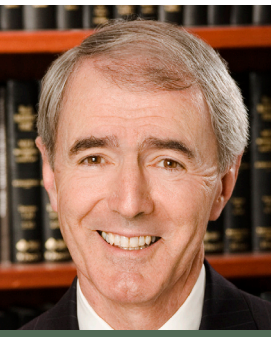
It's What You Don't Know That Can Hurt You

By Johnnie M. Jackson, Jr. and Howard J. Smith, III

Electronic data management and e-discovery is a board-level compliance and litigation-readiness obligation



Johnnie M. Jackson, Jr.

Howard J. Smith, III

Just when management and boards of directors thought it was time to take a breather, more compliance and readiness challenges are surfacing and they cannot be ignored. This is especially true with respect to a company's electronic data management and its litigation readiness in cases in which there is intensive electronic discovery.

More than two years have passed since the flurry of Sarbanes-Oxley compliance activity began. For the most part, companies have now done what they needed to do—at least with respect to financial transparency and basic corporate governance. But now, rather than take a breather, there are "other things to worry about," and the headlines and reported cases of the future will be replete with new company names and new stories of woe for those companies that do not properly manage their electronic data obligations.

In fact, it has already started—big time.

Coleman and Zubulake

In Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc., for instance, plaintiff Coleman (Parent) Holdings, Inc. ("CPH"), received a jury award of over $1.4 billion based largely on Morgan Stanley's failure to preserve electronic documents to which CPH was entitled and that were discoverable by plaintiff in that litigation.

In short, CPH, controlled by billionaire financier and Revlon chairman Ronald Perelman, alleged that Morgan Stanley conspired with Sunbeam Corporation ("Sunbeam") to defraud CPH in connection with CPH's sale of its stock in Coleman, Inc. to Sunbeam in return for Sunbeam stock.

In the litigation, CPH sought access to Morgan Stanley's internal files, including e-mails and other electronic data. The Court ordered Morgan Stanley to review e-mails, conduct searches for and produce responsive documents, produce backup tapes and to certify that it had complied with the Court's order.

Morgan Stanley conducted its review and subsequently filed a certification of compliance with the Court's order, though the facts later indicated that thousands of backup tapes that could have contained responsive documents had not, in fact, been reviewed. In addition, months after Morgan Stanley had certified its compliance with the Court's order, Morgan Stanley alerted the Court to the existence of "additional documents" that possibly could have been responsive to plaintiff's discovery requests.

The Court was not impressed.

In response to Morgan Stanley's conduct and less-than-diligent review, the Court found that it was "inescapable" that Morgan Stanley "sought to thwart discovery" and granted plaintiff's motion for an adverse inference instruction to the jury, which sealed Morgan Stanley's fate.

