

Conducting Internal Corporate Investigations

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Types of Internal Investigation

- Alleged company misconduct
 - Option backdating
 - Financial statement irregularities
- Alleged individual officer/employee misconduct
 - Embezzlement
 - Harassment
 - Code of Conduct violation
- Note – individual violations often lead to allegations of company violations (e.g., option backdating)

Triggers Prompting Internal Investigations

- Internal discovery of possible violation
- Victim
- Whistleblower: Classic case: Sherron Watkins
 - Retaliation issues
- Third party
 - Analyst
 - Media
 - Stockholder
 - Demand letter (N.C. Gen. Stat. §55-7-44(a) & (b))
- Government inquiry

Complaint Analysis

- Take all complaints seriously
- Gatekeeper role of general counsel
- But, a full-blown investigation is not needed in response to every complaint, tip, etc.
 - *Credibility* is the key – is the allegation:
 - Anonymous? (not decisive)
 - Detailed?
 - Material?
 - Believable/plausible?
- Whatever the trigger, take swift action; it's not safe to *ignore* even the nuttiest allegation
- Carefully document actions/decisions
- Contact a litigator early in the process

Purposes of Internal Investigation

- Investigations should be timely, thorough, accurate, fair and credible.
- The main purposes of any investigation are:
 - Find the truth
 - Address any problems
- Investigations should not be witch-hunts and should not be conducted with pre-conceived notions of the outcome

Purposes of Internal Investigation

- Where the company is implicated, the investigation may serve to:
 - Determine exposure
 - Identify corrective actions
 - Avoid or temper a governmental inquiry
 - Remediation and cooperation may have a salutary effect
 - See Seaboard Report (SEC)
 - Federal Sentencing Guidelines and Revised Guidelines

Seaboard Report - SEC Release No. 44969, Oct. 23, 2001

- Sets forth the criteria the SEC will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation:

Purposes of Internal Investigation

- Where an individual is implicated, the investigation may serve to
 - Determine guilt/innocence
 - Determine discipline
 - Determine whether others were involved
 - Determine whether the entity itself faces exposure
 - Identify systemic improvements to prevent future violations

Some Investigations are Mandated

- Code of Conduct violations
 - Waivers must be reported under SEC rules
 - Arguably, failing to address an apparent violation of the Code is a reportable “waiver”
- Section 307 of Sarbanes –Oxley
 - CLO’s must investigate evidence of material violations reported up by in-house or outside counsel
- Demand on the board (N.C. Gen. Stat. §55-7-44(a))

Who Should Lead/Conduct the Investigation?

- Who should lead the investigation?
 - Board of Directors
 - Audit Committee
 - Special Committee
 - General Counsel/In-house Counsel
 - Other
- Who should conduct the investigation?
 - General Counsel/In-house Counsel
 - Outside Counsel (regular or special)
 - Internal Auditors
 - External Auditors
 - Other

Independence

- Consider the need for independence
 - *Credibility* of the investigation is key
- Consider influences that may impede an impartial investigation
 - Investigation involves the General Counsel, CFO or CEO
 - Investigation implicates actions/inactions of individuals who might otherwise be involved in the conduct of the investigation
- Appropriate to weigh cost, efficiency, etc.

Roles of Inside and Outside Counsel

- Inside counsel appropriate for certain investigations
- Consider whether in-house counsel have time/resources/expertise to conduct a timely, credible investigation
- Preservation of privilege concerns
- Generally preferable to use outside counsel when:
 - The corporation itself is implicated
 - A senior executive is implicated
 - If the alleged misconduct appears pervasive
 - A government investigation is involved
 - The issue is material to the company's financial position

Regular or Special Outside Counsel?

- Carefully weigh independence of outside counsel; may need to hire special outside counsel
 - Can be a tricky issue
 - Generally best to err on the side of conservatism, particularly if a government investigation is involved
- Enron example
 - When faced with allegations of bogus transactions, Enron hired the same law firm that had structured the transactions to investigate them

Local Example: Ingles Markets Inc.

