Recent Trends in

INTERNAL INVESTIGATIONS

Both in-house and outside counsel seem to have a new job these days: tracking down allegations of wrongdoing. The investigations can range from misuse of the company car by a low-level manager to securities fraud by the CEO. The development of this new legal sub-specialty has been stimulated by the rash of corporate scandals in recent years, and while predictions vary about how this area will evolve over the next few years, the authors believe that the "gumshoe business" for counsel will be affected by several trends blowing through corporate America.

By Theodore L. Banks, Tom Giller, and Scott R. Lassar

Trend One: There Will Be More Internal Investigations

The factors that have generated internal investigations in the last five years are only increasing for several reasons:

More Whistleblowers

Famous whistleblowers like Sherron Watkins of Enron are emboldening others to come forward with tales of corporate misconduct, both real and imagined. Some employees are motivated by a desire to right wrongs. Others may be worried about being fired for incompetence and are looking for cover by blowing the whistle on their company (legitimately or otherwise). Sarbanes-Oxley provides a civil cause of action and criminal prosecution for those who retaliate against a whistleblower.[1] Although most cases of retaliation referred to the Department of Labor have been dismissed, there have been several notable successes by whistleblowers. For example, in *Welch v. Cardinal Bankshares*, the CFO successfully sued for reinstatement and backpay, claiming that his termination was in retaliation for raising accounting issues.[2]

Another motive for whistleblowing may be the desire to strike it rich. *Qui Tam* lawsuits have grown in size and number, until there is now a *Qui Tam* bar of plaintiff attorneys. Whistleblowers can collect 15 to 25 percent of settlements or judgments involving fraud against the government. The Department of Justice reports that in fiscal year 2005, of the $1.4 billion collected for fraud against the government, $1.1 billion was the result of *Qui Tam* lawsuits, in which $166 million was paid to the whistleblowers.[3]

Of course, the fact that a whistleblower has ulterior motives does not mean that their allegations are without merit. Often whistleblowers would have kept their knowledge of corporate misconduct to themselves but for the chance to protect their jobs, settle a score, or make some money.

In most internal investigations, attempts to unmask an anonymous whistleblower may be counterproductive or unjustified. First, such efforts may lead to claims of retaliation. Second, the identity is usually irrelevant to the important issue: Is the allegation true?

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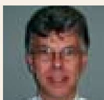

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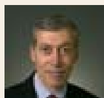

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Improved Compliance Programs

As companies improve their compliance programs, more allegations of misconduct surface. Codes of conduct encourage asking questions, and may even mandate reporting wrongdoing. The ability to report possible wrongdoing anonymously (e.g., through a "helpline") is mandated by Sarbanes-Oxley,[4] and is one of the components of an effective ethics and compliance program identified by the US Sentencing Commission.[5] Effective compliance programs help ensure that employee allegations will not be ignored or result in retaliation. Nothing makes a company look worse than encouraging whistleblowing and then not investigating the allegation or retaliating against the whistleblower.

Of course it is more than just looking bad. Substantively, failure to take action after being alerted to wrongdoing can create corporate liability where none previously existed. For example, reports of sexual harassment that are ignored by management can convert improper behavior by one employee into an actionable hostile work environment.[6]

More Government Investigations

The trend toward criminalizing the violation of regulatory requirements is continuing in the arenas of health care, securities, the environment, and elsewhere. Although many FBI agents and assistant US attorneys are now devoted to terrorism, that should not cause anyone to think that corporate crime will be ignored. The SEC had a 45 percent budget increase in 2003. By 2005, over 1,000 staff members had been added. Just as an increase in surgeons leads to more surgeries, an increase in SEC lawyers, investigators, and accountants will lead to more enforcement actions. The effect of the SEC budget increase has been delayed as it has taken time to hire and train new personnel. The US Attorneys Offices have taken advantage of this source of manpower by working more closely with the SEC, sometimes using the SEC's investigators instead of the FBI.

More Demands for Investigations by Auditors

The relationship between a company and its auditors has been transformed in the post-Enron era. Once ac-

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O.R.

cused of being lap dogs, auditors now more resemble attack dogs. Auditors are under great pressure. An indictment of an accounting firm can be fatal, and Arthur Andersen's dead body proves it. The new Public Company Accounting Oversight Board (PCAOB) is aggressively reviewing accountants' work. Audits must now be designed to detect illegal acts.[7] To prove their "independence," as required by Sarbanes-Oxley, auditors seem to be stepping out of an advisory role and adopting more of a regulatory stance. In response to this environment, auditors who come across suspicious circumstances are demanding independent, outside investigations of individuals or issues, sometimes walking away from an audit until the investigation is complete. With only the "Final Four" mega-audit firms remaining, companies have little choice but to order an investigation.

