



After Fraud: Responding to Allegations of Impropriety

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MARNI CENTOR: Hello everyone. The Association of Corporate Counsel and SmartPros Legal & Ethics welcome you to today's webcast: "After Fraud: Responding to Allegations of Impropriety."

[The instructions provided here were intended for attendees of the live webcast when it was originally broadcast.]

Our presentation today will be moderated by Kerry Schalders, corporate attorney for R.H. Donnelly Corporation. And now, I'll turn it over to Kerry.

KERRY SCHALDERS: Thank you. Well, we are very pleased to present from the Association of Corporate Counsel's Litigation Committee this webcast, "After Fraud: Responding to Allegations of Impropriety," hosted and sponsored by Ernst & Young.

We have two heavy hitters on the roster today. First is Lynda Schwartz. She's a CPA with more than 20 years of experience in accounting, forensic investigation, and business valuation. Her practice focuses on forensic investigation and expert witness testimony related to financial and economic damages. She's a contributing author of the recently published *AICPA Guide to Investigating Business Fraud*. She's a partner in Ernst & Young's Boston office.

Joining her is Thomas J. Dougherty. If you support your board of directors, you probably have his *Directors' Handbook* on your bookshelf today. He's a partner and head of Skadden Arps' litigation office, focusing on the representation and defense of companies, their officers, directors, underwriters and auditors. His experience includes litigating in defense of corporate actions and disclosures, proxy contests, hostile takeovers, and numerous class action and derivative cases. He received his J.D. from Harvard University.

Today we'll be talking, as you know, about fraud, and our agenda is broken into four parts. First, we'll speak extensively about how to respond to and investigate allegations of fraud. Then we'll move into a discussion about mitigation and recovery. Third, we'll do a recap of top lessons that you need to take away from this webcast as in-house counsel. And, finally, there'll be an opportunity for you to ask your questions. And, as you know, throughout the webcast you can submit them, and we'll generally treat them at the end of the webcast.

First, let's go ahead and poll the audience. We'd like to know a little bit more about you and what your experience is in investigating and responding to fraud.

MARNI CENTOR: OK. And here is our first poll: "Have you a role in investigating fraud allegations or setting anti-fraud controls for your company?" Please vote for one of the following: "Yes," "Not actively but I would participate if concerns arose," or "No, I'm just interested in the topic."

And we will give our audience a few more seconds to vote. The votes are coming in and we're going to close the poll now and see the results. OK. And 67 percent of our audience says they do have a role in investigating fraud allegations.

Kerry, back to you.

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KERRY SCHALDERS: Thank you so much. Lynda, let's go ahead and start the presentation with details about responding [to] and investigating the fraud.

LYNDA SCHWARTZ: Sure. Well, let me just start off by saying that one of the first times I met with one of my partners to talk about fraud and fraud issues at his client, he looked at me exasperated and said, "Well, what are you talking about here? Are you talking about employee theft, thefts of cash, or asset misappropriation? Are you talking about a financial reporting matter? Are you talking about some sort of kickback or bribery? I mean, are you talking about one of those things that are fraud and abuse in a regulation?" And it caught me that, really, you do need to start, when you're talking about fraud, by defining the kinds of fraud you're talking about, because the word really is used so broadly in our society.

Generally speaking, when we're talking about fraud on this webcast, we're going to be thinking across the spectrum of fraud, at the various types of fraud that are listed on your screen. Generally speaking, when I'm talking about fraud, we do think about asset misappropriation, like employee embezzlements of cash, conversion of assets and inventory. But we also encourage companies to think about theft of valuable assets that might not come to mind right away, like intellectual property or theft of data. And those kinds of theft may or may not include false documentation or changes to books and records to cover those thefts.

When I think about corruption, bribery and FCPA issues, I'm typically thinking across the spectrum of kickbacks on contracts, on bid-rigging, on conflicts of interest, and, clearly, the Foreign Corrupt Practices Act and public bribery overseas are also areas of significant attention by enforcement authorities and companies these days.

I know that both Tom and I have spent significant time in our careers working on financial reporting and disclosure matters—things like cooking the books, either intentional or perhaps somewhat unintentional mistakes, or misstatements in the numbers or disclosures, and that can include literally the numbers themselves or some of the nonfinancial disclosures. And clearly the regulatory compliance can involve fraud as well.

Now, the reason I stepped through all those areas is that oftentimes we tend to focus on the kind of fraud that we've experienced in the past or that our company has experienced. But oftentimes as we're planning for fraud or thinking about anti-fraud controls, it's helpful to think across the spectrum and then focus on those things that are likely to be most significant, either individually or when taken together.

Let's go on to the next slide. I think one of the challenges in responding to fraud issues is really in identifying the issues and triaging them. As a practical matter, it's really difficult for employees to think about whether or not what they're seeing when a fraud initially presents itself is a big deal or not a big deal. Is it an ice cube or an iceberg? And it's particularly difficult to surface allegations if the issue involves a well-established process or something that seems OK in the industry. It can also be difficult to surface allegations in our global and decentralized

organizations. It's particularly hard, for example, for employees to surface allegations against their countrymen to a corporate headquarters that might be in a different culture or country, and global organizations can also have significant challenges around misunderstanding or obstacles with respect to communication.

