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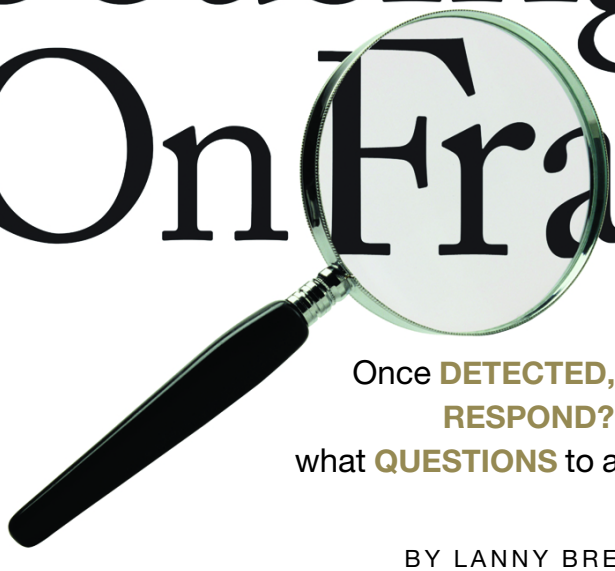
Focusing In On Fraud



Once **DETECTED,** how should a corporation **RESPOND?** Here are **GUIDELINES** on what **QUESTIONS** to ask and how to **PROCEED.**

BY LANNY BREUER AND ALAN VINEGRAD

In the wake of the recent spate of highly publicized corporate scandals, corporations that receive or uncover an allegation of fraud must navigate increasingly difficult waters in trying to formulate an effective and expeditious response.

On the one hand, the failure to act aggressively against potential fraud could result in civil suits, enhanced criminal penalties under the U.S. Sentencing Guidelines, new sanctions established by the Sarbanes-Oxley Act of 2002, and enforcement actions by federal and state regulators. Yet planning a response raises a litany of concerns.

Does the alleged activity amount to fraud? Should the allegation be investigated at all? If so, who should conduct the investigation? How should employees involved in the fraudulent activity be handled? Will the corporation's investigation remain confidential? Should a disclosure be made to the authorities? And if fraud is established, what are the consequences for the corporation?

How a corporation responds to possible fraud will vary depending upon whether the company discovers the allegation through internal sources, a civil lawsuit, or an investigation by the government. What is clear, however, is that a corporation is best advised to develop a sound strategy not only for responding to allegations of corporate fraud, but also for detecting and preventing fraud before it becomes a problem.

DETECTING, PREVENTING

Cataloging all the federal and state laws proscribing fraudulent activity, not to mention their common law counterparts, would take volumes. By one count in the late 1990s, the terms "fraud," "fraudulent," "fraudulently," or "defraud" appeared 82 times in the federal criminal code alone.[1] Yet the range of "frauds" that can be committed obscures the fact that "fraud," at a conceptual and practical level, is

Lanny Breuer, former Special Counsel to President Bill Clinton, and Alan Vinegrad, former United States Attorney for the Eastern District of New York, are partners at Covington & Burling. Bradley Smith, an associate at the firm, assisted in the preparation of this article.

usually predicated on the relatively straightforward act of lying to or deceiving another for some economic benefit. The risk that this may occur in the corporate setting is readily apparent, even if the conduct is not of an Enron or Worldcom magnitude.

As recent events demonstrate, perhaps the most important step for a corporation to take is to implement appropriate procedures for detecting and preventing fraud rather than having to respond to it after the fact as a result of a lawsuit or government investigation. But detecting sophisticated corporate fraud can be a difficult task, not surprising given that wrongdoers can only enjoy the fruits of their schemes if their activity goes undetected. However, several basic steps can minimize the risks.

A robust internal compliance program overseen by sophisticated individuals of integrity and experience is the best mechanism for identifying and preventing corporate fraud. Developing and implementing such a program requires an understanding of the industry in which a corporation operates, areas in the industry inherently vulnerable to abuse, and how the company recognizes revenue and expenses.

