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The Changing Landscape Of Internal Corporate Investigations

By Harvey L. Pitt, Compliance Week Columnist—July 27, 2004

Although the spectacular, seemingly daily, announcements of multi-billion dollar global corporate implosions is now—hopefully—behind us, each day's press still brings news of companies under government investigation. Indeed, the SEC opened nearly 700 investigations this past year, an all-time record.

More and more frequently, companies finding themselves in the government's cross-hairs announce the onset of the investigation, and declare the intention to cooperate. The following day ineluctably brings a precipitous market cap drop of between 10 and 20 percent.

Particularly in the current post-Sarbanes-Oxley environment, public companies must assume that they will become the subject—if not the target—of a governmental investigation at some point, most likely relating to their accounting practices and financial reporting. To ameliorate the sting of unwelcome government interest in their affairs, many companies undertake a so-called "independent" internal investigation.

While there are sound reasons for undertaking that kind of effort, two recent law enforcement cases demonstrate that there are also perils in incorrectly determining whether, why, when, with whom and how to undertake a corporate internal investigation.

In May, three former Computer Associates executives pled guilty to obstructing justice by lying to an outside law firm conducting an internal investigation, who then passed the lies on to federal investigators. While some people consider it a sacred right to be able to lie to lawyers, and none of the executives lied directly to federal agents or the grand jury, the U.S. Attorney correctly concluded that the false statements "were intended to—and did in fact—obstruct justice."

Then, in June, the SEC announced Del Global Technologies agreed to pay a $400,000 penalty, in part for commissioning "an internal investigation that sought to shield the architect of the fraud," the chairman and CEO.

These cases help re-emphasize the high bar for internal investigations.

1. **When should you conduct an internal corporate investigation?**

   There are three discrete time frames in which an internal corporate investigation may make sense, but they can cover virtually the entire extent of every corporation's existence:

a. The company learns of a problem that hasn't yet reached a government radar screen;
b. The company learns of a government concern or inquiry; and
c. The company wants to satisfy itself that some significant potential wrongdoing hasn't occurred.

From the government's perspective, internal inquiries undertaken in response to the first and third reasons have the greatest credibility, but that doesn't undercut the potential value or need for an inquiry undertaken once the company learns of some government concern.

2. **Why should you conduct an internal corporate investigation?**

There are at least two discrete perspectives from which the rationale for an internal corporate investigation must be viewed—that of senior managers, and that of outside directors.

From management's perspective, it cannot be gainsaid that government investigations are cumbersome, invasive and often long drawn-out affairs. They can be costly and divert necessary attention from the day-to-day business activities of a company, and they can rattle nervous employees. They can also attract headhunters who seek to siphon off a company's best talent.

An internal corporate investigation gives a company a chance to seize control of a bad situation, and make it manageable. Answering questions from company-designated inquisitors is less troublesome than answering questions before a stenographer and a band of government gumshoes. Moreover, a well-managed and conducted internal inquiry may influence the amount of time government investigators spend pursuing their own.

For outside directors, the stakes and issues are different. When informed of, or upon becoming aware of, potential employee misconduct, outside directors should not sit by and simply allow the company to defend itself. Rather, depending on the nature of the potential misconduct—as well as the source from which it was learned—outside directors have an obligation to answer at least three critical questions:

a. Did wrongful conduct occur (and if so, to what extent and effect)?
b. Have all reasonable steps been taken to ameliorate the effects of the company's wrongful conduct? and
c. What assurances does the board have that similar misconduct will not recur?

3. **Should you defer an internal review during ongoing government investigations or plaintiffs' litigation?**

Frequently, companies are discouraged by defense counsel from commencing an independent internal corporate review in the midst—or in anticipation—of a pending government investigation or ongoing litigation over the same subject matter. This counsel stems from the concern that a separate corporate inquiry may turn up evidence that will hoist the company by its own petard, so to speak.

But, that advice views the corporation from a perspective that no longer applies, if it ever did.

Especially when possible corporate misfeasance is already known by third parties, the likelihood of avoiding governmental sanctions or successfully defending litigation is significantly diminished. At that point, the proverbial cat is out of the bag, and everyone will be watching the company to see exactly how it handles the possibility of wrongdoing. Indeed, the company's treatment from the government will invariably depend, in large measure, on how the company reacted to news of possible misconduct. The company that sits back and allows others to take the lead is the company that will fare the worst in the context of either governmental or civil proceedings.

Moreover, if it is possible that the company may not have violated the law, an independent inquiry is the best way to establish that fact. Neither government investigators, nor plaintiffs' lawyers, have an incentive to conclude that nothing wrong occurred. A thorough and appropriately conducted internal inquiry can lend credibility to a company's assertions that it didn't violate the law, or that any violations that did occur were inadvertent or of minimal consequence.

4. **How should you conduct an internal corporate investigation?**

To have maximum impact, an internal corporate investigation must be thorough, independent, transparent and competently performed. This often sounds easier than it really is.

From a regulatory perspective, the best internal investigation is one that does the government's work for it. This means conducting a swift but thorough investigation and remediating problems or adverse consequences of any misconduct. In essence, if you leave nothing for the government to do, it's less likely the government will take action or—if action is taken—that any action it takes will have devastating consequences.

Questions often persist regarding what constitutes a thorough investigation. Does this mean that the company has to look for any and all other forms of misconduct that might have occurred?

