APRIL 2010

SEC TARGETS INDEPENDENT DIRECTOR FOR FAILING TO INVESTIGATE CEO

The SEC rarely brings an enforcement action against independent directors. Yet, on March 15, 2010, the SEC filed a settled action against Vasant Raval, former Chairman of the Audit Committee of InfoGroup, Inc. (now InfoUSA, Inc.). At its core, the lawsuit alleges that Mr. Raval failed to sufficiently investigate certain "red flags" surrounding the company's former CEO and Chairman of the Board, Vinod Gupta.[1] The SEC's case is notable in that it may signal the start of a new era of heightened SEC scrutiny of independent directors.

For more than a decade, the SEC has warned corporate directors that they have "affirmative responsibilities" and must be "vigilant in exercising their authority throughout the disclosure process."[2] For instance, in 1994 the SEC issued a report of investigation chastising the board of a public company for a perceived failure to satisfy its obligations when confronted with serious indications of management fraud. The board, after learning that senior management concealed fraudulent self-dealing transactions, allowed the company to issue a press release that inaccurately denied any knowledge of wrongdoing. Furthermore, the board allowed a director involved in the fraudulent transactions to continue to serve on the board and participate in board meetings. Notably, although the SEC admonished the board for failing to satisfy its obligations, it did not sue the board members. Instead, the SEC merely warned that board members must move aggressively in fulfilling their duties to oversee the conduct and performance of management and to ensure that the company's public statements are candid and complete.

The SEC reiterated its warning in 1997 in a report criticizing the directors of W.R. Grace & Co. for "failing to take steps ... to ensure full and proper disclosure." In its report, the SEC stated that W.R. Grace & Co.

---

1 *SEC v. Raval*, Civil Action No. 8:10-cv-00101 (D.Neb. Filed Mar. 15, 2010).

2 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Exchange Act Release No. 39157 (Sept. 30, 1997).

© 2010 Jones Day. All rights reserved. Printed in the U.S.A.

violated the securities laws because proxy statements and periodic reports did not fully disclose the substantial retirement benefits of the company's CEO. Although W.R. Grace's directors were informed of the CEO's retirement benefits, they took no action to correct the misleading disclosures. The SEC found that the directors' reliance on the company's disclosure process, although not bad faith, was insufficient to adequately discharge their duties. Again, the SEC did not sue the directors but repeated that directors who know or should know that a company's public statement is inadequate or incomplete must take steps to correct the failure.

More recently, in 2008, Linda Chatman Thomsen, then director of the Division of Enforcement, publicly reminded those serving as directors of public companies that they "are potentially liable whenever a company makes a materially misleading public statement or omission" and admonished that "there are perhaps no more important issues [for a board] than … oversight of the senior executives."[3] Thomsen herself, however, correctly acknowledged that "the Commission rarely sues directors solely in their capacity as directors" and noted that in recent years, the SEC had sued less than a dozen outside directors.

Thus, although the theory that the SEC can sue an independent director for the failure to properly discharge his or her duties is not novel, an enforcement action alleging the same is. The case against Raval, therefore, may signal the start of a new enforcement trend. However, the allegations against Raval are particularly egregious and may accordingly illustrate little more than the axiom that "bad facts make bad law."

The SEC's complaint alleges that Raval served on the board of directors for InfoGroup in various positions from 2003 to 2008, including a stint as Chairman of the Audit Committee. During this period, Raval allegedly turned a blind eye to allegations that Gupta directed the company to improperly pay himself $9.5 million that he then spent on corporate jets, service for his yacht, life insurance premiums, and payment of personal credit cards. In addition, the complaint alleges that Gupta directed the company to enter into related party transactions totaling approximately $9.3 million with entities that he controlled or with whom he was affiliated. These related party transactions were not disclosed in the company's public filings.

More specifically, the complaint alleges that Raval was first alerted to the CEO's misconduct when the Audit Committee uncovered payments to Gupta that he used for personal recurring monthly yacht and home expenses in 2005. Raval was tasked with investigating the propriety of the transactions. Rather than seeking assistance from outside counsel or rigorously scrutinizing the transactions, Raval presented a report to the company's board that omitted critical facts a mere 12 days after he began his "in-depth" investigation. Separately, Raval was twice alerted by successive internal auditors that Gupta was charging to the company personal expenses such as club memberships and expenses related to his cars, homes, and yacht. Subsequently in 2006, the company's disclosure counsel sent a memo to Raval communicating that various invoices submitted by Gupta were likely for personal purposes. Despite these numerous prompts, Raval failed to undertake a thorough investigation. As a result, the company allegedly failed to disclose related party transactions and materially understated Gupta's compensation in its Form 10-K and proxy statements.

Although Raval did not personally profit from his inaction, his failure to properly discharge his duties allowed Gupta to continue misappropriating the company's funds. The SEC

3 Linda Chatman Thomsen, SEC Director, Division of Enforcement, Keeping up with the Smartest Guys in the Room: Raising the Bar for Corporate Boards (May 12, 2008) (available at http://sec.gov/news/speech/2008/spch051208lct.htm).

charged that, if not for Raval's inattention, the fraud would have been uncovered sooner. The SEC charged Raval with violating the anti-fraud, proxy, and reporting provisions of the Exchange Act. To settle his case, Raval consented to the entry of a permanent injunction prohibiting future violations of the related provisions of the federal securities laws, a $50,000 civil penalty, and a five-year ban from serving as an officer or director of a company.

It remains to be seen whether the SEC's action against Raval signals the beginning of a new era of heightened SEC scrutiny of independent directors. At a minimum, *Raval* reinforces the Commission's expectations for independent directors as previously described in reports of investigations and public statements. In any event, the case sends a clear signal that, when confronted with red flags, a director should seek the assistance of independent counsel, promptly and efficiently investigate all allegations of wrongdoing, and report all significant details to the board.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Patricia J. Villareal
Dallas
+1.214.969.2973
pjvillareal@jonesday.com

Peter J. Romatowski
Washington
+1.202.879.7625
pjromatowski@jonesday.com

Henry Klehm III
New York
+1.212.326.3706
hklehm@jonesday.com

Joshua S. Roseman
Dallas
+1.214.969.4898
jsroseman@jonesday.com

Samantha S. Cox
Dallas
+1.214.969.5083
sscox@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.