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Ethical and Practical Issues in Internal Investigations by In-House Counsel at Investment Advisers and Mutual Funds

by David B. Bayless

In-house counsel at investment advisers and mutual funds are conducting an ever growing number of internal investigations. Regulatory requirements, as well as best corporate practices, have led to in-house internal investigations on everything from racial or ethnic slurs to alleged securities fraud.

While much has been written about the “Dos and Don’ts” of internal investigations by outside counsel, relatively little has been written directly addressed to in-house counsel. But internal investigations trigger numerous ethical and practical issues that in-house lawyers must face. Significant issues arise from the fundamental fact (that everyone acknowledges but not always appreciates) that

in-house counsel represents the company, not any individual. This article addresses these ethical and practical issues.

Who Is the Client and Owns the Privilege?

The first set of ethical issues arises during the initial interview with an employee, when certain disclosures must be made. In-house counsel must make clear to the employee that the attorney represents the company only. The Model Rules of Professional Conduct (Model Rules), and specifically subsection (f) of Model Rule 1.13, address the obligation of an attorney representing the company to disclose the identity of his or her client and where his or her loyalties lie:

In dealing with an organization’s directors, officers, employees, members,

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shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

Also, Model Rule 4.3 sets forth company counsel's ethical obligation to avoid misrepresenting his or her loyalties. Importantly, this requires in-house counsel to make reasonable efforts to correct any misimpressions that an unrepresented person (in this case, an employee) might form as to whom counsel represents.

If the investigation implicates possible self-reporting to regulators, then company counsel, because he does not represent the employee, also must make clear that any information obtained during the course of the interview may be disclosed to the government (or to other third parties such as outside auditors). Put another way, the attorney-client privilege belongs to the company and not the employee, and so the decision to waive or not waive the privilege likewise resides with the company and not the employee.

Many employees, even senior management, often misunderstand or do not appreciate this point. It is natural for employees, who interact with in-house counsel regularly, to view such counsel as "their lawyers." After all, they seek legal advice from in-house counsel all the time. That is why, in the context of any internal investigation, the fact that an in-house attorney represents the company, and not the individual, must be made clear.

Failure to explain this point could result in the individual later seeking to block disclosure of information to the regulators. It also could lead to the disqualification of counsel. Worst case, it could lead to disciplinary action by a state bar. So, it is essential that this initial disclosure be made, and that it be explained in a way that the employee understands.

Keep notes that reflect the fact that you made the disclosure, and that the employee stated that he understood what you told him. Ideally, though this often is not feasible as a practical matter, have someone else with you who can witness and document this point being made.

Witness Cooperation

Let's assume that, as a result of this disclosure, the employee balks at speaking to in-house counsel. It is not necessary from an ethical standpoint

to tell the employee that he or she has a right to his or her own attorney. Nor is there an ethical obligation to disclose that the employee may refuse to speak with the company's attorneys.

But it is essential to make clear to the employee that the failure to cooperate in an investigation can have severe employment consequences, up to and including termination. Again, this is a point that often employees misunderstand, thinking that they have a Fifth Amendment right not to speak (which they do, but this right is only enforceable against the government, not against an employer). It is important to make clear, then, that the company has the right to terminate or otherwise discipline employees for refusing to cooperate.

The more difficult practical question is what happens if an employee says he or she would be willing to cooperate, but only after having an opportunity to consult with his or her own lawyer. After all, you've just told the employee that you don't represent them. It's natural for an employee to respond, in essence, "well then, I'd like to get my own lawyer."

Some lawyers conducting an internal investigation insist that the employee provide information immediately, without separate counsel present, under penalty of discipline up to and including termination. Others, though, view the quality of the information received to be better and more meaningful after the individual has had an opportunity to speak with his or her own attorney. But, either way, ethical considerations have little to do with a company's response to this issue.

But prudential considerations are very relevant here. When dealing with an employee, morale must be considered. If employees are forced to speak without having had a meaningful chance to consult with an attorney, despite their request to do so, this will be known companywide within hours (if not minutes) after the interview ends. And that will have a negative impact on morale. Also, a sense of fairness dictates giving an employee a chance to consult with an attorney if he asks for such an opportunity. What kind of message does a company send to its staff if it refuses a reasonable request to obtain individual representation?

Thus, on balance, my view is that it is better to give an employee a reasonable amount of time to get his or her own lawyer.

Joint Representation

Another set of ethical issues arises during consideration of joint representation—deciding whether company counsel can simultaneously

represent both the company and the employee in an investigation. While the primary purpose of the initial interview with employees is to gather relevant information for the inquiry, this interview also provides information to answer the question of joint representation.

An attorney representing the company may, under certain circumstances, also represent corporate employees. Model Rule 1.13(g) provides:

A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7 [governing Conflict of Interest]. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Indeed, numerous factors favor joint representation. An obvious advantage is avoiding expense. Another is having the benefit of counsel who understands the corporation, has a broad and detailed knowledge of its business practices, and also has an in-depth understanding of the developing facts and issues involved in the investigation. A third advantage is eliminating the need for coordination with other attorneys.