While the answer to this question will depend on the peculiar circumstances, it is important to mesh the company's perspective with the likely perspective of the government. Thus, for example, if a problem is found in Latin America, it's reasonable to ask whether a similar problem exists in other company locales.

While companies may not be required to go looking for problems of which they have no indication, once a problem is perceived or suspected, the investigation should be reasonable in scope to find possible *related* problems.

5. **What constitutes an independent internal inquiry?**

As the *Del Global Technologies* case shows, companies must be able to demonstrate that they've conducted a bona fide, independent, investigation. If the investigation appears to

be an "inside job" or a "whitewash," it will completely undermine the credibility of the findings, and will be worse for the company than having conducted no internal inquiry at all.

It is critical that an internal corporate inquiry be entrusted to someone who is completely independent of the company and of the events likely to be investigated. The most effective oversight will come if the investigation is given to either a standing committee or a special committee of the board comprised *solely* of independent directors.

Entrusting the oversight of the inquiry to a member of senior management, or even the company's in-house counsel, is often problematic. Judgments that must be made on how to conduct the inquiry—and about what to inquire—demand complete independence in the process. The goal of the inquiry should, in every case, be to find out what happened, why it happened, what the impact is, and whether sufficient steps have been taken to prevent problems like this from recurring. Those are judgments that should be entrusted to an independent board member or, if necessary, someone entirely independent of the company.

If outside counsel and other experts are retained (as is inevitable), the board members entrusted with oversight of the investigation, not management, should make all hiring decisions. A condition of retaining any outside experts to assist in conducting the internal inquiry should be that they have not done work for the company for at least two years prior to their retention, and that they agree not to do any work for the company for two years subsequent to the completion of the inquiry. The outside experts should be independent and experienced in conducting internal investigations, and should be discerning. It's hard to believe that the prominent law firm representing Computer Associates didn't know they were being lied to.

6. **Investigators should be given broad access to people and documents.**

The operative framework is that management should not seek to impose restraints on how the investigation is conducted. Restraints, of course, are critical, or the investigation may never end, and its cost may bankrupt the company.

But those are restraints that must emanate from the independent board committee charged with oversight of the inquiry, not senior management. Very often, senior managers may seek to participate in, or attend, interviews of various witnesses. In some cases, employees may feel more comfortable with someone they know in the room. In other cases, they may feel intimidated by the presence of someone from senior management. As a general proposition, it's always best to conduct the interviews *without* the presence of senior management.

Employees also need to understand that lawyers conducting the interviews do not represent them, but rather represent the company's board, and they must be told that information they provide will likely be passed on to regulators and others. It is, however, crucial—and now legally mandated by Sarbanes-Oxley—that employees about to be interviewed be assured that no retribution will be visited upon them for telling the truth. Conversely, as *Computer Associates* demonstrates, employees should understand that

some retribution may be visited upon them at the government's instance if they do not tell the truth.

7. **The pay of the independent investigators should be structured to promote independence, competence and diligence.**

   Internal investigations are intense but generally very lucrative. This is why the retention of outside experts must be handled by those responsible for the oversight of the investigation, to avoid fostering ties with company officials under investigation.

   Whether the experts are hired pursuant to an hourly or flat fee is a matter that should be carefully considered by the board committee that retains the experts. And, in light of *Del Global*, retention agreements should provide for a return of fees in the event the government concludes the investigation was not bona fide or thorough.

   Indeed, it's strange that, in *Del Global*, the penalty was extracted solely from the company and not the lawyers who conducted the flimsy investigation or the individuals who put them up to it. If the internal investigation really was staged, the lawyers should have been made to return their fees to the company and be barred from appearing or practicing before the SEC. Instead, the shareholders effectively paid twice for the poorly conducted internal investigation by paying the legal fees and then the fine. They also had to pay for new counsel and endure a federal investigation.

8. **Expect your internal investigation to be investigated.**

   If the internal investigation raises regulatory issues, consider discussing them with appropriate regulators. Very often, raising inchoate concerns with regulators can prove to be a self-fulfilling prophecy. But the temptation to keep negative and unproved information secret has to give way to the pragmatic reality that there are very few secrets in this era of instantaneous electronic communications.

   Before discussing any concerns with regulators, of course, the company must have a well-defined strategy for dealing with the complaint or allegation, and must have considered the types of questions regulators are likely to raise when they learn of the concerns.

9. **Consider publicizing the internal investigation in an appropriate fashion.**

   It's a mistake to think that a complaint that finds its way to the CEO or some corporate ombudsman will remain a secret. The better policy is for companies to treat the concerns raised directly, disclosing the existence of the allegations internally—and perhaps externally—coupled with a statement announcing the internal investigation and its purpose.

   The company should convey that it wants to assure itself as well as its employees, customers and shareholders that improper conduct hasn't occurred, but if the investigation should prove otherwise, it is a violation of corporate policy and appropriate remedial action will be taken.

10. **Don’t wait for problems to find you.**

The old wisdom—that companies shouldn’t go looking for problems—is no longer valid.

Under Sarbanes-Oxley, companies are already required to establish mechanisms enabling employees to bring potential misconduct to the attention of someone independent, and it is in companies’ interests to do so. Encouraging employees to bring possible misconduct to the company’s attention is the best way to prevent turning a small peccadillo into a humongous crisis.