What we've found, as an organization, is that proactive and regular communication is particularly helpful in trying to surface allegations: Allowing people to understand the expectations around the business practices, making sure that that communication is localized, and making sure that whatever training or communication we have about business practices are linked to the actual work practices.

So, the other thing that we've tended to see is challenges around hotlines. One of the things I like to share with audiences is just to think about whether or not your hotlines are working by taking some census of what you're getting through your hotlines, or what you're surfacing through those hotlines. I've sometimes had clients tell me that they feel really comfortable that they've got fraud issues under control, because they're not getting much through their hotline. And generally speaking, it's my experience that an empty hotline is a broken hotline.

I think the other challenge is really triaging allegations as they come in and trying to filter them. Tom, I know when we were talking in the preparation, we talked a little bit about some of the challenges of figuring out how you should filter, how much should go to the audit committee, and how much can be delegated. Maybe you can share some viewpoints about that.

THOMAS DOUGHERTY: Sure. This is Tom Dougherty here. I think one of the difficulties is recognizing the significance of the issue as it comes up. There may be pressures at the management level to characterize—as it gets filtered to, let's say, the office of general counsel, or it may be presented as isolated in attempts to minimize it—to say, "Look, there may be an issue but let's please, general counsel's office, let's get through it. Let's not make waves."

Initially, the spadework by the OGC [office of the general counsel] needs to be sort of active—and we'll get to an example in a minute—as to how there can be sort of the development of a body of issues that need to be explored, and the communication, then, to potentially to the chair of the audit committee, should the issues list look significant enough. But at the initial stage, when the OGC's attention is brought to the matter, I think, initially, you've got to recognize that there may be direct value initially in preserving the attorney-client privilege, in having the OGC follow up with the initial contact, whether it's through the hotline or through an executive. And so OGC's active and quick response, as we'll see, is going to be important.

LYNDA SCHWARTZ: I think the other challenge is that companies really do need to triage what is the right level of response for each given allegation, and some of them can come from left field. Some of them come through a well-established hotline or process, but some can just bubble up through questions at training, or—we'll see in our case example—in a performance review. So trying to understand, "Do we really have an issue here? And what is the right response? Is it an internal routine response or is it something that requires a heightened level of response?" is a challenge.

Some of the factors that I think tend to lean toward a greater response are things that might have

immediate threats to the business or its employees, or customers, or other third parties: Things that just look on their surface as if they might have a potential impact that could be qualitatively or quantitatively material, something that might impugn the company's reputation or brand, something that looks like criminal conduct, or an issue that the government has already identified as one that might receive scrutiny, or something that suggests that internal controls or processes aren't working as they are expected to work, which suggests that there might be broader problems.

Smaller issues that don't have any safety or security issues, or financial impact is clearly immaterial or inconsequential, or that are clearly internal matters that are identified by their controls might have a lesser response.

Tom, I know you've worked on a lot of global investigations. What are some of the considerations you've seen globally?

THOMAS DOUGHERTY: Let me say that I think at the initial level—and you've given some of the possible and qualitative issues that could arise—the initial thing I think is for the office of general counsel, in the initial screening, to take what I would call a [Section] 12(b)(6) approach, from wherever it comes from, whatever geography. That is to say, in court a judge would look at a set of contentions on a motion to dismiss, and say, “Well, what if these were true?” and leave aside the allegor, who may be a disgruntled employee, or who may have a particular axe to grind. The information that comes to the office of general counsel may be layered with a kernel of question, embedded within characterization and also perhaps some potential agendas on behalf of one person or another, and that all has to be sort of recognized. But nevertheless, from whatever source, I think that you have to say, “Well, what if this were true?” And then work from there on a series of parameters that we'll get to, as to how you can size it and how you can define a scope of proceeding.

But I think the skepticism, initially, is probably the most important single issue, regardless of where it comes up.

LYNDA SCHWARTZ: Yes, I think that's an important lesson that I've learned in practice, [which] is just how hard it is sometimes to take that approach. I think there's a powerful instinct on all of us to believe that what's happening in our companies is probably good. I think most of us are optimistic about our companies, and it's sort of cognitive dissonance when the whistleblower comes in. So, there's a powerful instinct, I think, for everyone to minimize the problem and to focus on the future, and responding is probably the first lesson that many of us have learned from prior investigations. I think your comment about not focusing on the messenger is really important.

The other things that tend to get in the way of triaging sometimes are just vague reports. So, someone says, “You have a problem in a particular country,” or makes an allegation in a way that's sort of sideways or sidelong. In those instances, I think, it's also hard to figure out how to triage the right response. But following up is probably the first lesson learned.

Let's go to our next slide and narrow the discussion just a little bit. I started off by talking about a broad range of frauds, but let's take one case example so that we can focus our discussion a

little bit.

