

## **DIRECTOR'S FAILURE TO INVESTIGATE "RED FLAGS" PROMPTS SEC ENFORCEMENT ACTION THAT SHOULD SERVE AS WARNING TO ALL OUTSIDE DIRECTORS**

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To Our Clients and Friends:

The U.S. Securities and Exchange Commission rarely brings enforcement actions against outside directors for failing to properly discharge their duties. Regardless, directors should heed the warning that those cases make explicit: when allegations or "red flags" come to your attention that suggest potential wrongdoing, you have an affirmative duty under the federal securities laws to get to the bottom of what has happened and make sure adequate remedial measures are taken. The SEC recently reiterated this lesson in an action against Vasant Raval, an outside director of InfoGroup Inc. and the former chairman of the company's audit committee. The SEC alleged that Raval ignored several red flags that put him on notice of allegedly fraudulent conduct by InfoGroup's CEO. The SEC also alleged that Raval signed SEC filings that he knew were false.

### **SEC'S CLAIMS AGAINST THE OUTSIDE DIRECTOR**

The SEC alleged that, from 2003 through 2007, InfoGroup's CEO, Vinod Gupta, received \$9.5 million in unauthorized and undisclosed compensation. Additionally, during this same period, InfoGroup allegedly entered into related-party transactions with three entities that Gupta controlled or was affiliated with. According to the SEC complaint, Gupta improperly used corporate funds to pay more than \$3 million for personal jet travel to South Africa, Italy, and Cancun; \$2.8 million for expenses related to his yacht; \$1.3 million for personal credit card expenses; and for costs associated with 28 club memberships, 20 automobiles, homes across the U.S., and premiums for three personal life insurance policies.

The SEC alleged that the audit committee first learned of the improper payments and related-party transactions in January 2005, and subsequently tasked Raval, as the chairman of the audit committee, with conducting an investigation and reporting back before InfoGroup filed its 2004 Form 10-K and March 2005 proxy statement. Over the course of twelve days, Raval allegedly conducted his own cursory internal investigation, which revealed insufficient documentation and explanations concerning Gupta's expenses and related-party transactions. Moreover, Raval allegedly received an unsolicited document from InfoGroup's director of internal audit that raised serious questions about the business purpose of Gupta's expense reimbursement payments. According to the SEC's complaint, Raval assured the director of internal audit that he would discuss the concerns with Gupta. But Raval did not do so. In fact, the SEC alleged that Raval failed to take any meaningful action to further

investigate Gupta's expenses. Additionally, Raval allegedly did not seek the assistance of outside counsel or other outside experts during his investigation. Raval then prepared and submitted a report of his "findings" to the full board of directors. The SEC found that the report omitted critical facts and failed to disclose that Raval was aware of insufficient documentation for Gupta's expenses.

In June or July 2005, a new director of internal audit also allegedly expressed concerns to Raval about Gupta's expenses and stated that the March 2005 proxy statement should have disclosed Gupta's personal expenses as compensation. In July 2006, InfoGroup's disclosure counsel sent a memorandum to Raval expressing similar concerns. The SEC charged that Raval did not disclose any of this information to the board or to the company's outside auditors.

As a result of the information he was provided, the SEC alleged that Raval knew, or was reckless in not knowing, that InfoGroup's Form 10-K and proxy disclosures were false and misleading but that Raval signed the SEC filings anyway. The SEC stated that Raval had "a duty to take steps to ensure the accuracy and completeness of the statements contained in the company's filings." Furthermore, the SEC alleged that the CEO's fraud could have been uncovered sooner had Raval investigated the red flags, hired outside counsel to investigate the red flags, or informed the full board of directors of the red flags.

The SEC charged Raval with violating the anti-fraud, proxy, reporting, books and records, and internal controls provisions of the Exchange Act. Raval settled, without admitting or denying any wrongdoing, agreeing to a five-year ban from serving as an officer or director of a public company, an injunction against future violations, and a \$50,000 civil penalty.

## **HISTORY REPEATS ITSELF**

The SEC has occasionally brought enforcement actions against outside directors for options backdating, Foreign Corrupt Practices Act violations, and various securities law violations. The case against Raval, however, is unusual, because it marks one of the only times the SEC has brought an enforcement action against an outside director as a primary violator for failing to "take steps to ensure the accuracy and completeness" of a company's SEC filings.

In 2003, the SEC brought nearly identical fraud charges against an outside director of Chancellor Corporation as well as several executives for having "[ignored] clear warning signs that financial improprieties were ongoing at the company and [failed] to ensure that the company's public filings were accurate." The SEC explicitly warned that the Chancellor case would serve as a model for future enforcement actions against directors who ignored misconduct and were reckless in their oversight of management. The Chancellor case, which was brought in the wake of the scandals at Enron and WorldCom, was widely interpreted as the beginning of a new focus by the SEC on directors' oversight responsibility. But to this

day, the SEC has rarely brought enforcement actions against directors. It remains to be seen whether the case against Raval will mark a renewed effort by the SEC to focus on directors' oversight responsibility.

### **IMPLICATIONS FOR OUTSIDE DIRECTORS**

Although it is highly unusual for the SEC to sue an outside director, the alleged facts of the case against Raval were so egregious that it is likely the SEC would bring an enforcement action against any officer or director under the same circumstances.

The Raval case makes clear that when a director becomes aware of a potential red flag or allegation of misconduct by management, the director has an affirmative duty to take appropriate steps to ensure that there is an immediate and comprehensive investigation of those allegations. The Raval case also signals the SEC's skepticism of an outside director's ability to conduct such a comprehensive internal investigation without assistance. A solitary investigation like the one Raval conducted significantly risks exposing the individual and, potentially, the larger board of directors (who accepted the results of such an investigation) to liability. Depending on the specific circumstances and their potential seriousness and complexity, the board should consider whether in-house or outside counsel, internal audit, or other outside experts should be involved in conducting the investigation. Indeed, the provisions of the Sarbanes-Oxley Act specifically empower audit committees to retain advisors when needed and mandate that management must pay for those advisors. Under any circumstances, the results of an investigation should be reported to the full board without delay, so that appropriate disclosure and other decisions can be made on a timely basis.

Please feel free to contact us with any questions.

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