- *Madvig v. Gaither*, No. 1:05-CV-234, slip op. (W.D.N.C. Oct. 11, 2006)
 - Demand made on Ingles board in a shareholder derivative action relating to accounting errors
 - Special committee formed to investigate pursuant to N.C. Gen. Stat. §55-7-44(a) & (b)
 - Independence (committee and law firm)
 - Reasonableness of investigation
 - Good faith

Key Takeaway

- **Response should be driven by credibility factor**
 - Complaint analysis
 - Who conducts the investigation
 - Scope, nature and process to be followed during the investigation

Initial Investigation Process

- Who is the client?
 - Company
 - Board of Directors
 - Special Committee of the Board

- Common Pitfalls
 - Preservation of evidence
 - Preservation of privileges
 - Company spokespersons

Gathering Evidence and Conducting Interviews

- Timeliness
- Documents
 - Preserve, segregate and collect as in litigation
 - Manage: Review, log and maintain consistency
 - Analyze “hot documents”
 - Chronology of relevant facts
 - Document destruction is a crime under SOX

Interviews:

- Timing and strategy
 - Early stage interviews
 - Lower level employees
- Process
 - Two questioners/one note taker
 - “Upjohn warnings”
 - Other potential disclosures
 - Reports of interviews/transcriptions

Aftermath of the Investigation: To report or not to report (in writing)

- Advantages
 - Tangible evidence of investigation
 - Informed consideration of recommendations
 - Can be supplied to enforcement authorities
- Disadvantages
 - Creates an evidentiary record
 - Open to misinterpretation or misuse
 - Difficult to maintain confidentiality

Aftermath of the Investigation: To disclose or not to disclose

- Required disclosure
 - See e.g. *SEC v. Time Warner, Inc.*, Litig. Release 19147 (Mar. 21, 2005).
 - Specific regulations, e.g. Regulation S-K regarding material effects of environmental compliance costs; Anti-Kickback Enforcement Act; suspicious activity reports for nationally regulated banks
 - Material information necessary to make a public company's statements not misleading

Aftermath of the Investigation: To disclose or not to disclose

- Voluntary disclosure
 - Control release of information so as to manage adverse consequences
 - Disclosure to regulatory or law enforcement to forestall or limit liability; McNulty issues: Credit for cooperation?
 - Counter-considerations:
 - Loss of attorney/client privilege and work product protection—there probably is no selective waiver
 - Strike suits; derivative suits; market reaction

Aftermath of the Investigation: To discipline or not to discipline

- Facts or conduct underlying the investigation
 - Timing is important
 - Opportunity to respond
 - Red flag to regulatory authority
- Employee's conduct during the investigation
 - No 5th Amendment right to refuse to cooperate
 - Understand basis for resistance
 - Authorities view lack of discipline unfavorably
- Demand (explicit or implicit) of regulators

Insurance Coverage Issues

- Preliminary points
 - Policies vary widely; individualized issue
 - SEC enforcement prohibits third party reimbursement for monetary penalties, but not disgorgement or defense costs

Directors' and Officers' Coverage

- General Insuring Clauses
 - Loss arising from Claim alleging Wrongful Acts
 - Side A (direct) and Side B (indemnity) coverage issues
 - Side C coverage (entity coverage)
- Exclusions
 - Fraud, criminal acts, dishonesty, personal profit
- Misrepresentation and rescission
- Notice

Other Coverages

- Errors and omissions
- Excess Side A/Side A-Only

Ethics Issues

- Who is your client?
- How do you present yourself to employees?
 - “Are you my lawyer?”
 - “Do I need a lawyer?”
 - “If I hire a lawyer, will the Company pay for it?”
 - “Is what I tell you privileged and confidential?”
 - “Are you disinterested?”
- When do you become conflicted?
- Are you responsible for the professionals you hire?

Further Information

- For further reading on crisis and board management in the face of a crisis, *Board Leadership for the Company in Crisis* is a very good planning tool. It can be obtained from www.nacdonline.org/publications
- The American College of Trial Lawyers has published a paper entitled *Recommended Practices for Companies and Their Counsel in Conducting Internal Investigations (February 2008)* which is a very helpful guide and which may be found on the ACTL website, www.actl.com, under “Publications.”