

Effectively Managing an Independent Investigation

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Heightened focus on corporate governance and financial transparency, culminating in the passage of the Dodd-Frank Act, has brought renewed attention to the need for increased investigative activity at many public companies. The SEC's recent implementation of the whistleblower award program has further underscored the importance for companies to have a plan in place to investigate issues promptly and effectively. When circumstances dictate that the company conduct the probe independently of management, the Board of Directors or a Board committee typically takes responsibility for managing the investigation with the assistance of outside advisors. Since an investigation can have far-reaching implications for an organization, the company's directors have an obligation to manage the project effectively, balancing often-competing considerations in the best interests of the company's stakeholders. Rick Ostiller and Jonathan MacKenzie, leaders of Navigant's GAAP/GAAS Investigations practice, and John Tang and Tim Crudo, partners in the securities litigation and investigations group at Latham & Watkins, discuss best practices in conducting an independent investigation.

WHAT SHOULD BOARDS OR COMMITTEES CONSIDER WHEN DETERMINING WHETHER TO PERFORM AN INDEPENDENT INVESTIGATION?

Rick Ostiller/Jon MacKenzie: Management may sometimes advocate conducting the investigation themselves, rather than an investigation led by independent directors and outside advisors. Management's desire to conduct an investigation is often influenced by understandable concerns about cost containment. Although an independent investigation may involve more time and expense, it carries significantly greater weight in the eyes of courts, regulators, auditors, and other interested third parties (including the press) who may later judge the investigation with the benefit of hindsight. Consistent with the value placed on independent investigations, the Sarbanes Oxley Act of 2002 contains provisions permitting (although not requiring) companies to empower the audit committee and other independent Board committees to retain independent counsel and other advisers.

Who conducts the investigation can make a significant difference. For example, in exercising their charging discretion, both the SEC and the DOJ give strong consideration to the company's own investigation. If reliable and well-done, an investigation that is shared with the government can lead not only to reduced charges but even to no charges being filed at all. See *S.E.C. Enforcement Manual* § 6.1.2; *U.S. Attorney's Manual* § 9-28.720. However, the government can be a skeptical consumer. An investigation that it perceives to be insufficiently thorough or independent because the person(s) conducting it are deemed too familiar or too aligned with the potential subjects of

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the investigation may not receive the full benefits that would otherwise accrue to an “independent” investigation. Similarly, while an internal investigation may provide the basis for a motion to dismiss a shareholder derivative lawsuit in its preliminary stages, the independence of the investigators is a key factor in the court’s consideration of whether to defer to the findings of the internal investigation. See, e.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

The company’s outside auditors, who generally work in parallel with the company’s investigators, may also take a dim view of an investigation that isn’t sufficiently independent. Often, the audit firm will have its own forensic accountants conduct a “shadow” investigation that monitors the work of the committee and its external advisors. The primary goal of the shadow investigation is to ensure the scope of the independent investigation is adequate to allow the auditors to rely on the findings.

In summary, the credibility of the investigation is often a paramount consideration. While an independent investigation can be more costly than a management-led process, it can be conducted efficiently to keep costs under control.

WHAT ARE SOME OF THE INITIAL STEPS A BOARD SHOULD TAKE WHEN AN ISSUE ARISES THAT MERITS AN INDEPENDENT INVESTIGATION?

John Tang/Tim Crudo: If the decision has been made to undertake an independent investigation, the Board should form a special committee of independent directors to manage and oversee the investigation. For the reasons discussed above, it is critical that the members of the committee be disinterested and independent of any of the people, companies, and issues that could be the subject of the investigation. Although some types of connections between members of the committee and the subject(s) of the investigation (for example, common membership in a trade organization or social club) may not be legally disabling, all connections however modest should be identified and vetted at the outset. Indeed, it is not unusual for a Board to appoint additional directors with no prior connection to the company, solely for the purpose of constituting the special committee charged with the con-

ducting the investigation. Alternatively, the company’s Audit Committee may lead the investigation (provided its members are not associated with the people, companies, and issues that prompted the investigation).

The Board should establish a charter or resolutions that clearly describe the committee’s charge and authority. Among the matters that the charter or resolutions should specifically address are the committee’s authority to retain outside advisors, incur costs, gain access to company information and personnel, and whether the committee is empowered with the full decision-making authority of the Board, or rather is empowered to recommend a course of action to the Board based upon the investigation’s findings and conclusions.

The committee should promptly ensure that the company preserves relevant documents and information and evaluate the need to engage outside advisors. In addition, the committee should communicate with the company’s outside auditors and work with the appropriate resources within the company (for example, the investor relations department) to plan for external communications regarding the investigation and the matters that prompted it. The recipients of such external communications will depend upon the circumstances, but often will include various regulators (SEC, DOJ, FINRA, listing agencies, etc.), investors (individuals and institutional holders), market analysts, the press, and other interested third parties.

WHAT ARE SOME KEYS TO A WELL-RUN INVESTIGATION?

Tang/Crudo: Accuracy, proportionality, sound processes and judgment, active committee and Board involvement, and responsiveness to the company’s various constituencies. In addition to their fact-finding mission, the committee and its advisors must also take into consideration the company’s business, legal, reputational, and other interests surrounding the issue under investigation.