In this case example, I named a company in my hometown of Boston, and assumed that it was a global company with subsidiaries in several parts of the world. Now, let's assume that a sales executive in New York has a performance review, and she complains to her supervisor that coworkers have been inflating their sales commissions by falsifying order documents and booking fake sales. And let's further assume that the supervisor thinks she's just disgruntled and doesn't like her performance review. But he talks about it with his friend in internal audit, and they look at some documents, and a couple of weeks go by, and then finally they do raise the issue to the ethics and compliance officer. And let's also assume that the company has got a quarterly report coming up.

The reason I picked this case example is [that] it's an illustration just of how sometimes these things can come up in things like performance reviews or during training.

And let's step then into our next slide and talk about: How do you organize a response?

THOMAS DOUGHERTY: And let me take the lead here. If you recall from the example, where there's an allegation that comes that there were inflated sales figures or falsified order documents and fake sales, that frequently breaks into sort of two large categories, and they overlap obviously. But one [is] of an allegation of wholly faked sales, fake shipments, fictitious customers, falsified order documents; that's on the one hand. And the other, equally problematic, and at times I think more difficult, are sales where the sales representatives grant unrecorded concessions to give a real customer a benefit in order to close the sale—to get the business—without advising the finance department.

And so you can have two very different kinds of allegations, at least: of inflated sales that are important and need to, I think, be somewhat differentiated; they have an import for the kind of scope of the follow up.

For example, if within those two, you had an allegation of the fake sales and fake shipments, initially—as to the organizing of the investigation—if this amounts to some potentially serious matter, you are going to need the right structure, and that right structure matters a lot. A fully independent audit committee, or special committee with independent counsel, with full authority and with the requisite financial expertise, and with the time for the job, is going to need to get involved.

But just stepping a moment before that, there's a need for pace and quickness on the part of the office of general counsel in the initial pick-up—the initial effort to take what the ethics officer has and follow up on it—and that would include speaking to the sales executive and the supervisor and the ethics officer, identifying that you're representing the company, that you need their help, [and] that the matter may well be reported to the audit committee and potentially even externally. And then if there are any named shipments or named orders or payments, you can create an initial issues list and give a call to the audit committee chair that you're now tracking this matter. That audit committee chair will both appreciate the heads-up and then be able to assess whether you've got a handle on something at the moment that appears large or small. And in the beginning it may not appear that large, but you've acted conservatively and proactively to

get the audit chair that heads-up.

That initial issues list then—if, for example, it's fake sales, fictitious customers—that's an easier initial challenge to look for the shipments and look for the customers and try with the finance department to do a quick look on the part of the OGC, and then hand that off to the audit committee. If, on the other hand, it is a situation of hidden contingencies with real customers, real shipments, those contingencies sometimes come to light much later and may be difficult to initially track.

So, you'll gather whatever you can and do it with some speed, so that you can at least advise the chair of the audit committee whether you think this might be a single sales [representative] who's a renegade, or it might be a more systemic fraud. But, in any event, give some initial definition. And then that audit committee will—or special committee with the requisite expertise—will take charge of that audit investigation, with the OGC's role then as the important supporting role. But it will hire its own counsel, and get its own set of other skills and help—forensic help—to conduct the investigation from that point on.

I'm going to come back to that in detail in the next slide, but, at the moment, then—also, you see on this slide the reference to—[we] talked about who reported the allegation and the reliability—I would suspend judgment on the reliability until you do that “what if it's true?” screen and whatever checking you can do on the actual orders that are identified, if any.

As to the scope: What is the scope? The scope is a concept that's going to both evolve and not be complete until you're done. So, it starts with the initial issues list, but as we'll see in a moment, it evolves from there. And as for strategies for controlling cost, the single most important one that I'd like to leave with you today is that you should try to what I'll call parallel process, not serially process, the matters here. That is to say, there are several tasks that need to be done in parallel across several objectives, and at the same time, to avoid having to go back and redo prior tasks. And the best way to, I think, illustrate that is to go, if we can, to the next slide.

LYNDA SCHWARTZ: Tom, I'll just add two strategies for controlling costs that I've seen that have been really effective for general counsel. One is: If you've got a pretty vague allegation or a fraud that seems diffuse, and you're not sure where you can start, I think [you should] talk with some of the attorneys or forensic accountants that you're working with on strategies to screen some of the population. Some of the electronic evidence tools, or other early case assessment tools, can help you. Ernst & Young has been doing some work recently on data analytics that don't require us to do reviews of e-mail—reading of e-mail—but we can begin to do some initial scoring of who in the organization might be the ones that ought to be the focus of initial work. So, trying to find ways to narrow a vague allegation is a way to try to avoid scope being too broad at the outset.