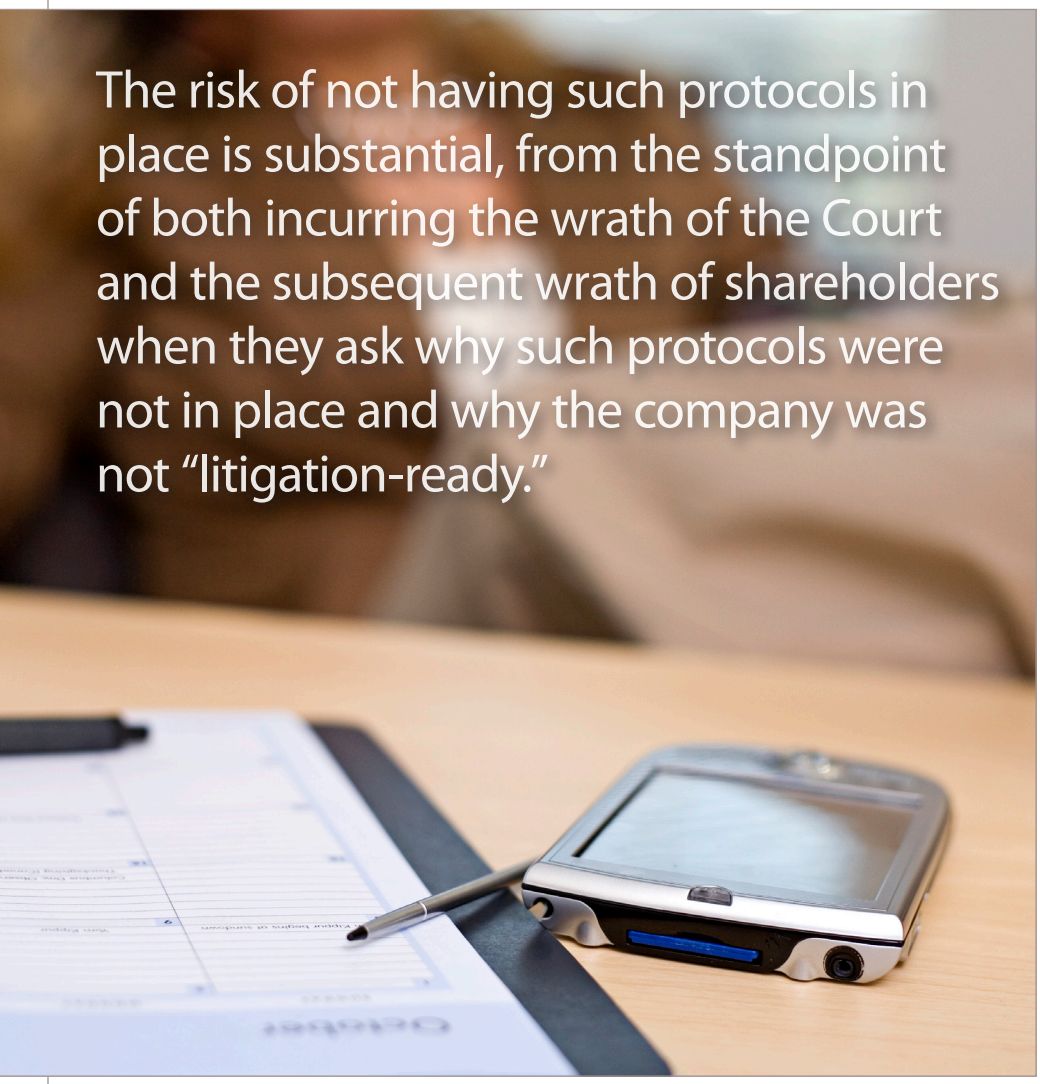
The experiences of Morgan Stanley and UBS as a result of electronic discovery failures demonstrate that companies are vulnerable to huge sanctions and adverse consequences if they are not appropriately managing their records and electronic data.

After the adverse inference instruction, the jury found that Morgan Stanley acted fraudulently and awarded plaintiff $604.3 million in compensatory damages and $850 million in punitive damages.

This was a catastrophe from Morgan Stanley's perspective. To put it in context, the jury award of over $1.4 billion was approximately four times the $360 million that Morgan Stanley had placed in reserve for litigation contingencies account and, to make matters worse, Morgan Stanley had rejected an earlier offer from Perelman and CPH to settle the case for $20 million.

Similarly, in what has become the leading case globally addressing electronic discovery issues, Judge Shira Sheindlin issued a series of opinions in Zubulake v. UBS Warburgh.

In that case, the plaintiff sued defendant UBS alleging employment discrimination on the basis of gender. While described by Judge Scheindlin as a "routine" employment discrimination case, this case nonetheless culminated in a $29.3 million verdict for the plaintiff after Judge Scheindlin granted plaintiff an adverse jury charge upon finding that UBS willfully destroyed e-mails and repeatedly failed to properly manage electronic discovery.



The experiences of Morgan Stanley, UBS and numerous other companies that have been sanctioned by courts and juries as a result of electronic discovery failures demonstrate that companies are vulnerable to huge sanctions and adverse consequences if they are not appropriately managing their records and electronic data.

New Federal Rules Regarding Electronic Discovery

The Federal Courts are already active making new rules in the area of electronic discovery.

For example, on September 30, 2005, the Federal Judicial Conference Committee on Rules of Practice and Procedure approved several amendments to the Federal Rules of Civil Procedure that specifically address electronic discovery. Scheduled to take effect on December 1, 2006, the proposed amendments to the Federal Rules will officially usher in the era of electronic discovery foreshadowed by the issues raised and decisions made in cases such as Zubulake and Coleman.

Under the proposed amendment to Rule 26, "electronically stored information" will be a central focus of discovery in litigation beginning at the initial Court-ordered "meet-and-confer" session at which electronic discovery issues will be discussed and procedures and protocols to govern the electronic discovery process will be adopted.

Rule 26 assumes that a company will have electronic data protocols in place that will allow in-house counsel, outside counsel and IT professionals to inform the Court

The rules don't give guidance about the kind of "system" that must be in place, but we can be sure that not just any system will do. The bar is being raised.

regarding the electronic data that exists and what of that data can and will be produced. The risk of not having such protocols in place is substantial, from the standpoint of both incurring the wrath of the Court and the subsequent wrath of shareholders when they ask why such protocols were not in place and why the company was not "litigation-ready."

