Wednesday, October 22
9:00 am-10:30 am

805 Fraud & Malfeasance: State & Federal Enforcement

Robert Falk
General Counsel
Human Rights Campaign and Foundation

Scott L. Fredericksen
Partner
Foley & Lardner LLP

Bruce Philipson
Manager Exempt Organizations, FIU
Internal Revenue Service

Robert F. Roach
University Compliance Officer
New York University

Faculty Biographies

Robert Falk

Robert Falk is the general counsel for the Human Rights Campaign ("HRC"), the nation's largest organization advocating for equal rights for gay, lesbian, bisexual, and transgender individuals. His day-to-day work includes regulatory compliance, contract negotiation, tax exempt issues, human resources, and intellectual property matters.

Prior to joining HRC, he worked for in the health care industry, advising clients on fraud and abuse matters, defending clients under investigation, and negotiating settlement agreements with federal and state agencies. He has also served as the general counsel of the Whitman-Walker Clinic in Washington, DC and as acting general counsel of DC General Hospital.

He is an adjunct faculty member of George Washington University where he has taught compliance and risk management.

He attended Princeton as an undergraduate and graduated from Yale Law School.

Scott L. Fredericksen

Scott L. Fredericksen is a partner with Foley & Lardner LLP, and is a member of the firm's white-collar defense and corporate compliance practice. Mr. Fredericksen brings more than 27 years of litigation experience to the firm. His practice at Foley is concentrated on white-collar defense.

Prior to joining the firm, Mr. Fredericksen served as special counsel to the US Attorney. In this capacity, he advised and counseled on cases, investigations, special projects, and other sensitive matters. Mr. Fredericksen also was a managing partner and chair of the labor and employment practice group at Stoel Rives' Seattle office, where he focused on general civil litigation and white-collar criminal defense. Previously, Mr. Fredericksen was associate independent counsel in the Office of Independent Counsel in Washington, DC, serving as trial counsel in the criminal investigation of alleged fraud at the US Department of Housing and Urban Development under former Secretary Samuel R. Pierce, Jr. Mr. Fredericksen also served the United States Attorney's Office for the District of Columbia, and later for the Eastern District of Virginia. While in these positions, his trial experience included extortion, product tampering, fraud, and white-collar matters.

He is a member of the Edward Bennett Williams American Inn of Court. In 2000 and 2001, *Washington Law and Politics* chose Mr. Fredericksen as one of Seattle's Super Lawyers.

Mr. Fredericksen graduated from the University of North Dakota with a BA, cum laude. He received his JD from Boston University School of Law.

Bruce Philipson

Bruce Philipson is the manager of one of only two examination groups making up the Financial Investigation Unit (FIU) in the Exempt Organizations operations of the Internal Revenue Service. The FIU is a specialized examination function charged with conducting forensic civil tax investigations of tax-exempt organizations and related individuals having indications of potential fraud and abuse. In addition, the FIU provides forensic investigative and expert witness support to the IRS Criminal Investigation Division as well as multi agency Joint Terrorism Task Forces. The FIU provides coverage nationally.

Mr. Philipson has years experience with the IRS and specialized EO experience and has served as a manager of the FIU since its inception.

Robert F. Roach

Robert F. Roach is the university compliance officer at New York University, where he oversees the university's ethics and compliance program.

Prior to joining NYU, Mr. Roach served as chief of staff at the New York City Department of Investigation (DOI), where he was responsible for NYC's ethics and corruption prevention programs and conducted investigations into white-collar crimes and public corruption. As chief of staff, Mr. Roach worked closely with New York City's five local prosecutor's offices, the NY State Attorney General's Office and Organized Crime Task Force, the US Attorney's Offices for the Eastern and Southern Districts of New York, as well as other federal and state investigative agencies. Prior to DOI, Mr. Roach served as assistant district attorney in the rackets bureau of the Manhattan district atorney's office and section chief of the antitrust bureau of the NY State Attorney General's Office, where he specialized in the investigation and prosecution of public corruption and white-collar crimes.

For his work, Mr. Roach received the US Department of Justice Award for Public Service; the Federal Bureau of Investigation award for Outstanding Performance in a Joint Investigation; the US Attorney, Eastern District of New York Award for Outstanding Performance in a Joint Investigation and Prosecution, and an award of appreciation from the NYC Police Department, Detective Endowment Association. He is currently secretary for ACC's Corporate Compliance and Ethics Committee. Mr. Roach is a Certified Compliance and Ethics Professional (CCEP) and Certified Fraud Examiner (CFE).