I completely agree with you, Tom, that the scope has to be broad enough to cover the issues entirely, plus a little bit [more] to make sure you've caught it all. But the other thing that I'd really emphasize in terms of controlling costs is to really—as, Tom, you said—be thinking down the line about who will be using this information. Are you going to be using it for an insurance claim? Will it be important to your auditors? And be thinking [about] involving the stakeholders that you can get involved early, so that you can avoid rework. Just the worst cost-sink is redoing

things. And it's the most frustrating and least satisfying of investigative tasks.

THOMAS DOUGHERTY: Let's also point out that that initial screening—let's differentiate between the office of general counsel compiling a first look before the hand out, then when there's an inclusion, and potentially—let's say actually here—a handoff to the audit committee, that audit committee will then, itself, develop that initial screen and decide how it—and use its judgment—to how best to get that initial screen large enough so as to not potentially overlook something at the start, but not so large as to slow and encumber everything and make it unduly expensive. And that's going to be driven by those audit committee members, in their judgment, based on that initial look.

So, if we go to this next slide: This is a busy slide, but it's a very important slide, and it's entitled "Compressed Time Frame," and that's exactly what we're dealing with. And you'll see—and I'll go through it—there are several simultaneous, parallel efforts that need to be made in a very compressed time frame. In the example that we gave, which is very, very typical, it stated that there were 30 days left towards the filing of a 10-Q. So obviously, if you look at the top part of this chart, above the line in the middle, you'll see the end of the quarter therefore has already passed, 10-Q filing deadline is upcoming, and the auditors are doing their SAS 100 timely quarterly review.

So, let's stop there.

If this matter is sufficiently important that the audit committee has undertaken to look at it, then the audit committee (and/or the general counsel, at the direction of the audit committee) will have advised the auditors of that fact. It's very likely that the auditors will not sign off on their SAS 100 review if there's an outstanding special investigation going on. If that's the case, with the quarterly filing coming up in 30 days, there's, at most, a five-day automatic extension that can be granted for that filing. If the investigation cannot be concluded within that time, you're on a potential delisting panel inquiry from the exchange that your company's stock is listed on. That panel will convene within about three weeks. And, for example, Nasdaq would give an audit committee doing an investigation, typically no more than 90 days to finish its work and to get whatever amended filing—if there is to be any restatement arising out of the matter or not—completed and filed. So, that the time frame for the investigations now is very compressed and very driven by the Nasdaq panel.

I'll show you another dynamic below the line as to how the exchange panel listing proceeding also affects things. Just looking below the line: You will have the need, on the part of the audit committee, or the general counsel initially, to have, with the chair's permission, notified the auditor. And, for reasons of self-reporting, you'll want to consider and often will notify the SEC [Securities and Exchange Commission] in order to both give the SEC the heads-up that there is an inquiry going on, and get the credit for the cooperation from the SEC for doing so. Now, later on we're going to spend more time on that concept, but that's a very early activity.

At the same time, you're identifying at the audit committee level an initial scope of your investigation; we'll come back to that. You also will then have potentially to issue a press release indicating that there is an investigation ongoing. That press release will need, if possible, to try to size—as difficult as it is—the investigation as it stands at that point. And typically, that's on the

one hand hard to do in certain ways, but in other ways it's usually driven by the number of transactions, possibly the geography, and the time period and perhaps the size of the transactions, from low to high. [For example]: "The audit committee is investigating some transactions in a particular geography"—if that's the case—"and they range in size from, say, \$1 million to \$5 million at the moment; 10 transactions in the 2008 fiscal year period. This is an ongoing investigation; that scope may well change." The audit committee usually does not undertake in that press release to—or the company—to commit to updating that release, but it's a consideration to keep in mind.

Once that release goes out, you can imagine the class actions and derivative suits [that] will be filed. And the reason why I've put the little box "Define the initial scope" just after that: It's not that you haven't already had a preliminary scope, and it's not that you've not already been acting on it, but you may get additional leads right there, once your press release goes out, to add. And by this time, you've got some scope of that investigation kind of in hand.

At that point, you want to be asking to meet with the SEC or Department of Justice, depending on what it is, to proactively tell them what it is you're going to be doing. And you can even vet with them your scope of investigation. They aren't going to necessarily comment, although sometimes I've seen them say, "Well, I see your key words; you might add this. I see your parameters; they look good. What are your geographies that you're covering, etc.?" So, you get some comments at times. So, all that happens within days of the initial audit committee meeting.

And it needs to be recorded as to what happened when, because, among other reasons, the delisting panel—each of the exchanges has a set of panel procedures—those panel procedures include, for example, for Nasdaq, a set of Q&A's that must be answered, and they want to know: When did the matter first come to the attention of the office of general counsel or the finance department? What date? In what manner? What happened next? They want a detailed chronology. Consequently, the speed and quickness of that initial sort has a big impact on the company's being, and appearing to be, responsive in the exercise of their fiduciary duty and their responsiveness to the regulatory requirements.