A corporation should develop a written policy clearly setting forth its policies and procedures for reporting fraud. The policy should make clear that the commitment to preventing fraud runs to the highest levels of the corporation. Indeed, a company would be well-advised to appoint a person of stature and independence, at the executive level, to oversee its internal compliance program and receive reports of wrongdoing. The policy also should make clear that those who report fraud will not be retaliated against for doing so, and that those who participate in fraud will be held accountable.

Simply drafting a policy for detecting and preventing fraud is not enough, however. A company also should have in place a strong internal audit team that has the ability and resources to monitor business practices. A corporation also must train its employees on the compliance policies on an ongoing basis, updating and retraining the employees as the policies evolve. Finally, common sense is key to detecting fraud. For example, complex transactions, sudden changes in revenue and expenses, or transactions lacking in obvious business purpose should be viewed with healthy skepticism.

INTERNAL INVESTIGATION?

Once a corporation identifies an alleged fraud, the next, and perhaps most critical, question is whether to conduct an internal investigation into the charge. The benefits associated with quickly launching an investigation often far outweigh the risks.

A corporation can develop a sound strategic plan for addressing the allegation if it knows and understands better than other parties the scope of any fraud, the individuals involved, and the potential victims. Moreover, by promptly investigating potential fraud, a corporation best positions itself to minimize possible liability and penalties, blunt public criticism, cabin harm caused by the fraud before it spreads, and dissuade the government from undertaking its own investigation. Conducting an internal investigation, in essence, allows a company to gain — and hopefully maintain — control over the fraud.

That said, internal investigations carry intrinsic risks. When a corporation is unable to ensure confidentiality and preserve relevant legal privileges, an internal investigation, and the documents generated during that probe, can lay bare the case for government action and private lawsuits. In some instances, by initiating an investigation — even when a thorough investigation is the appropriate response — a business may create the appearance that it operated inappropriately, even when, at the end of the day, the investigation reveals nothing untoward.

PRESERVE RELEVANT DOCUMENTS

Once a corporation decides to investigate an allegation of fraud, it must learn the full extent of any wrongdoing, and critical to understanding the fraud is collecting documents. Generally, steps should be taken immediately to preserve and protect any relevant documents as soon as a company learns that it or its employees may have engaged in fraudulent activity. While it may not always be feasible, or even possible, for a large business to identify every individual who may hold pertinent materials, preservation efforts should be broad enough to ensure that all employees who are potentially connected with the fraud preserve their relevant documents.

The need to preserve documents takes on particular significance in light of criminal penalties the Sarbanes-Oxley Act[2] imposes on anyone who "knowingly" destroys documents with the "intent to impede, obstruct, or influence" a federal investigation or "in relation to or contemplation of any such" investigation.[3] Given that a leading pubic accounting firm met its demise as a result of an allegation of improper document destruction, a written document retention policy is advisable, if not essential.

Special care also must be taken to secure any electronic material, including e-mails, until the matter is resolved. This may require purchasing additional software or other computer hardware to increase a business's electronic storage capacity. Though costly, preserving electronic material is essential in today's world. The government is unlikely to sympathize with a company that, while aware of possible fraud, deleted or lost potentially relevant electronic documents.

INVOLVE COUNSEL

Almost without exception, an attorney for the company should be involved at the outset in planning its response to possible fraud. By including an attorney at the initial stage, the corporation maximizes its ability to claim that its deliberations (and any documents that corporation lawyers or their agents create during the investigation) fall within the attorney-client and work-product privileges.

A corporation may, for strategic reasons, later waive privileges, but by placing an attorney in charge of formulating the response, a company at least gives itself the option of asserting a privilege claim. It also puts someone knowledgeable about legal ramifications and disclosure obligations in the middle of the corporation's response.

A company also must decide whether to retain outside counsel when facing fraud allegations, particularly when it decides to conduct an internal investigation. On the one hand, having an in-house attorney conduct the investigation has advantages. A person affiliated with the business possesses institutional knowledge that can only be acquired by outside counsel through time, effort and expense. Moreover, the costs of an investigation are apt to be lower if conducted internally. Less tangible reasons may exist for relying on in-house personnel: asking an outsider to participate may cause some within the company to "clam up" and view any ensuing internal investigation in a hostile, uncooperative manner.