Finally, and critically, representing both the company and the employee sends a signal that the company finds the employee's interests are not at odds with the company's interests. While many lawyers believe that employees, if given the opportunity, would almost always choose their own counsel, in fact the opposite often is the case. An employee in an investigation frequently begins with a view that his or her interest is aligned with the corporation and wants to be, and be perceived as, a "team player."

Of course, some factors favor separate representation. The primary one is when the interests of the corporation and the individual diverge. And this can occur even if the divergence is slight. The employee is entitled to objective, independent legal advice from his counsel, and that may not always be possible to the full extent required by the ethical rules if the same lawyer represents both the company and the individual.

Importantly, the decision about joint representation is fluid. It is entirely possible that an initial decision to provide joint representation may later

evolve into a decision to provide separate representation for certain employees. This occurs when facts are further developed or when it becomes apparent that the regulatory focus is on an individual employee specifically. That is why often it is prudent for an employee to have "shadow counsel" who can then step out of the shadows if the need for separate representation ever arises (though this increases the expense). Ethically, it is essential that company counsel clearly communicates this possibility of a later decision to change from joint to separate representation, as well as the process that will be followed in such an event.

So how, then, should in-house counsel respond to the question: "Do I need my own lawyer?" As it sometimes is difficult for company counsel to remain completely objective on this point, the best practice is for the attorney simply to reiterate that he represents the corporation and, therefore, cannot advise the employee. It is not unusual (and ethically appropriate) for company counsel to let the employee know if they do not see a conflict at the present time, which in effect informs the employee that joint representation is possible. But it is essential to make clear, as noted above, that this judgment can change over time and that, if it does, the lawyer will so inform the employee. A middle view would be to say that there is currently insufficient information to determine whether a conflict exists.

If the company and employee move forward with joint representation, the employee must separately be advised in writing that the privilege continues to be held by the company and that such communications might be disclosed to the government or to third parties. He also must be told that if a conflict develops in the future "his" counsel will continue to represent the company while no longer representing him or her. As noted earlier, there could be serious consequences to the in-house lawyer if this is not made crystal clear.

Indemnification and Fee Advancement

Finally, if the employee insists on having his own attorney, this raises the issue of the company's duty to indemnify and to advance attorney fees. Under Delaware corporate law, a corporation must indemnify any person who is a party or is threatened to be a party to a proceeding or investigation, unless that person did not act in good faith and in a manner believed to be in, or not opposed to, the best interests of the corporation. And the corporation must indemnify an officer or director who is successful on the merits or

otherwise in the defense of a qualifying claim. In addition to indemnification required by corporate law, individual employees (typically, senior management) often have contractual indemnification rights that must be honored.

Also, depending on the nature of the allegation and the terms of the policy, D&O insurance may trigger payment of defense costs. Finally, but often overlooked, state law must be analyzed. California, for example, in its Labor Code provides, in essence, an employee's right to reimbursement. And this right is provided to any employee, not just senior management, officers, and directors.

There is a difference, however, between the duty to indemnify and the duty to advance defense costs. Corporate bylaws on contractual indemnification may require advancement. But, absent such language in the corporate charter or bylaws, there is no right of employees to obtain advancement of attorney fees. But it is probably the norm, rather than the exception, that employees have their attorney fees advanced. This then is mitigated by the undertaking letter the employee signs, agreeing to repay any amounts advanced if it is later determined that the employee was not entitled to indemnification.

There are reasons both for and against the advancement of attorney fees. When company counsel recognizes a conflict of interest and the need for the employee to have separate representation, there is a benefit to the corporation if the employee is cooperative. The failure to advance attorney fees will make cooperation less likely.

A key reason not to advance attorney fees is the very rare situation in which the corporation

can conclude with a high degree of certainty that it is highly unlikely that the employee has met the standard for indemnification. Or, if the company has a high degree of confidence that there is no conflict, and having separate counsel would be both wasteful and unnecessary, it might warrant a decision not to advance fees but to insist on joint representation. But that raises the problem, identified earlier, that cooperation by the employee then becomes unlikely.

Conclusion

What this discussion shows is that the internal investigation process is fraught with potential ethical and practical hazards. Thus, it is essential that in-house counsel put protocols in place to address the issues raised in this article. Having these protocols in place before the issues arise makes it easier to insulate a later decision on any of these issues from judicial attack. And it ensures greater consistency in the decisions made. In other words, a preexisting protocol helps create both the perception and the reality that decisions are objectively made and not *ad hoc*.

In 2008, the daily life of in-house counsel of investment advisors and mutual funds involve internal investigations of all stripes. Be aware of the issues addressed in this article and put guidelines and protocols in place now to address them. Follow these guidelines during internal investigations, and you will meet your ethical and professional obligations while representing the best interests of your client.

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