IRS Exempt Organizations

Financial Investigations Unit

Bruce M. Philipson
Manager IRS
Fraud Integrity Unit

Introduction To Exempt Organizations

Purpose of Presentation

- Overview of IRS Exempt Organizations function
- Provide specific information on the Financial Investigations Unit (FIU)
- What to expect during an examination by FIU

The term “tax-exempt organization” can be applied to a wide variety of entities.

The most common include:

IRC 501(c)(3)

- Frequently referred to as “Charities”
- Largest category of tax-exempt orgs
- Contributions are generally deductible by the donor
- Public Charities
- Private Foundations

EO, Who We Are

Exempt Organizations (EO) is part of the Tax Exempt/Government Entities (TE /GE) Operating Division of the IRS

Charged with helping tax exempt organizations understand and comply with tax laws and regulations governing their tax exempt status

IRC 501(c) Others Examples:

- 501(c)(4) – social welfare
- 501(c)(5) – labor organization
- 501(c)(6) – business leagues
- 501(c)(7) – social and recreational
- 501(c)(8) and (10) – fraternal
- 501(c)(19) – veterans

Why?

- Tax Exemption is a privilege afforded by the IRC to Organizations which are organized and operated in accordance with the law.
- EO ensures organizations comply with requirements and are entitled to exemption.
- Ensure public confidence

Two Main Sections of the EO:

1. Determinations
2. Examinations

Why Examine EOs?

The examination is conducted to determine many factors including:

- Whether an organization continues to be organized and operated in accordance with its stated exempt purpose and exempt status
- Whether an organization is liable for the unrelated business income tax or other taxes

Examinations

- Responsible for examinations of Forms 990, 990 PF, & Forms 990-T filed by EOs
- Examination of an EO is primarily concerned with the *activities* of the organization, as well as its financial aspects.

Why Examine EOs?

- Whether an organization is engaged in impermissible activities
- Whether an exempt organization has filed all appropriate returns and schedules
- Private Benefit and Inurement

What Are We Looking For?

- Transparency
- Sources of income
- Inurement / Private benefit
- Self-dealing
- Political activities

Specifics on FIU

Stood-up in April 2005

Staffed with two groups

- 17 Forensic Investigators
- National Top Secret Clearances
- EO and Income Tax Backgrounds
- 12 PODs
- Work cases throughout U.S.

Background on FIU

- Growing concern for transparency in the charitable section
- 09/11/2001
- EOs are becoming increasingly sophisticated

Specifics on FIU

Responsibilities Include:

1. Examinations of Potentially Fraudulent EOs, Related Entities, and Individuals
2. Work with CI (and other Law Enforcement agencies)
3. Provide Expert Witness Testimony

Examination Process

- Case Identification and Selection
- Pre-examination Analysis
- Field-work
- Conclusion

Cases Identified for FIU

- Referrals and Informants
- Lead Development
- Requests for Assistance

Cases Assigned to FIU

- Cases involving substantial indicators of potential fraud
- Organization on Terrorist Watch List (OFAC), etc.
- CI Request for Cooperating Agent Particularly JTTF Cases

Pre-Examination Analysis

- Classification Information
- Forms 990, 990 T
- Filing History
- Determination File
- Related Entities and Individuals
- Internet Searches Websites
- Internal Databases
- External Databases

Field Work

- Notice of Examination
- Request for Records
- On-site and Off site
- Interviews
  - Personnel
  - Third Parties
- Summons

Conclusion of Examination

- No Change
- Advisory
- Tax Adjustment
- Penalty
- Modification
- Revocation

May be Agreed or Unagreed (Appeals)

Focus of Examination

- Organization
- Officers
- Directors
- Related Parties

May cause conflict of interests

EO Reactions To Examination

Cooperative or Non-cooperative

Generally Organization and BOD are cooperative as IRS is assisting in assuring the Charitable mission is accomplished.