And then, along the way, by parallel processing—what I mean by that is: Not only do you keep—in essence, the audit committee—keep the auditor informed and the SEC informed, and the board, but it will provide updates so that the SEC or the DOJ, sure, they may be issuing subpoenas or information requests, but you know that you're in good rapport with them if you find that they are, in doing so, actually formalizing what you've already undertaken to provide to them in your self-reporting mode, so that you be, and you act, and you appear to be a responsible company that is going to isolate this—[find out] what is the fraud, as appropriately defined as you can find it, with an energetic scope that you're going to review as you go along and not cast in stone at the beginning, and get the credit from the regulator for having taken the proactive steps.

Now, with regard, if we could, for a moment, to the scope, can we go to the next slide and spend a moment here. When—if you look at the upper right—the people—same people—when the transactions are initially identified, you may find, of course, that there are people inside the company associated with them. You may have customers associated with them. But there's going to be some limitations on the part of the company in its ability to reach out to important

customers with regard to a matter, at least initially, because there's a customer relationship issue there that's got to be kept in mind.

But you will have a series of people, a time frame, and initially, therefore, a geography. And what you want to do is to look at the transactions involving those people and look for other transactions, other than those originally identified, in the same time frame as to those people, in the same geography as to those people, then track any receivables or any confirmations that were received from the audit confirmation process to see whether you find regularity or not. And if not, that may cause you to then find additional people and/or an expanded time frame as to the same people, or an expanded geography as to the same or different people. And you therefore iterate that scope.

And at the very beginning of the exercise, as an audit committee, you want to make sure you record that you were open-minded about that initial scope, that there's no effort by the company to minimize, sweep under the rug, write off and move away, but rather, "We will iterate that scope as we need—expand or reduce it, as we see appropriate." And then work through that; it affects a lot of things, including the varied electronic search and key words and other parameters. And so, Lynda, at this point, let me just be silent for a bit and ask you to, if you could, just comment a little bit on this question of how the scope both matters and gets addressed.

LYNDA SCHWARTZ: Well, I think it's a hugely important question, and sometimes when I see this slide, and you and I have talked about it in the past, it always looks almost impossible at the outset, particularly if you have a large and complex issue that you're facing. But I think it's relevant to think about the speed of investigations and the iterative nature of scope, even when you're looking at moderate and smaller-sized issues, because, quite frankly, some of them do become big, and no internal counsel wants to be blindsided by not having thought through the potential outcomes—and so, kind of looking at a full-blown, significant investigation and the timeframe, and the iterations with respect to the scope, I think is very relevant in sort of understanding how big some of the investigations can get.

But speed and scope evaluation is a completely scalable concept. Even if you were doing a small internal investigation that internal counsel was leading, internal counsel would need to think about the speed to communicate clearly any issues, would need to be thinking about securing evidence, or gathering data, and making sure that information that would be relevant to any investigation or follow-up is preserved. And a person—an internal forensic team or internal counsel—would still need to be thinking, "Have we got it all?" and be focused on the same questions [at the] same time: "Have we covered the same people? Have we covered the issues in the same geography? Have we followed the money?" And that process of iterating, "Have I got it all?" is important, regardless of the size of the matter.

THOMAS DOUGHERTY: So, maybe we could turn to the next slide and talk a little bit about the needs of the board and management, auditors, regulators and other stakeholders, and addressing auditor concerns in the process. As to the auditor concerns, those are going to be early, ongoing, and transaction by transaction. That is to say, one of the worst things you could do would be to conduct the investigation, get toward the end of that timeline, come to some preliminary conclusions, and then take a large database of information or a subset of it and say, "Now let's meet with the auditor to try to go through our considerations and our tentative

conclusions.” At that point, the auditor doesn’t have time—within the time limits that are in the earlier slide—to get a handle on the very information that you are providing, and so what you really want to do is: After getting the auditors involved with regard to the scope of your investigation, and continuing their involvement with regard to keeping them informed on that, you also want, as you develop transaction material, to review with them where you are in your process from time to time, and get them in a position to be able to start looking themselves, preliminarily, in parallel to you, in where the audit committee is in respect to those transactions. So that as you proceed, they are getting the benefit in some measured way of where you are when you are and not left for the end.

As to the needs of the board: Assuming that there is no one on the board who is conflicted, there would be obviously appropriate reporting by the audit committee from time to time telephonically or otherwise of where they are.

Again, as to management: The good news is, as the regulators would want, in any event, that an independent committee is in charge of the matter and is thereby insulating the company from any potential criticism that management might either seek to minimize or seek to expedite the matter unduly. Not that I’m saying it’s the case in any instance, but it protects against any appearance of that.

And they, again, are an important input to the committee. There may be, among other things, obviously the interviewing of management, including senior management, in connection with any transactions. But that’s what they are: an important input, and not knitted into the process of the committee’s work itself to a degree more than that.

As to dealing with regulatory and enforcement implications, we’ve already touched on the importance of self-reporting. It’s really to knock on the SEC’s door before the SEC inquires and get credit for cooperation. I have seen instances, of course, where the SEC was not aware at all of the matter, and they’re happy to have to the company report a potential issue, and if the sizing and determination ultimately is that it is not as significant as it might earlier have seemed, the SEC has been willing to say, “Thank you, and we’ll accept your conclusion. It was independently arrived at and that’s the end of it.”