Yet where substantial fraud is alleged, significant strategic advantages exist in retaining outside counsel to conduct the investigation. Outside attorneys experienced in "white collar" investigations will be familiar with the myriad civil, regulatory and criminal issues involved in responding to allegations of corporate fraud. Retaining outside attorneys also gives the corporation's actions an objectivity and credibility that may not be as apparent if in-house counsel alone handled the matter. These qualities may be critical in convincing any investigators and regulators later on that the company's investi-

gation was impartial and complete. Finally, and by no means insignificantly, outside counsel can act as a buffer between the corporation and third parties, such as government investigators.

Similar factors also should inform a company's decision to retain outside experts or consultants to assist in investigating potential fraud. For example, where it is alleged that a corporation falsified or misstated financial statements or accounting reports, hiring external financial analysts and auditors to investigate the claim, rather than relying exclusively upon internal auditors, may increase the perceived credibility of the corporation's response to the allegations and thus better position it in dealing with government authorities.

ESTABLISH AND PRESERVE CORPORATE PRIVILEGES

A corporation must be careful to preserve its legal privileges when responding to an allegation of fraud.

Establishing the attorney-client privilege is key. In the corporate setting, as a general rule, the privilege covers communications involving corporate employees and either outside counsel or in-house counsel, provided the communications are made for the purpose of obtaining legal, as opposed to business, advice. Distinguishing business advice from legal advice can be more difficult where communications are sent only to an in-house attorney, and generally a stamp or some other marking on documents should indicate that the communication is privileged and made for the purpose of obtaining legal advice.

The attorney-client privilege is not limited to counsel and employees, however. It also may protect communications with outside experts or agents, provided that the individuals work under the direction and supervision of counsel, and the information they gather is necessary for providing legal advice to the corporation.[4]

Depending on the context in which a company begins investigating allegations of fraud, the work-product privilege also may be available to a corporation. This privilege, which the Supreme Court outlined in *Hickman v. Taylor*[5] and which was subsequently codified in Rule 26 of the Federal Rules of Civil Procedure, protects from disclosure documents generated during or in anticipation of litigation by an attorney, his agent, or a corporate employee.

Unlike the attorney-client privilege, which, once properly established, is generally considered absolute and cannot be breached unless waived by the client, the attorney work-product privilege may be overcome where an opponent shows that a substantial need exists for the material and that it cannot be obtained from another readily available source. Even where work-product documents must be disclosed, however, the documents may be redacted to protect the attorney's mental impressions, opinions and legal theories.

The self-evaluative privilege also may apply when addressing a fraud allegation. As the name suggests, this privilege is premised on the theory that requiring a corporation to produce documents generated during an internal investigation would discourage corporations from diligently investigating and correcting wrongdoing.[6] Relying exclusively on the self-evaluative privilege would be unwise, however. The privilege is not frequently recognized, and has been rejected by a number of courts.[7]

INTERVIEWS

Along with collecting and reviewing relevant documents, interviews of employees, and perhaps of others, are critical to assessing allegations of corporate fraud. In conducing an employee interview, several factors should be kept in mind.

First, the employee should understand that the attorney conducting the interview (for reasons discussed above, an attorney should participate in any employee interview) represents the corporation, not the individual. Second, the employee should be told that while the interview is legally privileged, and the employee should therefore keep its contents confidential, any information revealed during the interview may be disclosed by the corporation to the government or others outside the corporation. Third, the employee should be informed that the company expects its employees to cooperate fully with the investigation, even going so far (if necessary) as conditioning continued employment on participating in an interview.

Occasionally, employees may ask if they should retain counsel in connection with any interview. Ultimately, only the employee can decide that, and, generally speaking, they should be told that the decision to hire an attorney is the employee's alone to make. However, because a corporation is a private entity, the right to counsel and the privilege against self-incrimination are not usually triggered by interviews conducted as part of an internal investigation. Thus, unless otherwise provided by company policy or an employee's contract, an employee who refuses to participate in an interview unless her attorney is present, or because of concerns about self-incrimination, may be terminated.

