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Companies Must Be Alert to Legal Restrictions on Document Destruction

Enron Collapse Puts Focus on Document Retention Obligations

The collapse of the Enron Corporation produced the largest bankruptcy in U.S. history. Shareholders, regulators and Congress are attempting to get to the bottom of the scandal. And the admitted destruction of thousands of documents and electronic files is adding to the uproar. It also has put a new focus on the law of spoliation: the destruction of evidence. There are lessons to be learned from the Enron case about the preservation of documents and files that might be needed as evidence in a legal proceeding.

The auditor for the Enron Corporation, Arthur Andersen, has admitted to the destruction of a significant number of Enron-related documents. If it turns out that such destruction amounts to *spoliation*, there may be civil and criminal charges, severe monetary sanctions, adverse inferences taken from the *absence* of evidence and even default judgements. See *Ohio v. Arthur Andersen*, 570 F.2d 1370, 1374, (10th Cir. 1978)(monetary sanction imposed on auditor even though most spoliated working papers eventually were produced); *Hazen v. Anchorage*, 718 P.2d 456 (Alaska 1986) (spoliation liability extended to a defendant's attorney who knew or should have known of the destruction)

Document destruction, by itself, is not suspect

Systematic destruction of documents and files, by itself, is not suspect. Companies today are awash in paper and electronic files. Good management practice dictates that files be purged on a scheduled and regular basis. The costs of storage are too great to save everything. And old documents can create unanticipated liability issues years after they were created, when they cannot be put in context or explained. Still, document destruction cannot be undertaken without consideration of the law. There are numerous record-keeping requirements imposed by law that exist irrespective of the risk of a particular legal proceeding — tax record retention requirements for example. A systematic document destruction policy must take into account such record-keeping rules.

And then there is the issue of spoliation: When does the destruction of files create a risk *even if* it is done in accordance with normal corporate procedures and record-keeping requirements?

What is spoliation?

Under the law of spoliation, a party is under the duty to preserve evidence that it knows, or reasonably *should* know, is relevant to litigation that is pending or reasonably foreseeable. The determination of when litigation is reasonably foreseeable is fact specific. The test turns on whether a party reasonably is on notice that litigation is likely to be commenced. In some cases, investigations and pre-complaint communications are sufficient to put a party on notice that litigation is imminent.

In a famous definition of obscenity, Justice Potter Stewart declared: "I know it when I see it," adding, "I shall not attempt to define further the kinds of material I understand to be embraced." *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964). The fact-specific nature of determining whether legal proceedings are likely and what materials may be relevant may require a similarly subjective test for spoliation. Still, there are some guidelines that have emerged over the years from litigated cases.

Communications about legal issues may constitute sufficient notice that files should be retained

A communication from an outsider raising a legal issue about corporate conduct may be enough to put a party on notice that files should be preserved. For example, in *Computer Associates International v. American Fundware*, 133 F.R.D. 166 (D. Colo. 1990), a federal district court found that pre-litigation communications between the parties were enough to put a document-destroyer on notice that litigation was foreseeable and that the central issue in any eventual action would relate to the documents destroyed. In that case, the plaintiff was a copyright holder of a computer program. It accused the distributor of its program of breaching the contract and of copying the program's software. Under the defendant's business procedures, only the most recent version of the software code was preserved and all earlier versions were destroyed. Two months before filing a complaint, the plaintiff communicated its concerns to the defendant and the parties engaged in settlement talks. During that time, the defendant continued its practice of destroying versions of the software at issue in these talks. The court held that it was inconceivable that the defendant did not realize from these pre-litigation communications that the software in its possession would be sought through discovery.

Past litigation experience and internal investigations may be enough to require document retention

Litigation has also been found foreseeable when the party has been faced with similar lawsuits in the past, or when it has dispatched its own investigators to gather information on an accident or event. In *Capitol Chevrolet v. Smedly*, 614 So. 2d 439 (Ala. 1993), it was held to be reasonably foreseeable that the insurance company might sue after it had sent its own expert to inspect and photograph the scene of the accident.