Exceptions:

a. Organization is willing participant in scheme
b. Controlled by Individual(s) doing improprieties.
c. Costs (taxes, penalties, legal, accounting)

Resources on IRS Website

- Go to: http://www.irs.gov/charities/index.html
- Workshops for Exempt Organizations
- Commissioner Comments on Abuses in Tax Exempt Sector
- Taxpayer Advocacy

What to Do When the Regulators Knock at the Door

Effective Compliance Strategies

Robert F, Roach
New York University
University Compliance Officer

By in-house counsel, for in-house counsel℠

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Overview

- Effective Compliance – Avoiding the Knock.
- Responding to Government Inquiries.
- Responding When Your Organization is the Government's Target

Effective Compliance – Avoiding the Knock

- Government Agencies Often Provide Guidance on Future Enforcement Programs:
  - IRS: Tax Exempt Bond Compliance
  - IRS: New Form 990 Compliance
  - IRS: General Guidance and Resources
    - **Advisory Committee on Tax Exempt and Government Entities**

      https://www.irs.ustreas.gov/taxexemptbond/article/0,,id=134438,00.html

Other Examples:

HHS OIG Work Plan
http://www.oig.hhs.gov/publications/workplan.html

NSF Audit and Semi-Annual Reports
http://www.nsf.gov/oig/pubs.jsp

Avoiding the Knock- Compliance Steps

- Conduct Risk Analysis
  - Government Guidance
  - Industry Actions (Risk Data base)
  - Outside Counsel, Industry Groups
- Develop the Compliance Team
- Map Current Business Processes
  - Identify responsible business offices
- Develop or Update Needed Policies
- Conduct Training
- Monitor Activities
- ***Discussion: NYU's response to IRS Tax Exempt Bond and 990 initiatives***

Responding When Your Organization is the Government's Target

- *Assessing the Investigation*
  - *Conversations with the Government*
- *Developing Response Team*
  - *Outside Counsel*
  - *The Role of Compliance*
- *Protecting Privileges*
- *Engaging The Board*
  - *When to engage the Board*
  - *How to engage the Board (issues for Not- For - Profits)*
- *Corrective Actions*
  - *Corrective Action- Settlement*
- ***Discussion: NYU's Experience with the NYAG Student Loan Investigation***

Responding to Government Inquiries

- Government agencies conduct regular audits and "investigative inquiries"
  - *Corporate Response Policy*

    http://www.med.nyu.edu/compliance/policies/Resp_to_Govt_InvFINAL.doc
  - *Assessing the Inquiry*
  - *Developing Response Team*
  - *Conducting the Compliance Review*
  - *Protecting Privileges (See Supplemental Material)*
  - *Response and Corrective Actions*

Special Issues in Managing Non-Profit Investigations

Scott L. Fredericksen
Partner, Foley & Lardner

Fundamentals in responding to an investigation

What kind of an investigation and how has it been initiated?

- Federal Grand Jury subpoena
- Search Warrant executed
- Agents approach employees for interviews
- Call from a federal prosecutor
- Civil Investigative Demand
- Other

Fundamentals in responding to an investigation

Responding to the investigation:

1. Retain experienced White Collar defense counsel immediately. Your regular civil litigator is not what you need.
2. Clients should have a plan and be trained ahead of time for what to do when an investigation is initiated
3. Talking to the federal prosecutor
4. Conduct an internal investigation
5. Status of your company and its employees
6. Separate counsel for employees?
7. Preserving documents
8. Search warrants special considerations
9. Obstruction of Justice issues

Special considerations for a non-profit

This can be life and death for a non-profit. Treat it as such

1. Who is in charge: The CEO, General Counsel, the Board or all of the above.
   a. Lines of communications
   b. Maintaining the privilege
2. Does the non-profit and/or the focus of the investigation pose a public profile with media interest?
3. External communicating with the media and the public
4. Leaks
5. Privilege issues: Attorney-Client, Fifth Amendment and consequences
6. Cooperation

CONDUCTING INTERNAL INVESTIGATIONS

Daniel S. Reinberg
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PCIAA Producer Compensation Mini-Seminar
December 15, 2004

In the current regulatory environment, companies are increasingly conducting internal investigations focused on potential wrongdoing. U.S. laws and law enforcement agencies increasingly expect that companies will police their own conduct and report potential misconduct to the appropriate federal law enforcement agency. Many federal and state agencies have adopted a formal disclosure protocol under which potential misconduct or unlawful activity can be reported. Additionally, the Department of Justice has adopted Federal Guidelines on the Prosecution of Corporations that specifically require consideration of "[the] corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation . . . ." State Attorney General Offices, including the New York Attorney General Office, likewise provide far more lenient treatment to companies that make voluntary disclosures of potential wrongdoing and voluntarily take remedial action. This regulatory landscape highlights the critical importance of the issues that we will be covering today relating to internal corporate investigations and government disclosure.