In addition to interviewing employees, it may be appropriate, if not essential, to interview non-corporate third parties in order to fully assess the nature and magnitude of the alleged fraud. Obviously, such interviews must be done with great care, for they risk disclosing publicly the existence of the allegation and investigation and are beyond the scope of the attorney-client privilege. But the facts of the situation may dictate that such interviews be conducted despite these risks. If so, the timing of these interviews should be controlled to at least minimize the risk of premature disclosure.

CONSIDER DISCLOSURE TO THE GOVERNMENT

Oftentimes, disclosure of fraud to the government will be compelled by statute or regulation. Even when it is not, however, a corporation's voluntary disclosure of wrongdoing to the government may be critical to minimizing the risk of criminal prosecution or regulatory action or reducing possible sanctions.

The Department of Justice guidelines setting forth criteria to be used by federal prosecutors when deciding whether to charge a company[8] provide that a "corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents" will be weighed.

Even if a corporation is ultimately charged, voluntary disclosure can inure to the corporation's benefit. Under the U.S. Sentencing Guidelines, for instance, a corporation's sentence following a criminal conviction may be reduced if it promptly reported the wrongdoing, cooperated with the government and accepted responsibility.[9]

Despite such important benefits, revealing information to the government involves perils. One notable danger is an incomplete or partial disclosure. Revealing only some information about fraudulent activity to the government could, in the worst case, later be parlayed by prosecutors into an obstruction of justice charge or, at the very least, could negate any benefits that might otherwise result from disclosure.

Additionally, disclosing information to the government may require waiving attorney-client and other privileges. For example, the same sentence of the Department of Justice memorandum that indicates a corporation's voluntary disclosure will be one factor the government considers when deciding whether a corporation "cooperated with the government" also states that a company's willing "waiver of the corporate attorney-client and work product protection" will be considered.

Normally, the memorandum indicates, any waiver request will "ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue," though the government is free to request a broader waiver under the guidelines. Yet by disclosing privileged material to the government, the corporation may be deemed to have waived the relevant privilege with respect to other parties, including potential civil litigants.

In some situations, the corporation may be able to protect privileges by negotiating an explicit confidentiality agreement in which the government agrees that it will not claim that the disclosure waived the attorney-client and work-product privileges,[10] but some courts have held the privileges (particularly the attorney-client privilege) waived even when a confidentiality agreement exists.[11]

A corporation also must decide how to deal with employees found to have participated in corporate fraud. While this is so regardless of whether the fraud is disclosed to the authorities, it is particularly important where such disclosure is anticipated.

The government considers how the corporation disciplined those responsible for the fraud when deciding what type of action to take against it. Terminating or demoting responsible individuals often is a necessary, if unpleasant, step in order to convince the government that the corporation is responding seriously to the fraud, as well as an appropriate corporate response in its own right. If possible, however, a corporation may want to structure the discipline in a way that maximizes its ability to gather information from the employee and others, such as by imposing discipline only after all employees are thoroughly interviewed.

In addition, the company should take remedial steps to avoid a recurrence of the problem. This may include reassigning personnel, increasing internal audit or supervisory scrutiny, supplemental employee training, or changing procedures or business practices relevant to the conduct giving rise to the problem.

KEEP SARBANES-OXLEY IN MIND

In developing a plan for addressing alleged fraud, a corporation also must consider the requirements created by Sarbanes-Oxley, in addition to other disclosure requirements imposed by securities and other laws. Several provisions of Sarbanes-Oxley are particularly noteworthy in the corporate fraud context.

For example, the Act establishes new fraud-related crimes and enhanced sentences for various types of fraud.[12] Moreover, under §307 of the Act, attorneys that appear and practice before the Securities and Exchange Commission on behalf of a public company must notify a corporation's chief legal counsel or chief executive officer of any "material violation" of securities laws, "breach of fiduciary duty or similar violation by the company" or its agents; if those officials do not take appropriate action, then the attorney must notify the corporation's audit committee, another independent committee of the board of directors, or the entire board of the violation.

