cannot be denied by the company in civil actions.

Litigation costs will also increase once the shareholders seek broad discovery to support their theories of liability, including all documents produced by the company to the government and depositions of individuals with knowledge of the facts uncovered during the criminal investigation.

The company may be able to protect its right to direct its own litigation if the board appoints a Special Litigation Committee (SLC) of independent directors to investigate the claims asserted on the company's behalf. Typically, an SLC will consist of two or three directors who joined the board after the events at issue, and whose impartiality cannot legitimately be questioned. The SLC will hire its own lawyers to assist in investigating the claims. Under Delaware law, the SLC's conclusions concerning which claims are in the best interests of the company to pursue, if any, are entitled to significant deference under the business judgment rule upon a showing that the SLC acted impartially and in good faith.

The use of SLCs to defend against the prospect of shareholder-controlled derivative actions has increased over the last five years. There are risks in using an SLC, however.

The first concerns a possible waiver of the company's attorney-client privilege and work product protections. Under the DOJ's new corporate prosecution policy, federal prosecutors may not ask the company to waive its protections over "core" attorney-client communications and work product in order to receive cooperation credit.

If, however, the audit committee turns over the work product from its investigation to the SLC, the company may have unintentionally waived its protections. The Northern District of California recently ordered an SLC to produce to the plaintiff shareholder "[a]ll transcripts, notes and summaries of witness interviews conducted by the SLC (or by the [audit committee] which were relied upon by the SLC)," even though those materials were protected.[36]

Another risk of waiver can arise if the SLC discloses its work product to individual directors who are not members of the SLC and who are represented individually by counsel. The Delaware Chancery Court recently held that by disclosing the SLC's findings to the full board (prior to the SLC's public disclosure of its report), including directors whose conduct was at issue and whose attorneys were attending the presentation, the SLC waived the company's protections over materials reviewed by the SLC and communications between the SLC and its counsel.[37]

A second risk from using an SLC relates to timing. Generally speaking, there is no limit on the time within which an SLC must complete its investigation, and SLC investigations have taken as little as 30 days to as long as over three years to complete. As a practical matter, however, the length of the SLC's investigation can impact the company's ability to pursue its claims.

For example, securities class action and derivative litigation involving conduct similar to that under investigation by prosecutors is sometimes settled prior to or during the criminal investigation, and those settlements often include broad releases of liability (in a court order) to all of the company's current and former directors and officers. If the SLC subsequently discovers that newly discovered evidence of misconduct was fraudulently concealed from the company at the time it granted the release, the company can move to overturn that release—under Rule 60(b) of the Federal Rules of Civil Procedure—only if it does so within one year of the date of the release. Thus, as a general matter, unless the SLC's investigation concludes by the end of that one-year period, the company may risk losing the ability to prosecute any of the claims the SLC concludes it should prosecute.

These risks from using an SLC are worth taking when the other option would result in the company losing its ability to control the prosecution of its own claims. But, what if the company beats the shareholder to court in the first instance?

If it can act quickly after the resolution of the criminal investigation (and maybe even before it concludes) and file a lawsuit against those former executives who engaged in misconduct while at the company, the company may be able to avoid many of the costs from the filing of shareholder litigation and the additional risks involved in appointing an SLC in response to it.

Either way, directors must be cognizant that, as much as the company wishes to leave a dark past behind, the conclusion of the criminal investigation often only signals the beginning of a new and costly phase of civil litigation.

36 *In re KLA-Tencor Corp., Shareholder Derivative Litigation,* No. 06-3445 (N.D. Cal. May 14, 2008).
37 *Ryan v. Gifford,* 2007 Del. Ch. LEXIS 168 (Del. Ch. Nov. 30, 2007), certificate of appealability denied by 2008 Del. Ch. LEXIS 2 (Del. Ch. Jan. 2, 2008).