There is no standard definition of the term "internal investigation." For purposes of this seminar, we mean to include the full range of information-gathering activities that a company engages in upon learning of possible wrongdoing. In some instances, the internal investigation may appropriately be limited to a few interviews and the gathering and review of a limited number of documents. In other instances, the internal investigation will require a far-reaching and comprehensive search for documents, the review of vast quantities of documents and other records, and extensive interviews of large numbers of witnesses.

For the most part, this outline focuses on internal investigations conducted as a result of concerns that *a company* may have violated U.S. law. Similar issues (as well as certain important differences) are involved in internal investigations where the company is the potential victim of misconduct (*e.g.,* theft of company assets) and we will touch upon those distinctions throughout the day.

What follows is a thumbnail discussion of seven steps for conducting internal investigations from the initial stages, to document collection, to corrective action and government disclosure.

I. DECIDING WHETHER TO INITIATE AN INTERNAL INVESTIGATION

The initial issue to be considered upon uncovering potential wrongdoing is whether an internal investigation is warranted. If it appears that the government has already initiated an investigation or that one is probable, then the case for undertaking an internal investigation is likely to be compelling. When faced with a government investigation, it is almost always in the best interests of the company to gather information to enable the company to respond effectively to the government's investigation.

There are several respects in which information gathered during an internal investigation can assist in forming an effective response to a government investigation. The internal investigation may uncover persuasive evidence from which the company can argue either that no violative conduct occurred or that the matter otherwise does not warrant prosecution. The results of the internal investigation can assist the company in deciding whether to attempt to settle the government investigation. The results of the internal investigation might assist the company in persuading the government to agree to a settlement that the company finds acceptable. Disclosing the results of the investigation can assist the company in persuading the government either that no government investigation is necessary or, more likely, that the government investigation need be far less extensive and disruptive than it might otherwise be. Evidence gathered in the internal investigation can also assist in preparing witness testimony. The internal investigation might uncover evidence that refreshes a witness's recollection so that the witness recalls exculpatory events or appears more credible than might otherwise be the case. In addition, an internal investigation might enable the company to develop themes that are helpful to the company and that place the alleged misconduct in an appropriate context.

In the context of a possible criminal prosecution, the federal sentencing guidelines for corporations provide for an increase in criminal fines to be imposed on corporations in connection with criminal violations of federal law if senior corporate personnel "participated in, condoned, or [were] willfully ignorant of the offense" or if "tolerance of the offense by substantial authority personnel was pervasive throughout the corporation." Guidelines Manual §8C2.5. Conversely, the federal sentencing guidelines for corporations provide for a reduction in the criminal fine to be imposed on a corporation, under certain circumstances, if the criminal offense occurred despite "an effective program to prevent and detect violations of law." Id. There is a presumption that the program was not effective if senior management participated in, condoned, or were willfully ignorant of the offensive conduct. §8C2.5(f). In addition, certain government agencies have formally implemented programs that are designed to encourage companies voluntarily to disclose misconduct to the government before the government begins an investigation.

The fact that, upon uncovering red flags, a company promptly undertook an internal investigation and implemented appropriate remedial action can also assist a company in arguing against the imposition of civil penalties. See United States v. Phelps Dodge Industries, Inc., 589 F. Supp. 1340 (S.D.N.Y. 1984). In Phelps Dodge, in considering the civil penalty to be imposed on Phelps Dodge in connection with an alleged violation of an FTC cease and desist order, the district court considered the company's failure to investigate indications of misconduct as one factor indicating the company's bad faith. Id. at 1364.

The case for an internal investigation is also likely to be compelling if private litigation has been commenced or is probable. An internal investigation can greatly assist a company in mounting an effective response to a private action. For example, in response to an allegation of discrimination, a prompt and effective investigation followed by appropriate remedial action can assist the company in successfully asserting an affirmative defense pursuant to Burlington Industries, Inc. v. Ellerth, 524 U.S. 742 (1998) and Faragher v. City of Boca Raton, 524 US. 775 (1998). Similarly, the extent, if any, to which the company may be exposed to punitive damages in a private action may be affected by whether a company conducted a prompt and effective investigation in response to indications that an employee or agent may have engaged in misconduct. The Restatement of Torts provides that punitive damages may properly be awarded against a

company for the misconduct of the company's employee or agent if, among other things, the company "ratified or approved of the" misconduct. Restatement (Second) of Torts § 909 (1979). Failure to conduct a prompt and effective internal investigation may be treated as a ratification for this purpose. See Davis v. Merrill Lynch Pierce Fenner & Smith, Inc., 906 F.2d 1206, 1224 (8th Cir. 1990) (Merrill Lynch "may have ratified [an employee's conduct] by failing to investigate the unusual increase in [trading] activity in [the account of an elderly widow]."). In addition, in determining the extent to which punitive damages are appropriate against a company, a trier of fact may consider whether company's management responded appropriately to indications that an employee had acted inappropriately. Id. at 1225.

