Corporate Internal Investigations: Some Basic Considerations

By Wilma A. Lewis and Stephen M. Byers

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Unless an internal investigation is properly conceived and executed, it may not only fail to achieve its goals, it may backfire. This article addresses a few of the common issues and decision points that can mean the difference between the best possible resolution of an unwelcome problem, or simply compounding the problem.

Issue One: Identifying the Investigator

When allegations of improper conduct first arise—whether internally, through the press, or as the result of governmental investigation—it is essential that the facts be determined as soon as possible. Indeed, depending on the nature of the allegations, the board of directors may have a duty to hire outside experts and launch an independent investigation pursuant to laws such as the Sarbanes-Oxley Act. But where to begin?

It is normally essential that lawyers conduct or at least oversee internal investigations so that the fruits of the investigation are protected by applicable evidentiary privileges. Otherwise, non-lawyer investigators could be forced to testify concerning their work in subsequent litigation, and all documents they create in the course of the investigation would likewise be fair game for discovery by potential adversaries.

This leaves three basic choices for the role of internal investigator: (1) in-house counsel; (2) outside counsel who has represented the corporation in other matters; or (3) "independent" outside counsel who has no prior connection to the corporation. *(Editor's Note: the implications of each of these choices are reviewed elsewhere in this issue).*

Issue Two: Defining the Scope of the Investigation

Once the investigator has been identified, the scope of the internal investigation should be defined at the outset. If the scope is drawn too narrowly, related and possibly even more serious misconduct than originally identified may be overlooked. In addition, stakeholders and government authorities may not only criticize such failures, but also dismiss the core investigation as lacking in objectivity and seriousness. On the other hand, an investigation without clearly defined parameters can become sprawling, aimless and unnecessarily costly.

Whatever the scope of the investigation, it should ordinarily be memorialized in some fashion (for example, a letter or board resolution), with the explicit understanding that the scope may have to be expanded or otherwise altered depending on what facts come to light.

Issue Three: Preserving Evidence

It has been a cliché since the days of Watergate that the cover-up is worse than the crime, but this axiom is truer today than ever before. One need look no further for proof than the recent prosecutions of Arthur Andersen, Martha Stewart and Frank Quattrone, all of whom were convicted not of any substantive crime but of obstruction of justice. The Andersen case is an especially apt cautionary tale for corporations under investigation. The venerable accounting firm was convicted not for its role in the Enron accounting scandal, but for destroying Enron-related documents in the shadow of a looming SEC investigation. In the wake of that conviction, Andersen disintegrated. In short, preserving relevant documents can be a matter of corporate life or death.

Given that the vast majority of internal investigations are conducted in parallel with, or in anticipation of, a government investigation, preservation of evidence becomes important not only for purposes of the integrity of the internal investigation itself, but also to avoid handing regulators and prosecutors a ready-made obstruction of justice case—which is typically much easier to prove than the original misconduct, if any.

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The Andersen case also illustrates the importance of a sound document retention policy that is conscientiously followed rather than honored in the breach. In upholding Andersen's criminal conviction a federal court of appeals recently stated: "There is nothing improper about following a document retention policy when there is no threat of an official investigation, even though one purpose of such a policy may be to withhold documents from unknown, future litigation. A company's sudden instruction to institute or energize a lazy document retention policy when it sees the investigation around the corner, on the other hand, is more easily viewed as improper."

Issue Four: Dealing with Employees

Personnel issues inevitably arise in the course of internal investigations, not only with respect to officers or employees accused of misconduct, but also because the allegations are often first surfaced by an insider—that is, a whistleblower.

Whistleblowers must be treated very carefully. If they raise allegations internally and believe their concerns are not taken seriously, they may go directly to governmental authorities before the company has had an opportunity to investigate the facts. In addition, whistleblowers must be treated with kid gloves because any action that could be interpreted as retaliation can carry with it severe sanctions, including criminal penalties under the Sarbanes-Oxley Act. And, of course, disgruntled whistleblowers are routinely embraced by the media, which can create a major public relations headache.

Those accused of wrongdoing must also be treated carefully, even when it appears that they have violated the law or company policy. The first reaction of senior management in such situations is often to terminate the individual immediately. But this may not always be the most prudent approach.

Particularly where a government investigation is underway, it may be better to suspend the individual or take other action short of termination to ensure that the company maintains some leverage until the investigation is complete. This is sometimes important to ensure effective cooperation with the government where the company has chosen that course. Also, hasty termination in an effort to curry favor with the government can backfire. In the Arthur Andersen case, for example, a culpable individual was terminated early on and characterized as a rogue employee responsible for illegal behavior. But this did not dissuade the government from prosecuting the firm. To the contrary, the government chose to feature the individual (who now had every incentive to turn on his former employer) as its star witness in the successful prosecution of Andersen.

Issue Five: Reporting on the Results of the Investigation

The results of the investigation must, of course, be reported to the corporate officers or directors responsible for the matter so that they can fulfill their fiduciary obligations. An important decision is whether this report should be written or oral.

In today's corporate compliance environment, stakeholders and government agencies may take the position that anything short of a full written report is inadequate to address serious corporate misconduct. A written report also enhances management's ability to understand and act upon the investigator's findings, conclusions and recommendations, particularly where the facts are complex.

The primary drawback of a written report is that its confidentiality may be compromised. This risk is especially significant where mandatory or voluntary disclosure of the investigation to a third party is likely. Once that step has been taken, the evidentiary privileges protecting the investigation will likely be considered to have been waived. At that stage, the report becomes a ready source of potentially damaging admissions and a roadmap to evidence for potential adversaries. Thus, whether a written report should be created is a question that should be given careful consideration, and is a judgment that is usually best made as the investigation is wrapping up.

Issue Six: Disclosures to Third Parties

In many instances a corporation will have a duty, or at least a powerful incentive, to share the results, and sometimes the details,

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of the internal investigation with third parties. This may include prosecutors, regulators, legislators, outside auditors, shareholders, institutional investors, lenders, customers, suppliers, employees and the media. But once the results of an internal investigation are disclosed, the evidentiary privileges that protected them are typically deemed to have been waived. This means, for example, that plaintiffs' attorneys seeking to bring derivative or class action lawsuits will have access to a treasure trove of dirty laundry.

Even general disclosures to third parties such as investors, lenders, customers and the media must be undertaken with care. One premise of an internal investigation by counsel is that the purpose is to provide confidential legal advice to the company. If counsel or the client make public statements about the investigation, courts may later conclude that business necessities and public relations, rather than legal advice, was the true purpose and that the details of the investigation are not protected by evidentiary privileges.

In highly regulated industries, there will often be an affirmative legal duty to self-report wrongdoing. More broadly, where misconduct may materially affect a public company's financial statements, disclosures of some kind will typically be required in SEC filings. Such mandatory disclosures, however, can sometimes be accomplished in a manner that does not waive the privileges protecting underlying facts uncovered in the course of the internal investigation.

Another situation in which the company will have little choice but to disclose not just the results of an internal investigation but also its details is an inquiry from outside auditors. In the wake of numerous recent cases in which audit firms have been held liable for failing to act as corporate "gatekeepers," outside auditors are now routinely demanding information beyond the bottom line results of an investigation, including the details of how the investigation was conducted and what facts were discovered.

Finally, even where no legal duty exists, companies will often choose to disclose the results and details of an internal investigation to regulatory or law enforcement officials in an effort to minimize the company's exposure. This is because such officials are increasingly pressuring corporations to "cooperate" with government investigations by waiving the attorney-client privilege and promptly turning over all information developed in the course of the company's own investigation. In this manner, internal investigators are essentially deputized.

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