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Successful Board Investigations

The stakes are high. Results can be subject to “second-guessing.” Is your board ready?

by David Bayless and Tammy Albarrán

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Editor	Ralph D. Ward
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EDITORIAL OFFICE

The Corporate Board
4440 Hagadorn Rd.
Okemos, MI 48864

Phone: (517) 336-1700

Fax: (517) 336-1705

Email: info@corporateboard.com

Web site: www.corporateboard.com

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Successful Board Investigations

by David Bayless and Tammy Albarrán

The times when a board of directors must conduct an internal investigation are rare, thankfully. Yet when an investigation is required from the very top of the company, the stakes could not be higher. By setting high goals and even higher standards of conduct, your investigation can satisfy the toughest critics, from investors to regulators.

It is not often that a public company's board of directors must conduct an internal investigation of alleged misconduct. However, when such an investigation is needed, it is critical that it be handled with great care and skill. While this task is fraught with peril, there are a number of steps a board can take to ensure that the investigation accomplishes the board's goals, which will enable it to make informed decisions, and withstands scrutiny by third parties.

The number of internal investigations is high. A 2012 survey of U.S. and U.K. in-house counsel found that 42 percent of respondents had retained outside counsel to conduct an internal investigation in 2012. Further, 88 percent of those responding to the survey expected that number to stay the same or increase this year.

Internal investigations are unique because they are often subject to a high level of scrutiny *after the fact* by third parties. These include skeptical regulators, prosecutors, shareholders, courts, auditors, and even trustees and receivers. Unlike other board responsibilities, this second guessing by hindsight subjects the board to outside scrutiny of its role in overseeing the internal investigation.

Not all internal investigations are conducted or supervised by the board. In fact, in almost every investigation, the in-house attorneys are involved at the outset, as they are the company's trusted advisers with deep knowledge about the company. However, there are times when the nature of the allegations or the parties involved warrant an investigation by independent legal counsel.

For example, when the allegations or conduct implicate senior management or a board member, the issues investigated may have a material impact on the company's financials. Or, the claims may be of keen interest to regulators and prosecutors, and thus an independent investigation may be needed. Once the need for independence arises, the board (or a disinterested board committee) oversees and manages the investigation.

When an independent investigation is needed, the role of in-house counsel can vary. In-house attorneys are a valuable resource to the investigation team, and are usually consulted and periodically updated (unless they may have been involved). However, regulators later may question the role of in-house counsel, and whether they were providing advice, which would affect the board's attorney-client privilege over communications with the in-house lawyers.

During an investigation, the board seeks to get to the bottom of allegations, either to substantiate or invalidate them. To ensure the investigation is successful, it must meet five key objectives:

- Thoroughness.
- Objectivity.
- Accuracy.
- Timeliness.
- Credibility.

Regulators are skeptical of investigations where limits were placed on investigators. If the investigation is viewed as less than thorough, its credibility is undermined.

Thoroughness. Regulators often question the thoroughness of an investigation to test whether they can rely on the facts discovered without having to repeat the investigation themselves. They are skeptical of investigations where limits are placed

David Bayless and Tammy Albarrán are partners in the law firm of Covington & Burling LLP. [www.cov.com]

(expressly or otherwise) on the investigators, in terms of what is investigated, or how the investigation is conducted. If the investigation is viewed as insufficiently thorough, its credibility is undermined.

□ *Objectivity.* The investigation must follow the facts wherever they lead, regardless of the consequences. This includes how the findings may impact senior management or other company employees. An investigation seen as lacking objectivity will be viewed by outsiders as inadequate or deficient.

□ *Accuracy.* The factual findings of an investigation must be well-supported. Otherwise, they are open to collateral attack by skeptical prosecutors and regulators. If that happens, the time and money spent on the internal investigation will have been wasted, because the government will end up conducting its own investigation of the same issues.

The investigation must be (and must be perceived as) credible as to what was done, how it was done, and who did it. Otherwise, the board's work will have been for naught.

□ *Timeliness.* Often, internal investigations must be done quickly. For example, because the SEC handsomely rewards whistleblowers who report alleged misconduct early, it is critical that the board get to the bottom of the matter in a timely fashion. Or, an impending SEC quarterly or annual report may need to be deferred absent a timely resolution of the matter. So timeliness is crucial.

