A Cautionary Tale for Audit Committee Chairs?

The SEC announced on March 15, 2010 that it had charged the former CEO, CFOs, and Audit Committee Chair of infoGroup Inc. with securities fraud and other securities law violations in connection with almost $9.5 million of undisclosed perquisites paid to the CEO and $9.3 million of undisclosed related party transactions with entities the CEO controlled. The CEO and the Audit Committee Chair agreed to settle the matter, without admitting or denying the allegations. The Audit Committee Chair, Vasant Raval, consented to an injunction against future violations, agreed to pay a $50,000 civil money penalty, and agreed to be barred from serving as an officer or director of a public company for five years.

Bad facts, it is frequently said, make bad law. It is difficult to know whether this case represents a measured response to a set of egregious facts or whether it sets a new standard to which audit committee chairs should be held. At the very least, it provides audit committee chairs with a roadmap of what **not** to do when confronted with allegations of improper conduct.

The infoGroup CEO, who was also its largest shareholder, appears to have utterly missed the distinction between appropriate corporate and personal expenses. He also appears to have engaged in multiple related party transactions through entities he controlled that were never disclosed in infoGroup's SEC filings. In January 2005, a list of related party transactions was brought to the attention of the board of directors, which tasked Raval, as chair of the audit committee, with investigating the issues. The following ensued:

- Raval conducted an investigation on his own, without the assistance of independent counsel, which revealed insufficient documentation and explanations for various reimbursements and transactions.
- During the investigation, Raval received an unsolicited communication from the company's internal auditor questioning various amounts reimbursed to the CEO. Raval was the only director who appears to have received this communication. He assured the internal auditor that he would address the concerns with the CEO, but did not.
- A mere 12 days after being tasked with looking into the related party transactions, Raval prepared a report he characterized as the product of an "in-depth investigation" of the matter. He did not, according to the SEC, inform the board that he was aware of insufficient documentation or that he had not, in fact, investigated the CEO's expenses.
- Raval received subsequent communications from internal audit and from outside disclosure counsel questioning various transactions but failed to inform the board or take appropriate action.

The SEC asserted that Raval knew, or was reckless in not knowing, that infoGroup was making false and misleading disclosures about the payments to and transactions with the CEO. These false and misleading statements were made in SEC filings that Raval signed as a director. The SEC asserted further that Raval "had a duty to take steps to ensure the accuracy and completeness of statements contained in the company's Commission filings." Had he investigated the red flags, hired outside counsel to do so, or brought the red flags to the attention of others on the audit committee or the board, the fraud could have been uncovered sooner. That was the basis for the complaint against him.

What does this proceeding mean for audit committee chairs? Notwithstanding the broad language of the SEC's complaint, it would be an overreaction to conclude that the audit committee chair must "fact check" a company's SEC filings. The SEC's statement that Raval had a duty to ensure the accuracy of a company's filings must be read in the context of a director who was aware of red flags but failed to take reasonable steps under the circumstances to investigate. What it does mean, however, is that when presented with credible allegations of improper conduct, a director should perform a vigorous and thorough investigation. That investigation should, at the very least, involve others on the audit committee, and consideration should be given to retaining outside counsel to conduct, or assist with, the investigation. It is worth noting as well that under state corporate statutes, such as Sec. 141(e) of the Delaware General Corporation Law, directors are fully protected in relying in good faith upon experts selected with reasonable care.

If you would like to discuss these or any securities law issues, please contact your usual Ropes & Gray advisor.