Determining whether to undertake an internal investigation is more difficult where the government has not yet initiated an investigation and where it appears improbable that the government will initiate an investigation or that a private action will be brought. Internal investigations can have a number of negative consequences to a company. They can be expensive and disruptive. They can distract the energy of management and create morale problems. They can uncover wrongful conduct that might otherwise never have become known. Moreover, the process of conducting an internal investigation can increase the likelihood that information regarding possible misconduct will reach the government and/or the press. Accordingly, in the absence of a government investigation or the threat of a lawsuit, management might hesitate to authorize an internal investigation.

There are a number of reasons why management nevertheless often authorizes internal investigations even when it does not appear that the government has initiated an internal investigation or is likely to do so. First, the willingness and capacity to conduct internal investigations in response to red flags is an important component of an effective compliance program. Company personnel are likely to take a company's procedures and policies less seriously if they learn that the company does not pursue indications of wrongdoing. For example, if employees observe both that company personnel routinely make improper payments to foreign officials in order to secure business for the company and that senior management appears indifferent to these payments, employees will be more likely to ignore company policies prohibiting such payments.

Second, senior management has an obligation to take steps when confronted with indications of wrongful conduct. Recent case law indicates that members of the board of directors might be personally liable for fines, penalties and losses incurred by a company as a result of unlawful conduct by the company or its employees unless the directors have "assur[ed] themselves that information and reporting systems exist in the corporation that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with the law and its business performance . . . ." In re Caremark International, Inc. Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996). In Caremark, the court opined that, under Delaware law, a director "has a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." Id. at 970. See also McCall v. Scott, 2001 WL 118037 (6th Cir. Feb. 13, 2001). In addition,

underwriters often require companies to maintain a compliance program as a condition to the issuance of an insurance policy covering officers' and directors' liability.

In bringing an enforcement action against senior officials of a major securities dealer, Salomon Brothers, Inc., the Securities and Exchange Commission ("SEC") took the position that supervisors have a duty to gather information in response to red flags:

> Even where the knowledge of supervisors is limited to "red flags" or "suggestions" of irregularity, they cannot discharge their supervisory obligations simply by relying on the unverified representations of employees. Instead, as the Commission has repeatedly emphasized, "[t]here must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity. . . ."[1]

In this particular case, the SEC sanctioned senior officials of Salomon Brothers on the grounds, among others, that upon receiving information that an irregularity had occurred, they failed to "take action to investigate what had occurred and whether there had been other instances of unreported misconduct."[2]

Third, and perhaps most importantly, companies recognize that even where it does not appear that the government has commenced or is likely to commence an investigation, future developments might result in a government investigation. In that event, for the reasons set forth above, the information gathered during the internal investigation is likely to assist the company in responding effectively to the government's later investigation and in preparing the company's defenses.

II. Staffing The Investigation

Once the decision is made to conduct an internal investigation in response to a red flag or other indication of wrongdoing, a decision must be made regarding who will conduct the investigation. In many instances, indications of possible wrongdoing can be quickly addressed and resolved by company personnel without the involvement of outside counsel. In certain cases, company personnel have the experience and expertise necessary to obtain the information and can do so with less disruption and expense to the company than outside counsel can. For example, the human resource department often has the skills and expertise necessary to investigate allegations of employment discrimination or sexual harassment. Similarly, the internal audit department might have the skills and expertise necessary to investigate allegations of theft or embezzlement.

Companies often elect to involve attorneys in the direction and conduct of internal investigations. While there is no requirement that internal investigations be conducted or directed by attorneys, there are several reasons why this task is often delegated either to attorneys or to company personnel acting under the direction of attorneys.

[1] See, e.g., In re Gutfreund, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067 at 83,606 (Dec. 3, 1992).

[2] Id.

First, attorneys, particularly former prosecutors or other law enforcement personnel, often have the skills and substantive expertise to direct and conduct an internal investigation effectively and efficiently. Such attorneys have been trained to plan investigations, gather and review documents, question witnesses, and organize and assess the resulting information.