Board Members Will Demand Investigations

Board members are not only increasingly worried about their own liability, but have been charged with a more proactive role. The business judgment rule, which used to shield directors, has taken some hits. Shareholder derivative suits may demand that directors be sued for breach of fiduciary duty for

Key Subjects to Include in Your Internal Investigation Guidelines

- If there is a reasonable basis to believe that there may have been a violation of law or company policy, use due diligence to collect and evaluate relevant facts.
- Investigation will comply with law.
- Treat all persons with respect and fairness.
- Extent of investigation to be guided by seriousness of allegations and quality of information.
- Investigators to be impartial and will consider all relevant facts.
- Use discretion and maintain confidentiality to the extent possible.
- Cooperation from employees and business partners is expected.
- Move quickly, but minimize business disruption wherever possible.
- No retaliation for good faith reporting or cooperation.
- Decision-making on discipline separated from investigating.
- Process and results to be documented.

allowing misconduct to occur. In 2003, the Delaware Court of Chancery found that the Walt Disney directors who were alleged to be derelict in the hiring of Michael Ovitz may not be entitled to the protection of the "exculpatory charter provision" of Delaware law and the company's by-laws.[8] As a result, directors are increasingly demanding that management investigate possible misconduct. Even in the absence of a red flag, the directors may want to be assured there is no problem, such as whether there has been a backdating of stock options.

Trend Two: Less Pressure to Waive Attorney-Client Privilege

In the post-Enron era, the pendulum has swung far to the side of criminalization of regulatory violations and aggressive tactics by regulators. There are signs recently, however, that the pendulum is beginning to swing back. One sign of this "warming" trend is the opposition to the government's practice of coercing companies to waive the attorney-client privilege as part of their cooperation with the government.

The Thompson Memorandum[9] provided federal prosecutors with guidelines that they are to consider when deciding whether to indict a business entity. This decision can result in a corporation being crippled or killed. A health care company may not survive debarment from Medicare. As already noted, Arthur Andersen essentially was destroyed just by the bringing of an indictment.

A key factor in the guidelines is the extent of a company's cooperation and voluntary disclosure. Part of that analysis was the company's willingness "to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection." While many prosecutors insist that they only seek privilege waivers in exceptional cases, in practice, waivers have been coerced on a regular basis. In a survey of over 1,200 in-house and outside corporate counsels by ACC, almost 75 percent disclosed that a "culture of waiver" exists in government agencies.[10]

More recently, however, ACC and a broad coalition of business groups, criminal defense attorneys, and civil libertarians that formed to oppose coerced waiver, have found a receptive ear in Congress. ACC and this same coalition persuaded the US Sentencing Commission to vote on April 5, 2006, to remove commentary from the organizational sentencing guidelines that gave a corporation credit for waiving privileges.[11] More importantly, in December 2006, the Department of Justice issued the McNulty Memorandum, which substantially retreated from the Thompson Memorandum.[12] If a prosecutor is seeking factual information, such as copies of key documents, witness statements, or purely factual interview memoranda, the US attorney must consult with the head of the assistant attorney general for the Criminal Division before granting the prosecutor's request. If, however, the prosecutor is seeking attorney-client communications or nonfactual attorney work product such as legal advice given before, during, or after the alleged misconduct, the prosecutor must get written approval from the deputy attorney general prior to seeking the waiver. The McNulty Memorandum cautions that prosecutors should seek such a waiver in only rare circumstances and that a refusal to waive may not be held against a company in making charging decisions.

The McNulty Memorandum is a major retreat under pressure by the department. Prosecutors will be much more hesitant to demand privilege waivers.

However, the desire on the part of corporations to avoid indictment is enormous. Many corporations will continue to waive privileges in an effort to get the maximum favorable treatment from the government. Now, however, one would hope that it will be more a matter of choice than capitulation to a demand.

As a degree of calm returns after the corporate scan-

In most **internal investigations,** attempts to unmask an **anonymous whistleblower** may be counterproductive or unjustified. First, such efforts may lead to **claims of retaliation.** Second, the **identity is usually irrelevant** to the important issue: **Is the allegation true?**

dals earlier in the decade, it has become clearer that requiring a company to give up its legal rights is not consistent with the promotion of compliance. Why talk to your lawyer if the conversation goes directly to the government?

Trend Three: Fewer Oral Reports

The trend toward less pressure to waive privilege may lead to more written reports of internal investigations. Previously, one way to deal with the pressure to waive privilege had been to avoid creating written reports. If a written report was turned over to the government, almost all courts have found that the attorney-client privilege is waived to everyone.[15] Corporations were naturally reluctant to make an investigative report available to plaintiff's attorneys who read about the investigation in the newspaper or in an SEC filing.

