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Managing crises by conducting internal investigations

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You are the Chief Executive Officer of a public company and your General Counsel calls to report that she received an email from a former employee in the accounting department. The email stated that (1) the manner in which your company recognises revenue is inconsistent with generally accepted accounting principles and (2) this fact has been kept from upper management and the outside auditors. You ask your General Counsel what she thinks should be done. The answer to this question will determine whether you will be able to do the right thing while steering your company through dangerous and potentially uncharted territory.

Potential problems such as the one described above cannot be taken lightly – particularly in light of current regulatory and corporate governance expectations. Whether it is a so-called whistleblower complaint, tip from an anonymous source, communication from internal accountants, or report from outside auditors, the critical issue is how a company responds to the problem presented. This article provides a summary look at one possible response: the internal investigation.

Choosing to conduct an internal investigation

Upon learning of a potential problem, your company should decide whether to self-initiate an internal investigation. Although your company might be legally required to conduct an inquiry (e.g., if its financial statements are implicated or if it is a regulated entity such as a broker-dealer), there are a number of reasons why voluntarily initiating an internal investigation may make sense. A voluntary investigation should enable your company to get on top of the facts quickly. Conducting some type of internal review also will demonstrate cooperation during a subsequent government investigation, be viewed favourably by the regulators, enhance credibility, and lead to mitigation or even crisis avoidance. Examples of possible cooperation include (1) continued communication with the government throughout the internal investigation, (2) submitting informational reports, (3) making in-person presentations by counsel and/or management, and (4) waiving the attorney-client privilege in some cases. The two main sources to consider when deciding how to cooperate are the SEC's October 2001 "Seaboard" 21(a) Report and the DOJ's January 2003 "Thompson Memorandum." While the details of these documents go beyond the scope of this article, the criteria contained therein should be carefully evaluated before commencing any internal investigation.[1]

Conducting an internal investigation is not without its own risks. Internal investigations can be costly and can be a significant distraction to management and employees. Such investigations increase the potential for leaks and other exposure. In addition, an internal investigation can lead to a waiver of the attorney-client privilege and attorney work product doctrine. This can be particularly problematic where civil litigation arises out of the underlying events that were the subject of the investigation.

In any event, whether undertaking an internal investigation or informal review, a company must look into all potential problems and uncover all facts. In our experience, some companies continue to have a "stick our head in the sand" approach. In our view, this makes no sense because it can undermine the integrity of the investigation. Furthermore, as a result of the certifications required by the Sarbanes-Oxley Act and the auditor and audit committee rules, it is inevitable that internally discovered problems will rise to the surface (and will do so at an accelerated rate).

Finally, before deciding what course of action to take, it is important to consider appropriate communications with (1) other senior management, (2) legal department personnel and outside counsel, (3) additional relevant personnel (e.g., compliance or internal audit), and (4) the Board of Directors and appropriate board committees (e.g., the Audit Committee). In many instances, it will be the Audit Committee, or a special committee of outside directors, that oversees or manages the investigative process (usually conducting the investigation through its own independent counsel retained for that purpose). Often, this approach is important to establish the independence of the fact-finding process. In any event, the board and relevant committees should be kept apprised of all developments as the investigation progresses.

Conducting the investigation

Once a decision to conduct an internal investigation has been made, the scope of the ▸▸

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investigation should be defined carefully. Every action should have a purpose, be well thought out, and be part of an overall plan. The ultimate goal of the investigation must be to get ahead of all problems and uncover all the facts. In our experience, it is not unusual to have to devote greater expenditures of time and resources in the beginning in order to yield less expenditures of time and resources overall. In addition, deciding not to explore an area of concern for fear that additional issues will surface often can be counterproductive. An investigation that is viewed as a "white wash" is risky and will not accomplish the objectives discussed herein.

To conduct the investigation, your company (or the Audit Committee) should retain a law firm that is experienced in handling internal investigations and dealing with regulators who enforce the federal securities laws. Keep in mind that this is not the same as general litigation. In addition, separate law firms might be needed to represent the company, board committees, and individual directors, officers, and employees. Company counsel should review the relevant bylaws and articles of incorporation (as well as employment agreements) to determine the extent to which the company must, or should, provide advancement of legal expenses and, ultimately, indemnification to individuals. In addition, it may be necessary to retain experts, such as forensic accountants and communications consultants. If so, they should act as agents of outside counsel to preserve the attorney-client privilege and attorney work product doctrine.

The majority of the investigation will be spent gathering facts from documents and interviews. Interviewees should be provided with *Upjohn* warnings to make it clear that they are not being represented by company counsel and that the privilege belongs to the company. In this regard, care should be taken to preserve the attorney-client privilege and attorney work product doctrine throughout the investigation – although a subsequent decision might be made to disclose privileged findings to the government.

Avoid compounding problems

At the beginning of the internal investigation, careful attention should be given to a document preservation mandate. No matter how serious the underlying misconduct, the one sure way to escalate a problem is to fail to take steps to preserve documents. All relevant documents should be preserved (even if they are scheduled for routine disposal as part of a pre-existing policy). Routine email purges should cease. In addition, electronic databases, programs, and other files should be frozen – e.g., a "snapshot" should be taken of the email system and other databases. Relevant personnel should be notified, via document preservation memoranda, of the need to preserve all relevant documents. Attempts to cover up a problem will destroy credibility, increase the regulatory consequences, and heighten the risk of a criminal charge.

During the interview process, counsel should inform interviewees about the importance of candour and consequences of deception. The credibility of an interviewee's answers must be assessed by checking against available documents and information. Due diligence is essential.

You also should be mindful of how individuals are treated during the investigation and should avoid any unnecessary alienation of personnel who are not implicated as potential wrongdoers. In particular, you should ensure that your company does not take any action against a whistleblower that could be perceived as retaliatory in nature.

Managing crises and making difficult decisions

Once the investigation is complete, an oral report of findings often will be sufficient. In certain complex situations, however, facts and findings may need to be set forth in a carefully crafted written report. If a written report is drafted, you should be aware that the government is likely to ask your company to waive its privilege and produce a copy (which will become the government's blueprint in its investigation). Moreover, notwithstanding the SEC's efforts to enter into confidentiality agreements, a report produced to the government likely will need to be produced to private litigants.

If the investigation finds that violations occurred, disciplinary action (including termination) must be taken. In our experience, how a company deals with its employees, particularly high ranking employees or people who control a lot of business, is an important factor in the government's assessment of the integrity of an internal investigation. In addition, possible remedial actions include (1) developing new or enhanced policies, procedures, and controls, (2) hiring consultants or additional personnel, and (3) providing training on the relevant issues. Remedial actions can be used as a sword (by helping your company in any government investigation) and as a shield (by making recurrence of the underlying misconduct less likely).

Finally, you should consult regular disclosure counsel to decide whether disclosure is necessary under the federal securities laws. If so, it should be prompt and complete. In addition, you should implement an external and internal communications plan (including preparing standby public statements and internal memoranda to personnel). Even if you decide not to disclose, events will move rapidly if the problem becomes publicly known.

An internal investigation can be an invaluable tool for a company with potential problems. It will not be an easy road to travel. But, in the end, you should remember that the best chance to mitigate the consequences of an enforcement action (or to avoid one altogether) is up-front during the investigation itself – not down the road in the courtroom. And, by uncovering any potential problems, rectifying them, preventing recurrence, and moving your company into a bright future, you will, indeed, be doing the right thing. ■

1 Copies can be found on the SEC and DOJ websites at: www.sec.gov/litigation/investreport/34-44969.htm, and www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

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