The Safe Harbor Rule

In addition to the amendment to Rule 26, Rule 37(f) is also in the process of being amended to read as follows:

Absent extraordinary circumstances, a court may not impose sanctions under these Rules on a party for failing to provide electronically stored information lost as a result of the routine, good-faith operation of an electronic information system.

This so-called safe harbor rule is intended to immunize from sanctions any company that loses electronic data but has nonetheless acted reasonably and in good faith. The sine qua non, however, is: the company must have an "electronic information system." The rules don't give guidance about the kind of "system" that must be in place, but we can be sure that not just any system will do. The bar is being raised.

Getting Litigation- and Compliance-Ready

Harbingers of what is coming are evident in cases such as Zubulake and Coleman. We also see them in the proposed amendments to the Federal Rules, and it is clear that the legal landscape has changed with respect to a company's obligations to manage its electronic data and be litigation-ready.

These changes may appear limited to litigation only, but in reality, they mirror broad changes in the law that have evolved over the last decade and have required heightened general compliance efforts. The burden to meet the heightened compliance standards has been placed squarely on management and the boards of directors.

The management of electronic data discussed in this article, for example, is just one of many compliance issues that must be addressed by the modern Board following the Delaware Chancery Court in In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996), wherein the Court suggested that the officers and directors of a corporation have a duty to ensure that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with the law and its business performance.

Certainly the "electronic system" underlying all the other systems contemplated by Caremark has to be one that is reasonable and well thought out—one that can be reasonably expected to serve the company well when needed.

Sarbanes-Oxley introduced broad reforms and new standards primarily to enhance the quality of financial reporting practices and corporate governance of publicly traded companies, but Sarbanes-Oxley also echoes Caremark in setting forth a general compliance mandate.

The Need for a Plan

It is an understatement to say that companies need to have a plan in place to fulfill their compliance obligations, including their obligations with respect to their electronic data. It is absolutely essential that a company and its IT and legal advisors fully understand the breadth, scope and extent of management control of company electronic information and have a plan in place for how to collect, use, manage and produce that information upon demand.

At a minimum, a company must fully understand its own IT system and legacy systems. Questions that can be asked include:

- What categories of data does the company have?
- How is IT management organized/staffed? Is there an e-discovery protocol in place?
- Is there a liaison between IT management and legal department management?
- What is the company's experience with e-discovery to date?
- What are the current and legacy hardware and software systems needed to produce and manage company electronic data?

(continued on page 34)

(Jackson & Smith, from page 25)

- When and how does the company implement a "litigation hold" when sued or threatened to be sued?
- Are the company's record retention policies current, effective and appropriate with regard to electronic data?
- Are there records and data that cannot be retrieved because of incompatible software applications or hardware?
- What legacy data or back-up tapes exist and, perhaps most importantly from the company's perspective, what is the burden or expense involved in searching and producing relevant information from its current and legacy IT systems given the company's current IT profile?

In order to comply with a company's general compliance obligations, stay ahead of the inevitable changes after the Federal Rules of Civil Procedure are amended, and anticipate the mandates of the next Zubulake or Coleman decisions defining a company's duties in this area, companies would be well advised to consider conducting an IT audit of their electronic data management and litigation readiness and use the results to promulgate procedures and protocols that will allow them to appropriately manage and maintain company electronic data.

Longer term management of electronic data most likely will require a cross-functional oversight management committee that includes representatives from a company's IT department, legal department, HR department and accounting and finance departments together with outside counsel and e-discovery technical experts. Such a committee, which could be called the Electronic Data Readiness Committee ("EDRC") would bring together on a regular basis the disparate but necessary disciplines within the company that must communicate in order for the organization to properly manage its electronic data and be prepared for the compliance and litigation demands that it is certain to encounter.

Taking proactive, affirmative steps to get its electronic house in order before the need arises and before the company is served with a subpoena will position the company, at a minimum, to demonstrate that it has acted reasonably and in good faith in appropriately managing its electronic data.

Johnnie M. Jackson, Jr. is a partner at Barton Barton & Plotkin, LLP, and brings 23 years of legal and business expertise as the Vice President, General Counsel and Secretary of Olin Corporation (NYSE: OLN) to BB&P's Corporate Transactions Group. At Olin, Jackson was responsible for all of the company's domestic and international legal affairs, managing a law department that combined the capabilities and resources of up to 30 in-house counsel with legal specialists in more than a dozen primary outside legal firms. Contact Mr. Jackson at jjackson@bartonesq.com

An associate in BB&P's Commercial Litigation practice group, Howard J. Smith, III brings years of comprehensive litigation and courtroom experience to BB&P's team of litigators and arbitrators. His academic pursuits have included studying in both China and Russia and learning their respective languages. Contact Mr. Smith at hsmith@bartonesq.com.