Based on the same reasoning, investigators may have presented their report to the board orally with directors being instructed not to take notes. Then, if the company decided to waive privilege, the investigators could repeat the oral report to the government, but if requested by a plaintiff's attorney in discovery, there was no written report to produce. Theoretically, a plaintiff could request the investigators' notes and memoranda of interview, and depose the investigators. Few plaintiff's counsel, however, want to engage in an inevitable court battle over privilege.

Written reports have many advantages. First, it looks more transparent to have a written work product and creates a better impression with regulators and the public. An oral report is inherently suspicious. Why is there no written report? Second, the production of a written report to the government is much more valuable to the government and will be appreciated. Third, a written report can be easily shared with other parties, such as the company's boards, auditor, bankers, and stock exchange who have an interest in learning what the investigators found. The "administrative" advantages are obvious. One of the authors has given the same oral report of an investigation on 10 occasions. One written report would have been much more efficient. Finally, a well-written report can provide a clearer, more consistent basis than an oral report for the ultimate decisions the company makes concerning the matter investigated.

O.R.

If the **investigator** misses fraudulent activities, the company or **shareholders may sue** for **malpractice**. On the other hand, if the investigator wrongly accuses someone of misconduct, the **investigator may be sued** for defamation.

Trend Four: More Executives Will Have Their Legal Fees Paid by Their Employer

Whether companies pay the attorney's fees of their employees, and the implications of such payments, has been a hotly contested issue. The Thompson Memorandum, discussed above, established guidelines to determine when federal prosecutors will exercise their discretion to indict a business entity, such as a corporation or partnership. An indicia of a corporation's non-cooperation was "protecting its culpable employees and agents" by a "promise of support." "Culpable" was not defined. Is it anyone under investigation or only someone determined to be guilty? The McNulty Memorandum retreats from this aggressive position and states that a company will only be punished for advancing legal fees if it is part of an effort to obstruct the investigation.

Prosecutors will also be deterred by the decision of Judge Lewis Kaplan in the KPMG tax shelter case.[14] In the KPMG case, the Court found that KPMG would have advanced fees but for the existence of the Thompson Memorandum and the implied threats made by the prosecutors. The Court held that the Department of Justice as a matter of policy, and in practice, violated the defendants' right to counsel and due process by causing KPMG to stop advancing their legal fees. The Court did not dismiss the indictment, but instead allowed the defendants to file claims against KPMG for their legal fees.

The impact of the McNulty Memorandum and the KPMG decision remain to be seen. They should deter the government from even discussing with a corporation whether it will advance fees to employees. Corporations inclined to advance fees should be emboldened to do so. Indeed, failure to do so may subject the corporation to liability. The by-laws of many corporations permit or even require the corporation to advance legal fees to executives who are under investigation. The executive often must sign an "undertaking" requiring him/her to repay the money if the executive is proven to have engaged in fraud or acted in bad faith.

Trend Five: More Employees Will Be Prosecuted For Lying to Outside Counsel

Despite the desire of many corporations to advance legal fees, the fear of prosecution still is likely to drive many business entities to do anything they think will put them in the better graces of the government, including refusing to advance legal fees to their executives. In the Computer Associates case, the government—for the first time—prosecuted employees for lying to outside counsel in the course of an investigation.[15] The defendants were interviewed by two sets of outside counsel, one conducting an investigation for the company, and another for the audit committee. The government's theory is that because the company was cooperating with the government, the defendants expected that their answers would be passed on to the government by outside counsel. By lying to outside counsel, defendants intended to obstruct the government's investigation.

The same theory was pursued recently by the U.S. Attorney in Houston.[16] The defendant was charged with lying to El Paso Corporation's outside counsel, believing that the lies would be passed on to government agencies investigating natural gas pricing.

This prosecution theory raises a number of issues. First, the same theory could apply to investigations by in-house counsel, although it is less foreseeable that the answers will be passed on to the government.

Second, should investigating counsel, inside or outside, warn the witness that if the witness lies during the interview, the witness may be prosecuted for obstruction of justice? On the one hand, it seems only fair to warn the witness of this possibility. The warning also may make the witness more likely to tell the truth. On the other hand, by giving the warning, investigating counsel may be supplying the government with exactly the link it needs to prove that the witness knew that its lies would be passed on to the government. Thus the warning may become a self-fulfilling prophecy.

The authors recommend that investigating counsel give the standard warning:[17] Counsel represents only the company. What the witness says is confidential to the company pursuant to the attorney-client privilege and may be revealed by the company at its discretion. This warning must be given in every interview conducted by counsel in order to preserve the attorney-client privilege. It warns

the witness that his/her answers could be revealed outside the company without specifying that the investigators will report to the government. Whether the answers will be revealed, or to whom, is the decision of the company, not the investigators.