But I have also seen situations, literally in a phone call from the SEC office advising them of an issue, where the company minutes later received a call from a different SEC office, where they had become aware of the issue. We called that office back and said, “Well, we want to be sure that you’ve put the two and two together, that this company has recognized as having been proactive and cooperative,” and they appreciate it if that’s the case.

And lastly I have seen instances—although very rare—in which there could even be an action by the informant to the company to seek some kind of payment by the company in order to provide information, which is essentially, ultimately the company’s information in any event, or to provide information that there should be no payment for, for any reason, and those sort of overlays are pretty important to track. There may be regulatory implications to that, as well.

LYNDA SCHWARTZ: I’ll just jump in, Tom. One thing I have really seen with all of these different implications is the great role that corporate counsel has in helping all of the people who

are affected by the investigation understand the roles of the different people and why they are doing the different things they are doing. So, for example: Board members often need to be educated on their responsibilities through an investigation and what the regulator and regulatory and enforcement implications will be. Oftentimes folks don't really understand all of the auditor concerns or needs for information, and those kind of misunderstandings can make investigation of fraud-related issues more difficult. So, for example, many folks—board members or managers—may not understand that the auditor needs to know more than just about the fraud itself, but maybe considering: What are the implications for the audit approach generally? Are there any other issues that could reach back into reporting periods where reports are already outstanding? And do there need to be any follow-up disclosures or pulling back any opinions or financial statements? Auditors might be thinking about implications for the audit approach and whether they need to do more work, whether they need to reconsider the integrity of people who may have given them information that was relevant to the audit. And there is sometimes very competing interests, so folks do need to get through things quickly, but others may be thinking about fiduciary duty. And internal counsel can have such a tremendously positive role in helping the different stakeholders understand the responsibilities of the others. And, almost always, there are important stakeholders who have never been through the process before.

THOMAS DOUGHERTY: Let me just touch on the last three bullets on this slide together, which is responding to enforcement and regulatory actions and the attorney-client privilege as it comes up there and handling competing interests.

On the one hand, the company does not need to waive the attorney-client privilege to be considered cooperative, and that is now pretty well established after a couple of years ago's court case and the regulatory response. So, that's good news. The other news, though, is as to the—call it the audit committee's work product, including any important counsel work product related to that, that is shared with regulators who want it. The SEC and the DOJ will want summaries and analyses, and to the extent that the committee chooses to provide those, even if it does so under a limited waiver agreement, the courts have been sufficiently wary of that, that you need to assume that that material is discoverable in the competing forums, that is to say the class actions or derivative actions, and not assume otherwise.

And that gets me to one of the—I think, I hope—one of the most important things I have to say today, [which] is: I think that you have to focus then on what committees do best and what they do less well in connection with handling the competing interests. I think committees are particularly good at finding transactional facts, especially facts that are within the control of the company. I think they are good at proposing remedial actions and recommending personnel actions, because obviously a manager can be asked to leave just on a vote of no confidence. I think what is difficult, though, is that, of course, the regulators and even the delisting panel will be interested not in finding transactional facts alone, but in finding fault. And a personnel action does not necessarily require the finding of fault. Obviously, remedial actions don't necessarily require that. Determination of transactional facts may or may not involve inferences of fault, but often they need not. And you have to keep in mind that the audit committee process, where there are interviews and the gathering of data—it's not transcribed, so it's not like a court case. It's not cross-examined, the interviewees. Often there is not a full set of counterparty witnesses; you don't want to necessarily disrupt every customer. So, there are limitations, I think, on finding fault. There will be regulatory pressures on the company to try to assist those entities in, perhaps,

their efforts to find fault. But given the ongoing derivative actions, given the class actions, and given the company's need to do what it can do well and take any personnel actions, you have to balance what the committee does best with those other considerations.

So, Lynda, let me turn it back to you.

LYNDA SCHWARTZ: Well, one of the things that internal counsel needs to advise on early, regardless of the size of the initial fraud that presents itself—or potential fraud—is preserving and securing evidence, including electronic records. And as an accountant, I can't give any legal advice about what things must be preserved. But I can say, from an investigative perspective, the goal is to maintain the integrity and completeness of the relevant records that would be needed moving forward.

Often this is an emphasis in activity in the early hours of investigation, and maybe before a full investigation team assembles. So, as we're thinking about securing evidence, think about the major classes and groups of evidence: the people, the paper-based business records and the electronic records, both structured data like accounting or financial databases and books and records, but also unstructured data like e-mail. And take steps to preserve what you can. Simple steps can be taking back up tapes out of rotation or taking a forensic image of server-based e-mail.

The thing I'll say about this is: People do funny things. I have worked through situations where people who ultimately didn't have a huge lot to be afraid of, threw records out, out of fear. Or people changed and deleted records as soon as they had a sense that the company was onto their activities. My friend who does work with electronic evidence says, "Electronic evidence is volatile and subject to constant change until it is in the hands of someone who is committed to preserving its integrity." So, just be thinking about that at the first instance.