In product liability cases, the plaintiff may be sanctioned for destroying evidence crucial to the defendant's formulation of a defense. In *Lee v. Boyle-Midway Household Prods.*, 792 F. Supp. 1001 (W.D. Pa. 1992), the court granted summary judgment to the defendant who was unable to formulate a defense to a product liability claim due to the plaintiff's spoliation of evidence prior to filing its complaint. The manufacturer of a drain cleaner was sued for injuries caused when the cleaner allegedly erupted during use at the kitchen sink. But the plaintiff had disposed of the can of cleaner before the manufacturer could examine it. Summary judgment was warranted because the destruction of evidence deprived the defense of the most direct means to counter the allegations.

Once a non-litigation legal proceeding has begun, such as an administrative agency hearing, litigation may be found to be reasonably foreseeable. In *McGuire v. Acufex Microsurgical Inc.*, 175 F.R.D. 149 (D. Mass. 1997), the destruction of evidence occurred prior to litigation but during proceedings before an administrative agency, the Massachusetts Commission Against Discrimination (MCAD). The obligation to preserve documents relevant to potential litigation arose during the agency proceeding.

State and federal civil and criminal law may cover spoliation

In eleven states (Alabama, Alaska, California, D.C., Florida, Illinois, Indiana, Montana, New Jersey, New Mexico and Ohio) spoliation gives rise to an independent cause of action in tort. There are also federal and state criminal statutes that cover the destruction of documents. For example, 18 U.S.C. §1503 provides that "whoever...obstructs, or impedes, or endeavors to influence, obstruct, or impede, the due administration of justice" shall be subject to fines and/or imprisonment. Destruction of documents falls squarely within that prohibition.

In the "post-Enron era," it is fair to predict that the standard for knowing when legal proceedings are likely, and when to keep documents, will be fairly low, and that the destruction of documents will be viewed with a great deal of skepticism if the documents relate to a legal proceeding.

Sanctions for spoliation

In a civil proceeding, a court is empowered to direct sanctions against a party under Rule 37 of the Federal Rules of Civil Procedure and its state counterparts, as well as under its inherent power to regulate litigation and preserve the integrity of proceedings. It is this latter power that permits courts to sanction conduct that takes place *prior* to the issuance of court orders and activation of disclosure requirements. Whether to sanction is within the discretion of the court, and relevant considerations will be the nature of the harm to the injured party, the nature of the interests promoted by the spoliator's actions, the means used by the spoliator, and the spoliator's motives.

The most severe sanction is entry of a default judgment against the spoliator. For such a remedy, a court must generally find bad faith destruction, prejudice to the aggrieved party and the inadequacy of alternate sanctions. In assessing the proper penalty, the court must consider whether the penalty will be sufficient to deter recurrence of the spoliation and whether there has been a pattern of spoliation in the past.

The nature of the evidence destruction in *Computer Associates*, supra, was enough for the court to award this severe sanction. The court held that even if maintaining a single updated version of a source code was in most circumstances a bona fide business practice, it could not go unpunished when the destruction took place after litigation was foreseeable with knowledge of the relevance of the earlier software versions.

More commonly, a court will permit the fact-finder to draw adverse inferences to the document-destroying party or will adjust the level of proof required for the aggrieved party.

Monetary sanctions are also frequently awarded and this may include compensation for attorneys fees and costs for investigation and research that were incurred to make the motion for sanction. A court may impose sanctions for the consumption of time and resources of the aggrieved party and any expenditures that otherwise result from the spoliation.

In some cases, the monetary sanctions can prove to be severe. In *In Re Prudential Insurance Co. of America Sales Practices Litigation*, 169 F.R.D. 598 (D.N.J. 1997), the court imposed a $1,000,000 fine, representing the unnecessary consumption of the court's time and resources in the spoliation issue.

In that same case, the court went even further to require the spoliating party to produce to the court a document preservation policy that would establish clear guidelines for document retention and destruction in the future. The defendant life insurance company had been charged with deceptive sales practices. One year earlier, in response to a regulatory directive that was issued, it had begun a process of destroying all unauthorized sales materials. It continued to destroy these documents long after commencement of litigation, with senior management failing to issue any firm-wide memorandum alerting employees to the court order or to the ramifications of violating it.

The court held that it was the obligation of senior management to be sure to preserve discoverable evidence and to make affirmative efforts to guarantee the compliance of all employees. Since the company had failed to properly manage document retention, the court entered an order requiring the creation of a document retention program.