□ *Credibility.* As noted, an internal investigation is reviewed after the fact by skeptical third parties. Thus, it must be (and must be perceived as) credible as to what was done, how it was done, and who did it. Otherwise, the board's work will have been for naught.

There are a number of ways in which boards can meet these objectives. Following are seven considerations that can make the board's internal investigation more successful.

□ ***Consider whether you need independent outside counsel.***

When the need to conduct an internal investigation

arises, the board often times turns first to its general counsel and regular outside lawyers. This makes sense as these lawyers are not only the board's most trusted advisers, but they also have a deep understanding of the company, its business and core values.

However, there are times when it is advisable for the board to retain independent outside lawyers. For example, the investigation may involve allegations of fraud by senior management. There may be pending shareholder or derivative litigation, or the company is the subject of a government investigation. The independence of the lawyers conducting the investigation then becomes important.

In these instances, the board increases the likelihood of a successful internal investigation if its outside lawyers are (and appear to be) unbiased. This is especially the case when the regulators are involved, as they prefer that companies use independent parties for internal investigations. For example, the SEC considers the following criteria when determining whether (and how much) to credit self-policing, self-reporting, remediation and cooperation:

- Did management, the board or committees consisting solely of outside directors oversee the review?
- Did company employees or outside persons perform the review?
- If outside persons, have they done other work for the company?
- If the review was conducted by outside counsel, had management previously engaged such counsel?
- How long ago was the firm's last representation of the company?
- How often has the law firm represented the company?
- How much in legal fees has the company paid the firm?

The appearance of partiality undermines the objectivity and credibility of an investigation. Because the board's work will be second-guessed after the fact by skeptical regulators and prosecutors, consider whether the circumstances warrant the selection of a law firm that has not done significant work for the company or its board in the past.

A Successful Internal Investigation **Acting Swiftly, Efficiently And Effectively**

The company in this case study acted swiftly, efficiently and effectively in response to a whistleblower's allegations. An employee in the company's accounting department was let go for performance reasons. Shortly after, he filed a lawsuit against the company alleging he was wrongfully terminated for having raised issues with the company's accounting practices. Through his attorney, he also contacted the Securities and Exchange Commission and sent the SEC a copy of his complaint.

Once the company's senior management learned of the complaint, they took the allegations seriously. Together with company counsel, management carefully considered the whistleblower's claims and determined that they were without merit. Nonetheless, the general counsel understood that the company could not simply treat this as a run-of-the-mill employment dispute. She knew that, as the whistleblower had reported this to the SEC, the SEC staff would likely raise questions about the purported irregularities. Thus, the general counsel reported the nature of the allegations to the board of directors and the audit committee, and recommended that they look into the accounting issues raised by the whistleblower.

The board quickly determined that the accounting fraud allegations, if true, might have an impact on the company's financial statements. Thus, it concluded that it needed

to conduct an independent investigation and retained an outside law firm with no prior relationship to the company.

After a carefully conducted investigation, outside counsel determined that there was indeed no merit to any of the accounting allegations of the whistleblower. While the investigation did uncover some financial reporting issues within the company, these were previously disclosed in SEC filings, and remediation efforts were well underway. Moreover, investigation counsel determined that, even if the allegations were true, the impact on revenue, as reported in the company's consolidated financial statements, would have been less than .2 percent. Thus, the allegations were not material.

After receiving the whistleblower's allegations, the SEC opened an informal investigation and contacted the company. By this time, the board's internal investigation was under way. When it learned that the company was investigating the accounting issues, the SEC requested that the company share the results of its internal investigation once completed. After the investigation was concluded, the company met with the SEC and shared the results of its investigation. The company's quick action and thorough investigation of the allegations gave it immediate credibility with the SEC staff attorneys. After the meeting, the SEC closed the matter without taking any action.

□ *Consider hiring an experienced "investigator" to lead the internal investigation.*

Well-conducted investigations that withstand scrutiny are typically led by an attorney who is familiar with how a regulator, prosecutor, or other outside party assesses the facts. The investigative team will consist of lawyers of different levels of experience and background. The board's investigation is bolstered, however, by retaining a lead lawyer for the team who has:

- Significant experience in conducting internal investigations.
- A background in criminal or SEC enforcement.
- Substantive experience in the particular area of law at issue.