On the next slide, we have some thoughts for internal counsel about preserving the company's reputation. Oftentimes, things that are relatively small and in the ordinary course are handled as a matter of internal matters, but certainly there are communications that are required, and understanding the impact of the situation on the company's reputation and brand is important.

Tom, you had some good examples of how such communication can be made to do the best for the company without overstepping into inappropriate communication. Maybe you could share that.

THOMAS DOUGHERTY: Yes. Remember, on that timeline, you'll be needing to contact the SEC and the exchange and the auditor if it looks as though the investigation is not going to be able to be completed in sufficient time for the Q to be filed, or in any event if it looks as though this is a matter sufficiently material that you determine that the market should be informed. At that point, you may not have an ability, as you will later on, perhaps, to say, "Look, this involved the following geography and the following millions of dollars in sales revenue and has an impact on the financial statements earnings line of such and such." But you are able initially, perhaps, to say, "We have got a certain number of transactions in a certain time frame"—year or years or quarters, perhaps in a certain geography—"and as small as this and as large as that." And that's a lot better, at least in terms of both market response and investor information, than leaving it

entirely unquantified and leaving the market and investors to sort of assume the worst or not have a basis to really form a conclusion at all.

Secondly, there is a need to convey the independence of the investigation in terms of how it's being handled and conducted, and a need to alert the public that the company is—if it has been—cooperating with any regulatory inquiries, so as to convey the message of responsive citizenship and active, engaged activity.

LYNDA SCHWARTZ: Let's turn to the next slide. The other thing that we can be thinking about is: How are you going to be using the results of any investigative work you do, whether that's internal investigations or a full external investigation?

I have seen situations, particularly around embezzlement and employee fraud, where there is some opportunity for asset tracing. So here, early information that can identify the assets of potential perpetrators, particularly if the evidence would be sufficient to allow the attachment of assets, is really, really helpful. And here, speed is of the essence.

And the other thing to be thinking about is whether or not the company has relevant insurance coverage, and whether or not it seems likely that that coverage would attach to this particular issue. The reason that that makes sense to think about early on is [that] there are usually notice provisions in the insurance coverage. But also, the investigation that you might do for the basis of an insurance claim may have a different scope and extent than the investigation that a company might do for the purpose of its own decision-making and corporate governance requirements, because oftentimes the insurance companies require a relatively thorough documentation of the basis for the claim. So, cost savings and benefits depend on how you are going to use the information. So thinking about that ahead of time can be very helpful.

I will say that in some kinds of fraud, there is really not a significant recovery of assets. So, for example, in financial statement fraud there may be limited recovery.

Let's look at the next slide. Tom talked a little bit about remedial actions. And I would agree with him that I have seen well-thought-out and thorough work by committees and boards focusing on remedial actions that are directly related to the incident. Things that are investigated internally—for example, internal counsel-led investigations—often focus very clearly on: What are the direct remedial actions on this thing that happened? So, if the issue is a particular embezzlement—let's say someone has stolen a bunch of checks and converted those checks to their own benefit—it's not at all tough for companies to lock up their checks going forward. So, the remedial actions directly related to the incident are usually a slam-dunk.

But the other things that are less frequently thought through is really updating, or in some cases performing a fraud risk assessment that focuses on all elements of fraud, and really asking ourselves, "What is it about this particular fraud that might give us greater insight to the company's overall exposures?" Sometimes I have found that companies don't really think that fraud can happen at their organization. Management may think it's money not terribly well spent, until after fraud allegations are made. And it is somewhat like closing the barn door after the horse is out, but there are so many horses. We talked about such a broad range of potential exposures to fraud. And using the information that comes out of the investigation—using the

experience of having gone through an investigation and triaged it to update the company's response—makes the company a learning company with respect to those issues. And there's lots that companies can do to strengthen their antifraud control before an incident and to restrengthen them after an incident. So, really getting to specific changes and controls and procedures to reduce the opportunity for future exposures are oftentimes investments that are very well spent.

Tom, maybe you can take a little more thinking about: How can you prevent being in these situations in the first place?

THOMAS DOUGHERTY: Sure. One exercise that I have seen companies go through and be helped by is actually to look—say, in the cycle of the calendar year when the governance committee is meeting to look at the charters of its various committees and look at the governance structure generally—to get out the risk factors section of peer-company financial statements. That is to say: Go back to the proxy, pick out the compensation peer companies or other companies, and then go to their 10-Ks and look at their financial statements and MD&A [management discussion and analysis] risk factor sections. And look at the financial risk factors that they identify, and match those against your own risk factor profile, and, in a word, try to be sure that the company's stated risk factors, externally, are meaningful internally and are current and not mere disclosure documentation, if you will, but are really tied to the charter of particular agents and activities within the compliance and audit functions—internal audit of the firm—such that you are both identifying the categories of risk that are as best identified as you can, and then tracking them as proactively as you can. And you then get surprising input from outside directors who are not necessarily on the audit committee, so, “Yes, now let me tell you a little bit about how we do it elsewhere,” without getting into any private information, but just other structuring of control network at other companies. So as to create a dialogue on an annual basis around this question, so that you're not in the position of only talking about the adequacy or currentness of risk profiling when a problem comes up.