SEVEN STEPS FOR DETECTING AND PREVENTING FRAUD

- Written corporate policy
- Management support
- Ongoing employee training
- Internal auditing
- Corporate executive to oversee compliance
- Appropriate discipline of wrongdoers
- Remedial steps to avoid recurrence

Furthermore, §302 provides that any fraud, regardless of its "materiality," must be disclosed to a corporation's outside auditors and audit committee if it "involves management or other employees who have a significant role in the issuer's internal controls." Consequently, depending upon the character of the fraud uncovered, a corporation may have to take steps to comply with disclosure requirements under existing securities laws, apart from what may otherwise be (or not be) in the corporation's best interests to disclose.

CONCLUSION

Dealing with an allegation of corporate fraud is not easy, but in today's environment, developing a system for detecting and preventing it, as well as responding to it, is essential.

Though the strategy will vary depending upon the facts of a particular situation and applicable laws, regulations and internal company policies, the corporation's best "response" is to have meaningful policies and systems in place for minimizing the risks of fraud and for detecting it before it becomes a major problem. Once a problem surfaces, moving expeditiously and discreetly to investigate the problem and take appropriate action is the next best course of action. Participation of in-house counsel is critical to the success of both approaches. •

1. See Ellen S. Podgor, "Criminal Fraud," 48 Am. U. L. Rev. 729, 740 (1999).

2. Pub. L. No. 107-204, 116 Stat. 745 (2002).

3. 18 U.S.C. §1519.

4. See, e.g., *United States v. Kovel,* 296 F.2d 918, 921-23 (2d Cir. 1961) (accountants); *In re Grand Jury Subpoenas Dated March 24, 2003,* 265 F.Supp.2d 321, 324-26 (S.D.N.Y. 2003) (public relations consultants).

5. 329 U.S. 495 (1947).

6. See, e.g., *Troupin v. Metropolitan Life Ins. Co.,* 169 F.R.D. 546, 548-49 (S.D.N.Y. 1996); *Webb v. Westinghouse,* 81 F.R.D. 431, 432-33 (E.D. Pa. 1978).

7. See, e.g., *In re Ashanti Goldfields Sec. Litig.,* 213 F.R.D. 102, 104 (E.D.N.Y. 2003) ("The question of whether a self-evaluative privilege should be recognized as a matter of federal law has not yet been settled by the Supreme Court or the Second Circuit, and a number of lower federal courts have declined to recognize it.") (citing cases).

8. These guidelines may be found at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

9. See U.S.S.G. §8C.2(g).

10. See, e.g., *In re Steinhardt Partners, L.P.,* 9 F.3d 230, 236 (2d Cir. 1993) (declining "to adopt a per se rule that all voluntary disclosures to the government waive work product protection" and suggesting that the privilege could remain if the party and the authorities "entered into an explicit agreement … [to] maintain the confidentiality of the disclosed materials"); *Mauzen Co. v. HSBC USA, Inc.,* 2002 WL 1628782, at *1-2 (S.D.N.Y. July 23, 2002) (holding that corporation did not waive its work product privilege where the corporation entered into an oral confidentiality agreement with relevant authorities to protect the privilege); *Information Res. Inc. v. Dun & Bradstreet Corp.,* 999 F.Supp. 591, 591-93 (S.D.N.Y. 1998) (collecting and summarizing case law).

11. See, e.g., *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.,* 293 F.3d 289, 294-306 (6th Cir. 2002); *In re Bank One Sec. Litig.,* 209 F.R.D. 418, 423-24 (N.D. Ill. 2002). See also *LaBelle v. Philip Morris, Inc.,* No. 20-98-3235-23, 2000 WL 33957169, at *4-*7 (D.S.C. Oct. 23, 2000) (summarizing cases).

12. See, e.g., id. §§802 (criminalizing the destruction of documents with the intent to impede a federal investigation), 804 (lengthening the statute of limitations for securities fraud), 807 (providing criminal penalties for new securities fraud statute); 902 (criminalizing attempts or conspiracies to commit fraud), 903 (increasing penalties for mail and wire fraud), 1106 (increasing penalties for violating the Securities and Exchange Act of 1934).