It is important to note that when spoliation is a concern, there are cases where a party anticipating litigation can obtain judicial relief *in advance* of litigation to preserve evidence that may be subject to easy destruction. For example, in *Quotron v. Automatic Data Processing Inc.*, 141 F.R.D. 37 (S.D.N.Y. 1992), a federal judge granted an ex-parte order allowing executives from the plaintiff company to join U.S. marshals in raiding the defendant company, to prevent it from destroying software before normal discovery could take place.

Document retention policies

Since reasonableness plays a role in a spoliation matter, the existence (or not) of a document retention/destruction policy and the adherence (or not) to that policy will be relevant considerations. Courts are less likely to find the element of bad faith in the destruction of documents when the company disposes the documents in adherence to a formal policy in the ordinary course of business, in the absence of other facts signaling the need to preserve evidence.

There is considerable variation in state law as to whether spoliation must be intentional to be sanctionable. If the purpose of punishing spoliators is to deter attempts to alter the outcome of a trial through the destruction of evidence, then only intentional acts should be punished. But if the purpose of punishing spoliators is to compensate the aggrieved party for its loss, then it may well make sense to impose liability on negligent spoliators as well. Some states have adopted the former rationale, some the latter.

In Ohio, for example, a finding of spoliation will occur only when the destruction of evidence was intentional, that is, destroyed for the purpose of rendering it useless to the opposing party in preparing their case. In a Sixth Circuit case applying Ohio law, *Nationwide Mutual Fire Insurance v. Ford Motor Co.*, 174 F. 3d 801 (6th Cir. 1998), the court held that the insurer's expert's disposal of the electrical wire harness in the car that was set on fire, before the defendant manufacturer could inspect it, was not done with the intention of willfully rendering evidence inaccessible, and was therefore not spoliation.

In other states, however, even negligent destruction of evidence is sanctionable. In *Kelley v. United Airlines, Inc.*, 176 F.R.D. 422 (D. Mass. 1997), the First Circuit upheld an adverse inference against the defendant based on its careless destruction of documents crucial to the plaintiff's case.

In an era when most business is interstate and predicting which state law will apply (and which court will hear a dispute) is problematic, the best practice is to have a document retention policy, but not to assume that the policy by itself will avoid spoliation liability.

Not just any retention policy will do. Courts look askance at companies that attempt to hide behind document retention policies that appear to have been intentionally crafted to permit the destruction of unfavorable records. They will also sanction companies that blindly adhere to a document retention program that is reasonable on its face but that, under the circumstances, should have been overridden.

In a recent case, *Stevenson v. Union Pacific Railroad Company*, 204 F.R.D. 425 (E.D. Alaska 2001), the court penalized a party for destruction that took place pursuant to a document retention policy. A motorist and the estate of his deceased wife brought an action against the railroad company after a fatal collision occurred at a crossing. Tape recordings that included communications between the train crew and dispatchers just before the collision and track inspection records made in the month of the accident had been destroyed by the railroad company pursuant to its document retention policy. Under that policy, tapes were destroyed after 90 days and written records after one year. The court considered several factors in finding grounds to sanction the railroad company:

a) whether the document retention policy was reasonable;

b) whether the policy was instituted or continued in bad faith;

c) whether the spoliator knew or should have known the evidence would become material and should have been preserved despite the policy.

The court found that while the policy was reasonable with regard to the destruction of tapes, the railroad company had to have known that personal injury or death claims would be made pursuant to the accident. Since the company had been regularly involved in similar litigation in the past, it was reasonable to anticipate that the same might happen here, and that the tape recorded statements by eyewitnesses would be relevant.

Poor management is yet another way that a company will find itself facing sanctions despite its reasonable efforts to create a sound document retention policy. In *In Re Prudential*, supra, while the insurance company recognized its obligation to preserve evidence in the face of ongoing litigation, it failed to communicate this to its personnel responsible for document retention. As a result, documents continued to be destroyed by uninformed employees in company branches despite court orders to the contrary. The company was subject to severe monetary sanctions, even though the spoliation was clearly inadvertent.

Conclusion

Courts increasingly are penalizing parties that destroy discoverable evidence prior to the commencement of litigation, where litigation is reasonably foreseeable. Sanctions can be financially severe and a company may suffer serious non-financial losses to its reputation through the exposure that comes with a spoliation charge. Document retention policies can go a long way to protecting against spoliation and its sanctions, so long as the policy is carefully crafted and properly administered, and so long as current disputes or potential disputes are considered before the shredding starts.

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