

DISCOVERY OF INTERNAL INVESTIGATION INFORMATION

For many years, companies and boards of directors have used internal investigations to address potential or identified wrongdoing within the company. Typically, these internal investigations are conducted by or with the assistance of outside counsel, who provide both expertise and an appearance of independence with respect to how the investigation should be conducted and the results of the investigation.

In the aftermath of Enron and similar corporate scandals, the number of internal corporate investigations has increased significantly in recent years. Companies are investigating in greater detail an increasing number of whistleblower allegations and other “red flags” which surface in various contexts. Absent an appropriately thorough response to those allegations or identified concerns, directors run the risk of breaching their fiduciary duty of care.

Likewise, outside auditors are requesting more information and documents as part of their audit procedures in today’s post-Enron environment. Sarbanes-Oxley, new accounting board rules and highly publicized litigation against auditors all contribute to this increased diligence by outside auditors. Among other things, auditors now routinely request copies of materials reviewed by or created as a result of any internal investigation.

Traditionally, the results of an internal investigation have not been discoverable by plaintiffs in litigation if the investigation is conducted by outside counsel. The attorney/client privilege generally protects communications between an attorney and client, including communications in the context of an internal investigation.

However, the attorney/client privilege is typically waived if the privileged information is communicated to third parties who are not a client of the attorney. Recently, plaintiffs who seek access to an internal investigation’s findings have successfully argued that the attorney/client privilege is waived with respect to the internal investigation in two common circumstances as described below.

1. Disclosure to Board of Directors

In most situations, the internal investigation is conducted by a special committee of the Board composed of independent and disinterested directors. The special committee retains independent legal counsel and other advisors as necessary and prepares a report of its findings. Frequently, the special committee’s report is presented to the full Board for consideration and perhaps actions.

In a surprising Opinion issued on November 30, 2007 in a stock option backdating case, the Delaware Chancery Court ruled that by submitting to the full Board the special committee’s

internal investigation findings, the special committee waived the attorney/client privilege which otherwise shielded the internal investigation from discovery by plaintiffs. Ryan v. Gifford, 2007 Del. Ch. LEXIS 168 (Nov. 30, 2007). As a result, the court allowed plaintiffs in the shareholder litigation relating to the alleged option backdating access to all communications between the special committee and its counsel and between the special committee's counsel and management relating to the internal investigation. According to the court, disclosure to the full Board of the special committee's report waived the privilege with respect to not just the report but all other communications with counsel relating to the investigation because some Board members were defendants in the related option backdating litigation and therefore were considered third parties with adverse interests to the special committee.

2. Disclosure to Auditors

Courts have consistently ruled for many years that outside auditors are independent from the company and therefore are treated as unaffiliated third parties for purposes of an attorney/client privilege waiver analysis. As a result, disclosure of privileged information to outside auditors waives the privilege. As a practical matter, though, this did not create a problem in most instances because outside auditors frequently would limit their request to only non-privileged documents.

Unfortunately, the combination of more thorough internal investigations and broader demands for information by outside auditors has created a very troubling environment for companies and their D&Os. In several recent cases, various parties in litigation have sought discovery from their opponent's auditors of information the auditors obtained in their audit which relates to otherwise privileged internal investigation information. In several of those cases, the court required the auditor to produce that privileged information since the court concluded the client waived the attorney/client privilege by showing information to the outside auditors. For example:

- In a lawsuit by Shaw Group against AES Corporation in connection with construction of an electric power plant in Texas, AES as part of its defense obtained a court order requiring Shaw's auditors to produce documents obtained by the auditor relating to Shaw's underlying investigation and recovery expectations in its litigation against AES.
- In litigation by Medinol against Boston Scientific relating to alleged theft of intellectual property, the court ruled that minutes of a meeting at Boston Scientific regarding a related internal investigation was discoverable because those minutes had been turned over to Boston Scientific's auditors. According to the judge, because the auditors must not share common interests with their client in order to properly do their job as an outside auditor, disclosure of information to the auditors is tantamount to disclosure to third parties.

These developments create a difficult Catch 22 for companies and their D&Os when dealing with outside auditors:

- If the company fully cooperates with the auditor's request for information, then otherwise privileged information may become discoverable;
- If the company refuses to provide information requested by the auditor, then the company may not receive a "clean" audit; and
- If a company reduces the number or scope of internal investigations to avoid these discovery risks, then D&Os may jeopardize their ability to demonstrate that they properly discharged their fiduciary duties by thoroughly investigating areas of concern.

3. Suggested Strategies

There is no easy solution to these privilege-waiver concerns. Some strategies that may help under certain circumstances include the following:

First, the persons conducting the internal investigation should be sensitive to these discovery concerns and should not needlessly create or retain potentially problematic documents. However, this may not be an entirely prudent solution in circumstances where the board wants to use the internal investigation to show that the board thoroughly investigated the matter, considered all relevant information and reasonably reacted to the findings.

Second, if the internal investigation can be couched as an investigation in anticipation of litigation, then the work-product doctrine may protect the results of the investigation from discovery by third parties. Unlike the attorney/client privilege, the work-product doctrine may be waived only when the confidential information has been otherwise disclosed to a company's adversaries. Courts have generally ruled that producing the results of an internal investigation to an outside auditor does not trigger this waiver. To qualify for the work-product doctrine, the internal investigation should expressly recognize the potential for litigation and documentation should be created which confirms the reasonable linkage between the investigation and a legitimate litigation concern.

Third, if some Board members are potentially implicated in the internal investigation, the Board should delegate to the special committee which is conducting the investigation full authority to implement corrective measures or otherwise respond to the findings of the investigation, thereby eliminating the need to present the findings to the full Board. Alternatively, the individual directors implicated in the internal investigation should be recused from any Board communications, discussions or decisions relating to the investigation.

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