These qualifications are desirable when the board's investigation must be viewed as thorough, objective, and credible. An experienced investigator will follow

the facts wherever they lead, and maintain a healthy dose of professional skepticism.

The role of an investigator is unlike that of a typical corporate lawyer and litigator. While corporate due diligence involves investigation of facts, this is done with an eye towards the client's interests in a particular deal or transaction. Also, corporate lawyers may lack the investigative skills and the experience of dealing with prosecutors and regulators that an internal investigation requires. Corporate lawyers with no investigative expertise may put at risk the thoroughness, objectivity, accuracy, and credibility of the investigation.

In contrast, civil litigators have investigative skills and routinely investigate facts, but the posture of a litigator is crucially different from that of an investigator. In litigation, a lawyer zealously defends a client against allegations made in a lawsuit. The

lawyer investigates the facts, but always with an eye toward advocating for and defending the client.

Selecting a lead lawyer uniquely qualified to conduct the investigation can assist the board in successfully investigating the matter and navigating through the regulatory process.

□ **Consider the need to retain outside experts.**

During an internal investigation, the need sometimes arises to hire other qualified outside experts and consultants. For example, if there are accounting issues, forensic accountants might be needed. In this day and age, an electronic discovery consultant is often required, and can be a cost effective option for gathering and processing electronic data for review.

The outside lawyers typically make recommendations on these issues. However, these are decisions that the company will ultimately pay for, so it is helpful to be aware of the options and understand their importance. The lowest bid may not necessarily be the best for a particular investigation. While cost is important, understand the limitations of each consultant and, with input from your investigator, determine which consultant best meets your goals.

Also, internal investigations today are more often than not cross-border. This requires language skills, cultural understanding, and knowledge of complex legal issues. Foreign jurisdictions differ from the U.S. on data privacy laws, the attorney-client privilege, and even labor and employment issues.

For example, your communications with in-house counsel regarding legal advice are protected in the United States, but not under European Union (EU) law. Also, data privacy and labor and employment protections in the EU are broader than in the United States. Failure to comply with privacy laws governing the collection, processing, and use of personal information can subject companies with operations in the EU to civil and criminal penalties.

Foreign labor and employment laws must be evaluated carefully when the investigation could support an adverse employment action involving an employee in a foreign jurisdiction. Consider whether the investigating lawyers have retained appropriate outside experts and consultants, or have the necessary expertise themselves to advise on these issues.

While a company's regular outside lawyers represent the company, during an investigation, the lawyers are hired by, and represent, the board of directors.

□ **Analyze potential conflicts of interest at the outset and during the investigation.**

There are two types of conflicts of interest that can arise during an internal investigation. The first arises when the law firm or lawyers conducting the investigation are those whose prior legal advice has some bearing on the matters being investigated. This can be problematic. Remember that a company's regular outside lawyers represent the *company*. During an internal investigation, however, the lawyers may be hired by, and represent, the *board or its committee*.

The second potential conflict relates to a lawyer's joint representation of the board and employees at the company. Regulators have become increasingly concerned with joint representations. As the director of the SEC's Division of Enforcement has pointed out, "the SEC's new cooperation program raises the stakes in multiple representation situations." The program offers reduced (or even no) sanctions, in exchange for truthful and substantial assistance in an SEC investigation.

This "increases the likelihood that one counsel cannot serve the interests of multiple clients, given the real benefits that could result from cooperation, such as one client testifying against another client represented by the same counsel." Another SEC senior official cautioned that taking on too many clients in an investigation can be problematic, as witnesses appear over-coached (too many similarities in accounts from multiple witnesses, including using the same words or explanations, or forgetting the same details).

Most boards understand that joint representation is not appropriate if there is direct adversity between the board and the individual. The trickier question is what to do when there simply is a *risk* that representing one client could limit the lawyers' duties to the other.

In these situations, joint representation may not be appropriate, though it is not always clear that such a

conflict will arise at the start of an investigation. An experienced investigator should be able to effectively manage these concerns and advise you when separate representation may be recommended.

It is important for the board to address joint representation issues with its outside lawyers at the outset of an internal investigation. While directors may rely on outside counsel's advice on this issue, it is important nevertheless to ensure that a joint representation is appropriate. Continual monitoring of conflict issues over the course of the investigation is prudent.