Second, attorneys are often asked to provide legal advice and services based on the results of the investigation. For example, if the investigation involves possible improper payments to a foreign government official, an attorney conversant with the Foreign Corrupt Practices Act will be able quickly to assess which factual issues are legally significant to the issue of whether the FCPA has been violated. Furthermore, in many instances, it is possible that there will be a need for the company to deal with law enforcement or regulatory agencies in connection with the subject matter. In these instances, there are benefits to utilizing attorneys who are familiar with the internal procedures and operations of those agencies.

Third, the involvement of attorneys will assist the company in successfully asserting the attorney-client privilege and the work product doctrine. See Upjohn Co. v. United States, 449 U.S. 383, 101 S.Ct. 677 (1981) (applying the attorney-client privilege to notes that attorneys prepared while conducting an internal investigation); In re Allen, 106 F.3d 582, 602 (4th Cir. 1997) (holding that an investigation may constitute legal services for purposes of the attorney-client privilege); United States v. Rowe, 96 F.3d 1294, 1297 (9th Cir. 1996) ("fact finding that pertains to legal advice counts as professional legal services"). The benefit of using attorneys to conduct the internal investigation is illustrated by In re Grand Jury Subpoena, 599 F.2d 504 (2d Cir. 1979). This subpoena enforcement action involved two internal investigations conducted on behalf of a single company. The first investigation was conducted "mainly by non-lawyer senior officials" of the company and the results were reported to the Board of Directors. The audit committee then retained a law firm to assist the company's vice president and general counsel in conducting a second investigation. The Court of Appeals held that the first investigation was not protected by the attorney-client or work-product privileges, even though the general counsel was one of the senior officials who participated in the investigation, but that the second investigation was protected by both privileges. Id. at 510-11. Significantly, interviews conducted by a non-attorney should be treated as privileged so long as they were conducted under the direction of an attorney and the purpose of the interviews was to assist counsel in rendering legal advice. See Carter v. Cornell University, 173 F.R.D. 92 (S.D.N.Y. 1997) (holding that interviews conducted by Associated Dean of Human Resources were privileged).

The preceding considerations apply to both in-house and outside counsel. There are a number of reasons why companies sometimes choose outside counsel to conduct an investigation. First, outside counsel often are hired because of a perception that they are more independent than company employees. This perception of greater independence can be important for a number of reasons. If the subject matter of the investigation implicates senior management or the legal department, the independence of the outside law firm might provide the board of directors additional comfort in relying on the results of the investigation. In matters that pose a potentially serious threat to the company, it often is appropriate to retain outside counsel. In determining whether the investigation is sufficiently serious to warrant the retention of outside counsel, companies consider the title and prominence of the individuals whose conduct will likely be the subject of the investigation, the potential financial exposure to the company, and the extent that the subject matter of the investigation is likely to result in law enforcement activity and/or

substantial media coverage. In order to heighten both the reality and the perception that the investigation was independent, responsibility for overseeing outside counsel is sometimes assumed by the Board of Directors, the Audit Committee, or by a special committee consisting of independent members of the board of directors. This is especially appropriate where the investigation potentially involves conduct by the senior management of the company.

A second reason for utilizing outside counsel is the need to dedicate substantial resources to responding promptly to a red flag or other indication of possible wrongdoing. It often is difficult for even large companies to pull a team of employees from ongoing tasks and devote them to an internal investigation.

A third reason for utilizing outside counsel is the possibility that members of the legal department will have relevant knowledge or that the conduct of the legal department will become an issue. For example, retaining outside counsel might be appropriate if the legal department had been consulted with respect to the transaction or activity at issue and had advised the client concerning the matter.

A fourth reason for utilizing outside counsel is the reality that specialized outside counsel might have the experience and expertise to conduct the particular investigation more effectively or more efficiently than company personnel who do not specialize in this particular type of investigation. In addition, to the extent that the subject matter of the investigation is likely to result in interaction with a law enforcement or regulatory agency, it is often useful for a company to be represented by counsel who is familiar with that agency. Similarly, if there is likely to be litigation, it often is appropriate to retain counsel with relevant litigation and trial experience.