We expect to see an increase in prosecutions for lying to counsel during an internal investigation. If the government attempts to interview a corporate executive, the executive is likely to retain his/her own attorney who may advise him/her not to participate in the interview. However, executives rarely decline to answer questions from corporate investigators who may appear less threatening. Also, refusing to answer questions posed by the corporate investigator can result in sanctions, including termination. If the target will not talk to the government, and the government cannot make a case on the underlying violation, the only possible prosecution of a corporate executive may be for lying to outside counsel.

Trend Six: More Trouble for The Investigators

As the number and significance of investigations increases, so will problems for the investigators. Investigations carry inherent dangers. First, the investigator may be unable to uncover a fraud due to an inability to obtain documents or interview witnesses outside the company. Second, investigation is not a science. Conclusions are often based on credibility assessments: Were accounting errors the result of an intent to deceive or the product of ignorance? Even experienced investigators may reach different conclusions based upon the same evidence.

If the investigator misses fraudulent activities, the company or shareholders may sue for malpractice. On the other hand, if the investigator wrongly accuses someone of misconduct, the investigator may be sued for defamation.

We are beginning to see actions taken against the investigators. In 2004, the SEC threatened action against an attorney who assisted in an internal investigation at Endocare. On July 27, 2006, the City of San Diego sued Vinson and Elkins, alleging that the firm's investigations of the city were a whitewash. Vinson and Elkins previously had been criticized for investigating its own legal work for Enron.

Guidelines for In-house Counsel

What should in-house counsel do in the face of this fluctuating legal environment? A few guidelines are in order:

- Make sure appropriate members of the legal staff, and other persons likely to be involved in investigations, get training on how an investigation should be conducted and that there is documentation of who received the training.
- Consider developing on-line refresher training as well as reference documents to help guide people conducting investigations.
- Ensure that persons assigned to investigate an allegation can do so objectively and do not have an interest in the outcome of the matter.
- Adopt an internal investigations policy that covers the key investigation principles, which are outlined in the sidebar, "Key Subjects to Include in Your Internal Investigation Guidelines," found on pg. 28.
- Establish policies and communications designed to ensure there is no retaliation against persons who, in good faith, report suspected misconduct.
- Treat the fact-finding process and the decision-making based on the inves-

O.R.

tigation as distinct parts of the process. Typically, this means that the investigators should present the facts to the board or senior management to then decide what action is appropriate based on those facts.
- Have qualified outside counsel available to assist with or conduct an investigation if internal resources are not adequate or appropriate. Have a different firm, preferably one that does no other work for the company, available to investigate matters of the highest sensitivity.
- Whenever a serious allegation of wrongdoing is made, move quickly to secure evidence—suspending normal document retention periods for potentially relevant documents, and investigate—and document the steps you take to diligently investigate the allegation.
- Monitor legal developments to avoid surprises. ■

Have a comment on this article? Email editorinchief@acc.com.

NOTES

1. Sarbanes-Oxley Act of 2002, Pub L 107-204, 116 Stat 745, §§ 806 and 1107.
2. *www.oalj.dol.gov/Decisions/ALJ/Sox/2003/WELCH_DAVE_v_CARDINAL_BANKSHARES.*
3. Department of Justice News Release (Nov. 7, 2005).
4. Section 301.
5. United States Sentencing Guidelines, § 8B2.1(b)(5)(C) and App. C. amend. 673.
6. *See, e.g., Hollis v. City of Buffalo*, 28 F. Supp. 2d 812 (W.D.N.Y. 1998).
7. 15 U.S.C. § 78j-1(a). Note ACC's position opposing waiver of privilege insisted upon by auditors seeking attorney investigation materials.
8. *In re the Walt Disney Company Derivative Litigation*, Memorandum Opinion, Case No. 15452, May 28, 2003. The Delaware Supreme Court subsequently affirmed the Chancellor's verdict that the plaintiff did not prove bad faith by the Board. *In re Walt Disney Co. Derivative Litigation*, Del. No. 411, 2005, June 8, 2006, but the protection in other states for a Board that was characterized as a "rubber stamp" may not be so great.
9. Department of Justice, *Principles of Federal Prosecutions of Business Organizations* (Jan. 20, 2003).
10. *www.acc.com/Surveys/attyclient2.pdf.*
11. U.S.S.G., § 8C2.5, Commentary 12.
12. *www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.*
13. *See, e.g., In re Qwest*, 2006 WL 1668246 (10th Cir. June 19, 2006).
14. *United States v. Stein et al.*, S1 05 Crim 0888 (S.D.N.Y. June 26, 2006).
15. *United States v. Kumar*, 04 CR 846 (E.D.N.Y. 2004).
16. *United States v. Singleton*, H-04-514-SS (S.D. Tex. Mar. 6, 2006).
17. *Upjohn v. United States*, 449 U.S. 383 (1981).