□ ***Carefully evaluate whistleblower allegations.***

These days, whistleblowers are often the source of information triggering internal investigations. Through legislation, such as Sarbanes-Oxley and Dodd-Frank, Congress and regulators have emboldened whistleblowers by providing bounties if they reveal wrongdoing that results in monetary sanctions against companies or individuals.

Yet, companies run into problems when whistleblower allegations are discounted, if not outright dismissed, especially if the whistleblower has a history of causing trouble or is perceived as incompetent. When this type of whistleblower makes a claim, it is easy to presume ulterior motives.

That may well be true, but that does not mean that the whistleblower's complaint is not valid. The substance of each complaint must be evaluated on its merits and independent of its source. Regulators are very wary of boards that do not satisfactorily evaluate a whistleblower's complaint based on a perception of the whistleblower himself, as opposed to the substance of the complaint.

The scope of what to investigate is not a static, one-time decision. It can, and usually does, evolve.

□ ***Request regular updates from outside counsel, without limiting the investigation.***

An internal investigation is a costly endeavor. If not properly managed, it can easily spin out of control, racking up tens of millions of dollars in

legal fees and costs. As important as managing the cost of the investigation, however, is the perception that the board may be placing improper limits on the investigation. The goal is to strike the right balance between the cost of the investigation and its thoroughness and credibility.

Depending on the circumstances, it may be entirely appropriate for the board to direct the outside lawyers on "what" to investigate (the scope of the investigation). For example, when a whistleblower complaint relates to improper revenue recognition in a subsidiary, it may be appropriate to limit the lawyers to investigate that issue in that subsidiary in that location at the outset.

However, flexibility is vital. Skeptical prosecutors may later view any limitations on the scope of the investigation as undermining the thoroughness of the inquiry. They may have concerns that the trail was not followed to its logical conclusion. Thus, an investigation that starts off with a limited scope of what to investigate may need to expand beyond that, depending upon what the investigation is turning up.

One suggestion is to start with an agreed upon initial scope of work, but revisit the scope of work as the investigation progresses. If conduct is discovered that legitimately calls for expanding the scope of the investigation, then the board can revisit the issue at that point. Put another way, the scope of what to investigate is not a static, one-time decision. It can, and usually does, evolve.

When concerns are raised about the integrity and thoroughness of the investigation, it is usually because limits were placed on "how" to investigate. That is, what witnesses could be interviewed or what documents could be collected and reviewed. Prosecutors and regulators are inherently very suspicious of such limitations.

When overseeing an investigation, it is entirely appropriate for the board to ask for regular updates, and to question the outside lawyers on what they are doing and why. In this way, directors can manage costs, while at the same time ensuring that the investigation is sufficiently thorough and credible.

□ ***Consider whether an oral report at the conclusion of an investigation is sufficient.***

At the conclusion of an investigation, boards may instinctively request a written report from the investigative team. While it is important to memorialize the investigation's conclusions, consider whether a written report to the board is really necessary. Indeed, there are often good reasons for preferring an oral report.

While a written report may be easier to follow and appear to be the logical conclusion to an investigation, it is an expensive and time-consuming endeavor, and it comes with great risk. First, it is much easier to inadvertently waive the attorney-client privilege if a written report exists. In the wrong hands, the report can serve as a road map to a plaintiff.

Second, those written findings and conclusions are set in stone. If later information comes to light that impacts the report's conclusions, altering the conclusions may undermine the credibility of the entire investigation. So, retaining flexibility to change the findings if further information is later learned is a real advantage of an oral report.

Third, it takes time to prepare a well-written and thorough report. When an internal investigation must

be conducted quickly, spending time to prepare a written report may not be an efficient use of time.

Finally, consider that it may be appropriate and sufficient for the investigators to present their conclusions at a board or committee meeting. These can then be documented in the meeting minutes.

That said, there are instances in which, given the nature of the allegations and the complexity of the matter, a written report may be necessary. The board should balance the need for a thorough and timely investigation with its need for a written report. You may find that an oral report of the investigation's findings and recommendations is sufficient.

The board likely will face many issues during an internal investigation. By keeping in mind the issues addressed above, the board will be better prepared for the investigation and readily able to exercise good judgment throughout the review. A well-conducted investigation by the board may spare the company further disruption and costs associated with follow-on investigations by the regulators, or at the very least minimize the company's exposure. ■

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Okemos, MI 48864-2414, (517) 336-1700
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