A fifth reason for utilizing outside counsel is a desire to increase the likelihood that the results of internal investigation will be protected by the attorney-client privilege and the work product doctrine. While both the attorney-client privilege and the work product doctrine can apply to the work of an in-house attorney, see United States v. Rowe, 96 F.2d 1294, 1296 (9th Cir. 1996), a court is less likely to find that a business purpose was the primary purpose behind the investigation if the investigation was conducted by outside counsel. Paul R. Rice, Attorney-Client Privilege In The United States, 7-28 (Lawyers' Cooperative 1993) ("the courts have held that communications to and from in-house counsel can be sheltered 'only upon a clear showing that [in-house counsel] gave [advice] in a professional capacity.'") (quoting In re Sealed Case, 737 F.2d 94, 99 (D.C. Cir. 1984) (in-house counsel also had "responsibilities outside the lawyer's sphere")). If the company elects to utilize in-house counsel, and not outside counsel, it may be appropriate to take steps to ensure that the in-house counsel conducting the investigation is not also performing a business advisory function and does not have non-legal responsibilities that are arguably relevant to the investigation.

If the decision is made to retain outside counsel, the company should consider whether it should retain one of its regular law firms or whether it should retain a law firm with little, if any, prior association with the company. There are a number of potential advantages to utilizing regular counsel. Regular counsel is likely to be familiar with the company and its operations, products, and personnel. On the other hand, there are a number of reasons why it might be appropriate to retain counsel with little or no prior association with the company. First, the conduct of regular outside counsel might be an issue in the investigation. Second, regular outside counsel might lack the skills to conduct the investigation, the skills and experience to handle the anticipated

litigation and/or law enforcement activity, or the expertise in the relevant statutes. Regular outside counsel may also lack either actual or perceived independence. For example, if a law enforcement action is considered likely, the company should seriously consider retaining counsel who has experience with the relevant agency and statutes. This experience will likely enhance counsel's credibility with the relevant law enforcement agencies.

If outside counsel is retained to conduct the internal investigation, the company should assign an employee to act as a liaison between the company and the outside counsel. The liaison can be an invaluable resource regarding background information regarding the company, its history, its operations, and its recordkeeping practices. The liaison can assist outside counsel in identifying individuals and departments that are likely to possess relevant information. The liaison can facilitate the interview process by making the initial introductions between the outside counsel and the company employees with relevant knowledge. In terms of supervision of the investigation, it is usually appropriate for the Legal Department or for other senior company officials to supervise the work of outside counsel, though in some instances, outside counsel should report to the Audit Committee or a special committee of the Board of Directors. Reporting to the Audit Committee or a special committee is especially appropriate in matters where it is important to establish the independence of outside counsel and its investigation.

Internal investigations often require the assistance of individuals with accounting, engineering, or other areas of substantive expertise. One of the decisions that must be made early in an investigation is whether to rely on company personnel or outside experts for that expertise. While it frequently appears that the individuals who can most efficiently assist counsel in analyzing company information are the company personnel already familiar with the matters at issue, the costs of relying on such personnel may outweigh the benefits. In Six Grand Jury Witnesses,[3] six corporate employees, who were responsible for monitoring the costs associated with certain contracts, had been asked by corporate counsel, in anticipation of litigation, to perform an analysis of those costs. The grand jury sought testimony regarding this analysis. The corporation argued that the analysis was protected by the work product doctrine. The court held that the witnesses could be compelled to testify regarding the analysis performed, and stated that "factual information is not protected . . . just because the information was developed in anticipation of litigation."[4] To the extent that company personnel are assigned to assist counsel in the investigation, they should be careful to keep confidential any documents that they generate in such capacity and to mark all such documents confidential, privileged, and prepared for the purpose of assisting counsel.[5]

If the decision is made to retain an accounting firm, consideration should be given to whether the company should retain a firm other than its auditors. The major advantage to using the audit firm is that its personnel are familiar with the company, its procedures, and its personnel. There are,

[3] In re Six Grand Jury Witnesses, 979 F.2d 939 (2d Cir. 1992).

[4] Id. at 945.

[5] To the extent that such documents are created on computers, it is important that the computerized version of such documents also bear such legends.

however, a number of potential problems with using the audit firm. First, in many instances, the individuals who worked on the audit are potential witnesses. Using a potential witness in an investigation can be a problem because they may not be able to compartmentalize the information that they learned during the investigation from the information they possessed before the investigation commenced. In addition, there is both a danger that the auditor will not be viewed as sufficiently independent and a danger that there will be a conflict of interest between the auditor and the company. Furthermore, there might be instances when the investigative personnel of the accounting firm feel compelled to share otherwise privileged information with the audit practice of the accounting firm. This sharing of information can jeopardize the ability of the company to control the dissemination of the investigation results and protect the appropriate privileges.