To the extent that the Board does delegate the investigation process to a committee or rely on the work of internal or external personnel, it is important to remember that in the end it is the Board’s investigation and that the Board is the ultimate fact-finder and decision-maker (bearing in mind that as circumstances warrant, a Board may decide to empower a committee with the Board’s decision-making authority). It is certainly appropriate for the directors to use and rely upon others



(such as outside advisors) in the investigation process; it is not expected that the individual directors or committee members will personally conduct the investigation. But by the same token, the directors cannot discharge their fiduciary duties by “over-delegating” their responsibilities to the point of abdicating them. It is therefore important to strike the right balance. To do this, the Board, through its committee, should keep informed and be actively involved throughout the investigation, by monitoring, overseeing, and directing the course of the work. This would include, for example: meeting regularly with and obtaining regular reports from the investigators; providing feedback on the investigation; challenging the committee’s advisors by raising questions and participating in decision making; reviewing key documents and interview summaries prepared by the investigators (and at times, participating in an interview of a key witness); and formally making final findings of fact and decisions about any disciplinary actions, reporting, process remediation, or other measures arising from the investigation.

At a minimum the investigation should be sufficiently thorough to satisfy the directors’ fiduciary duty to ensure that the Board adequately investigates problematic issues that come to the Board’s attention and to make any remedial or process and control adjustments based upon the results of the investigation. See, e.g., *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). In this regard, the committee’s investigation, whether carried out using internal resources or independent outside personnel, will typically be evaluated under the business judgment standard, which gives significant deference to a Board’s considered judgment as to the cost and scope of the investigation as long as that decision is an informed and disinterested one. Keep in mind, though, that the minimum investigation necessary to satisfy the business judgment rule may not be enough to satisfy other interested third party constituents such as the SEC, DOJ, auditors, and the press.

Ostiller/MacKenzie: The team should establish a work plan and be prepared to modify it as circumstances change. It is important for the committee and its advisors to be disciplined and thorough in identifying areas of inquiry and designing and carrying out the appropriate investigative steps. In addition, the team should remain flexible and willing to follow the investigation into additional areas as it learns information. At the same time, the committee should bear in mind the core issues that it is charged with investigating, and avoid unnecessary “scope creep.” Therefore, the investigative team should carefully consider significant

scope changes, and obtain committee approval before initiating them. If unrelated allegations arise during the investigation, the committee may choose to refer those matters to other constituencies within the company (including management) for consideration.

In addition to interviews of relevant personnel, the team should preserve, collect, and review relevant documents (including electronic data) and perform financial or accounting analyses as needed. It is also very important to meet regularly with the company’s outside auditors, who will ultimately need to concur with the scope and process of the investigation, particularly if it may result in a restatement.

WHAT COMMON CHALLENGES SURFACE IN INVESTIGATIONS, AND HOW CAN DIRECTORS OVERCOME THEM?

Tang/Crudo: One common challenge is balancing the company’s attorney-client privilege against appropriately informing important third-parties (such as regulators, auditors, and courts) about the investigation. Government regulators are generally prohibited from asking for privileged material and basing their charging decisions on whether the company will waive work product and the attorney-client privilege as part of its cooperation, although they will expect the company to provide “factual information.” See *S.E.C. Enforcement Manual* § 4.3; *U.S. Attorney’s Manual*, § 9.28.720. This balance is often achieved by providing high-level status reports that convey the progress or results of the investigation without disclosing privileged details.

Another common challenge is for the committee to conduct its investigation while the company preserves its position with respect to threatened or pending litigation stemming from the investigation. In addition to balancing resources and managing the distractions of personnel and customers, the board needs to remain attentive to coordinating the demands and strategies of all of the resulting litigation and non-litigation fronts. When and what steps are taken – or not taken – in one facet could have unintended effects on others.

Yet another challenge lies in the fact that the Board committee and its advisors conducting the investigation lack subpoena power. This can hinder the investigators’ ability to obtain cooperation and information from important third parties. And for investigations that involve



obtaining information from third parties outside the U.S., an additional challenge is the need to navigate the applicable laws and practices in the local jurisdiction. For example, state secrecy laws (such as those in China) or prohibitions on “U.S.-style” discovery may pose a significant obstacle to gaining timely access to necessary information. Other jurisdictions, including many in Europe, have expansive privacy statutes that may limit the ability of a company’s investigators to take documents and other information (including, for example, information obtained during interviews) out of that country – sometimes upon pain of criminal penalties. Therefore, it is important to understand in advance and plan for the requirements and restrictions of non-U.S. jurisdictions.

WHAT ISSUES SHOULD THE BOARD CONSIDER REGARDING REPORTING FINDINGS OF THE INVESTIGATION?

Ostiller/MacKenzie: The Board should provide sufficient information about the investigation to meet the company’s public reporting obligations while considering the implications of disclosures on potential shareholder or derivative litigation. Two of the most important reporting considerations are the format (oral/written, report/presenta-

tion) and the audience. Regulator and external auditor expectations, as well as the scope of the findings, will all affect those decisions. An investigation’s potential outcomes include:

- » financial reporting restatements;
- » corporate governance changes and internal controls enhancements;
- » remedial actions, including termination/reassignment and pursuing financial reimbursement;
- » regulator attention; and
- » litigation.

After the investigation is complete, directors should track implementation of recommended actions.

DO YOU HAVE ANY LAST WORDS FOR BOARD MEMBERS EMBARKING ON AN INVESTIGATION?

Tang/Crudo: Clearly set out the scope of the investigation and actively oversee the process.

Ostiller/MacKenzie: Keep the stakeholders posted on your progress.



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