KERRY SCHALDERS: Thank you, Tom. Tom and Lynda, we have a moment or two for you to state your top, number one “do” and “don't,” and then we'll move into a Q&A session.

THOMAS DOUGHERTY: Lynda, you go first.

LYNDA SCHWARTZ: Sure. I guess the one thing that I have really taken away from a lot of the fraud-related work that we have done is to really anticipate and meet the needs of the various stakeholders. Tom talked a little bit about the parallel processing, but what I have really observed is just how many people use the output at fraud investigation work and are focused on the company's response. To the greatest degree, if you can anticipate those needs, you can do it once and put the issue behind. The other thing that I would say about, from the “don't” side, is: Don't discount the message or fail to respond. It's better to triage and make some appropriate response than to let things go unanswered. And we certainly have seen that in practical experience.

Tom? Maybe you could share your top “do” and “don't.”

THOMAS DOUGHERTY: It would be focusing on transactional facts without trying to overreach on fault, given the capabilities and expertise of the audit committee and the limitations of the audit committee as tool, even while in the midst of a regulatory and other civil litigation

environment.

KERRY SCHALDERS: Thank you, good advice. Well, at this point, what we can do is [to] invite our audience members to submit any questions you might have. And in the meantime, while you are doing that perhaps our moderator here can go ahead and run the poll question.

MARNI CENTOR: OK, I will launch our poll, and the question is: Do you think your company currently has sufficient antifraud controls? Please select one: Yes, no, or unsure. And we'll give our audience a few seconds to vote. The votes are coming in. And we still have some votes coming in. I am going to close the poll in just a few seconds here.

Closing the poll. And the results of our poll: 64 percent say yes, they believe their company currently has sufficient antifraud controls. Back to you Kerry.

KERRY SCHALDERS: Thank you very much. We've had some audience interest in exploring this idea of premeditating situations which led to fraud versus finding the fault. And I wonder, Tom and Lynda, can you address that a little further? What do you think should be the goal of in-house counsel? Who should be looking to determine fault? Is that something that can happen after you do the remediation or should you work it at the same time?

THOMAS DOUGHERTY: Yes, let me do two seconds on this. There are going to be regulators and civil actions, and those are going to be focused on fault, and they're going to be ongoing, and they may have tools and time that the audit committee does not have in this compressed timeframe. And so I think the committee can abide events, I think the board can abide events on that. The personnel actions can be taken on the basis of confidence, not even as we would think of it as fault. If there is a lack of confidence in a manager, that person can be asked to leave without any final determination of fault whatsoever.

And as to remedial actions, one other thing you can do is to take a look at any peer restatement, which will include remedial actions, that has occurred in your industry in the last, say, couple of years or more, and just compare that set of remedial actions taken with your own present setup as to see whether or not there was anything that was done by another company as a result of one of these incidents that you don't already have in place.

LYNDA SCHWARTZ: And I'll just add: I have often worked with audit teams who are dealing with the output of fraud investigations and also with clients. And I think finding guilt or innocence—finding fault—is probably the wrong question at the conclusion of some of the investigations. For auditors it might be: "Do I need to do more work? Do I believe I can rely on the integrity of management? How does this affect the audit?" Those are the real questions that the auditors need to deal with. For the company it might be: "Can the people stay in the positions that they are currently in? Whether or not they do, what are the changes in our business processes, procedures or technology to reduce our known exposures? And three, what else do we need to do to strengthen our overall controls?" And you can leave the guilt or innocence for the next day. I think I agree with Tom that those are things that can abide a later disposition.

KERRY SCHALDERS: Thank you, Lynda.

[The instructions provided here were intended for attendees of the live webcast when it was

originally broadcast.]

KERRY SCHALDERS: At this point we're going to have to go ahead and close the webcast due to time. We thank our presenters, Lynda Schwartz, partner with Ernst & Young, and Tom Dougherty, partner with Skadden Arps, for sharing their expertise today. We also thank Ernst & Young for their generous sponsorship of this webcast event.

Finally, any ACC members are welcome to join the Litigation Committee's call, which will occur at 4 PM Eastern today. You can find the information on the ACC Web site. And we remind everyone that the ACC annual meeting will be coming up in October. If you haven't signed up we'd love to see you there.

So, thank you to everyone for participating in our call today, and have a very nice day.

MARNI CENTOR: On behalf of the Association of Corporate Counsel and SmartPros Legal & Ethics, thank you again for listening to today's program.

[The instructions provided here were intended for attendees of the live webcast when it was originally broadcast.]

MARNI CENTOR: Thank you again, and have a good day.