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# DISCLOSURE OF EXECUTIVE MISCONDUCT: DEFAMATION AND CONTRACT CLAIMS

**by**
**John L. Utz**
**Utz & Miller, LLC**
**jutz@utzmiller.com**

A federal trial court recently considered whether a company acted properly in disclosing a CEO's agreement to repay certain compensation following the Company's conclusion that a large bonus paid to the CEO was unauthorized. *Kamfar v. New World Restaurant Group, Inc.,* 347 F.Supp.2d 38 (S.D. N.Y. 2004). The case offers a roadmap on how to proceed when a company suspects unauthorized compensation may have been paid to a key executive.

The Company's dispute with its CEO reached the courts when the CEO brought defamation and breach of contract claims based on the Company's disclosure of the executive's alleged misconduct. The Company had retained a law firm to thoroughly investigate whether $3.5 million in bonuses paid to the CEO and two other executives (the CFO and General Counsel) were authorized by the board. The portion received by the CEO was alleged to be approximately $1.6 million. The law firm reported to the board that the bonuses were not authorized. Although the board's compensation committee had discussed the compensation at issue, the board had never acted in approving the compensation. The law firm advised the board that the Company's financial statements must, as a consequence, be restated.

The Company then entered into an agreement with the CEO to resign, repay his bonus of approximately $1.6 million, and receive severance pay in the amount of approximately $1.4 million. The agreement included mutual covenants not to make disparaging remarks, not to sue, and to keep the terms of the agreement confidential.

The Company issued a press release announcing the CEO's departure and the severance payments. The 10-K filed by the Company indicated that the bonuses were unauthorized, but did not disclose the parties to whom the bonuses were paid. A company representative, however, told a reporter that the CEO was one of those who had received the bonuses at issue. The reporter's newspaper then published this information. Although the law firm had advised the board that the securities laws required disclosure of the circumstances underlying the restatement and the $1.4 million payment to the CEO, it did not advise that the identity of the recipients of the bonuses must be disclosed.

**Defamation**. The court made several rulings. First, the court held that, under New York law, although the matter involved "private figure" defamation, the CEO was suing on a statement that was "arguably within the sphere of public concern" (which the CEO conceded). In this circumstance, a successful plaintiff must show that the defendant "acted in a grossly irresponsible manner, without due consideration for the standards of information gathering and dissemination ordinarily followed by responsible parties." The CEO failed to show that the Company acted with gross irresponsibility in publicly characterizing the bonuses as unauthorized. The court cited a number of New York cases where companies' reliance on thorough, responsible internal investigations of potential employee misconduct defeated defamation claims when the results of the investigation were published.

**Confidentiality Agreement**. Second, the court concluded that the Company did not breach the confidentiality provisions of its agreement with the CEO because whether the bonus was authorized was not a term of the agreement. Instead, the agreement prohibited disclosure of the terms of the agreement and the agreement did not itself describe the bonus as unauthorized.

**Nondisparagement Claim**. Third, the court refused to grant summary judgment for the Company on the CEO's claim that the Company breached the agreement's nondisparagement provision. Although the agreement prohibited disparagement of the parties by one another, it did allow the Company to make disclosure to the extent the Company, in good faith, believed disclosure to be necessary or desirable to protect the Company's interests. The court held that it was unclear whether the disclosure that the bonuses were unauthorized was the product of good faith reliance on the advice of counsel.

**Covenant Not to Sue**. Finally, concerning the CEO's covenant not to sue, the court found that there was no exception permitting the CEO to bring a tort claim or a declaration (which the CEO requested of the court) that the bonuses were authorized. Nevertheless, the court refused to award the Company attorneys' fees as a remedy for the CEO's breach of the covenant not to sue because the court said absent a clear intention to the contrary set forth in an agreement, parties can only use a covenant not to sue as a defense or to establish liability where suit is brought in obvious breach of the contract or otherwise in bad faith. The court found that the CEO's suit was not in obvious breach of the contract nor in bad faith. The covenant not to sue did not, incidentally, interfere with the CEO's ability to enforce the terms of the agreement, so the CEO's claim for breach of the agreement's nondisparagement provision could continue.

**Lessons**. The *Kamfar* case underscores the need for companies to carefully consider how they go about investigating, and ultimately disclosing, executive misconduct. The Company in *Kamfar* did a lot of things right. It was helped by having undertaken a thorough internal investigation of the charge of executive misconduct, and by employing a carefully drafted confidentiality agreement. In particular, the provision in the Company's agreement with the CEO permitting disclosure to the extent the Company, in good faith, believed disclosure to be necessary or desirable to protect the Company's interests was important. Because the court determined that additional facts were necessary to determine whether the disclosure that the CEO's bonus was unauthorized was the product of good faith reliance on the advice of legal counsel, the court did not, however, rule on the merits of the CEO's claim that the Company breached the agreement's nondisparagement provision. The lesson here may be that even after engaging in a careful investigation, including the use of outside counsel, a company will best be protected against nondisparagement claims by disclosing only those facts it is advised by legal counsel must be disclosed, and, one hopes, doing so under a contractual provision explicitly permitting disclosure to the extent the company, in good faith, believes disclosure to be necessary or desirable to protect the company's interests.

Note: This article has been published in the *The Stock Plan Advisor*, a publication of the National Association of Stock Plan Professionals (NASPP).

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**Utz & Miller, LLC**
13200 Metcalf
Suite 230
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

**John L. Utz**
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

**Eric N. Miller**
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

**Matthew J. Eickman**
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com