If a private investigator is retained to assist the investigation, steps should be taken to assure that the investigator does not engage in conduct that might be viewed as improper by either law enforcement agencies or triers of fact. Thus, investigators should be carefully controlled and instructed that they should not to engage in misrepresentations in order to obtain desired information or in any other conduct that would be improper for counsel.

In order to maximize the likelihood that all such work product is fully protected, counsel should prepare a letter or memorandum to each expert that specifies that the expert has been retained (or in the case of company employees, detailed) to assist counsel in providing legal advice and services; that the expert is being retained or detailed in anticipation of litigation; and that the expert agrees to keep confidential any work performed pursuant to the engagement or detail.

III. Defining The Scope Of The Investigation And Developing An Action Plan

An initial assessment must be made regarding the scope of the investigation. For example, if the internal investigation is being triggered by an allegation that a specific company employee might have made an improper payment to a Mexican government official in return for the government's awarding a specific contract to the company, the scope of the investigation will include determining: (1) whether the payment was offered or made to a person who was a foreign official within the meaning of the Foreign Corrupt Practices Act (the "FCPA") and (2) whether the offer or payment violated the antibribery provisions of the FCPA. The scope of the internal investigation will also include: (1) identifying the company personnel and agents who made the offer or payment; (2) identifying any other company personnel who knew that the offer or payment was made or was being considered; (3) determining whether the company personnel responsible for the offer or payment had involved the company in any other improper payments or offers to Mexican officials; (4) determining whether any false company records had been created in connection with the transaction; (5) determining the extent, if any, to which company procedures were violated or circumvented; and (6) determining the extent to which the appropriate compliance materials had been disseminated to the involved personnel and the extent to which proper training programs had been implemented.

Determining the scope of the investigation involves a delicate balancing of the factors discussed above in determining whether to undertake an internal investigation. In the above example, for instance, consideration should be given to: (1) whether the scope of the investigation is broad enough to determine whether misconduct did in fact occur; (2) whether the scope is broad enough to uncover evidence that might assist the company in responding effectively to a government

investigation; (3) whether the scope is broad enough to enable the company to take appropriate remedial action, including determining the extent, if any, to which company personnel should be disciplined; the extent, if any, to which company records were falsified; the extent to which compliance procedures should be enhanced and/or the company's compliance policies should be clarified or expanded; and the extent, if any, to which other remedial action should be taken (e.g., if company personnel made an improper payment for the purpose of influencing the government to award a concession to the company, consideration should be given to asking the government to reopen that decision); (4) if it is anticipated that the results of the internal investigation might be disclosed to the government, whether the scope of the internal investigation is broad enough to satisfy the government; (5) the expense and disruption caused by the internal investigation; (6) the need for speed; and (7) the need to maintain the confidentiality of the internal investigation.

At the outset of the investigation, the company should issue a charter setting forth the mandate pursuant to which the internal investigation is being conducted. This charter can consist of one or more of: a resolution of the Board of Directors; a resolution of the Audit Committee; an engagement letter; or a memorandum issued by senior management or the General Counsel. The charter should instruct the investigators to conduct a confidential internal investigation, define the scope of the investigation, authorize the investigators to inform company personnel that they are instructed to cooperate in the investigation, and specify (if appropriate) that the investigation is being conducted in anticipation of litigation and for the purpose of obtaining legal advice. Because some courts cease to protect attorney work product once the litigation relating to the work product has been concluded,[6] the charter should be drafted broadly enough to cover all conceivable litigation likely to arise, including securities class actions, derivative actions, and related commercial litigation. Such a charter forces the company to focus on the scope of the internal investigation and will assist the company in successfully seeking the protection of the attorney-client privilege and the work product doctrine in the event that discovery is sought for documents generated in connection with the investigation.

This initial memorandum should also identify the client. Usually, the client will be the corporation. Sometimes, the client will be the Board of Directors of the corporation, a standing committee of the Board of Directors (e.g., the Audit Committee or the Compliance Committee), or a special committee of Board of Directors.

The scope of the investigation should be constantly reevaluated as information is gathered and analyzed. While the initial red flags or indications of possible wrongdoing might have warranted an investigation of limited scope, the investigation might uncover information that warrants a substantial expansion of the scope of the investigation. For example, an initial indication that a company improperly reexported certain U.S. technology to Iraq could trigger an internal investigation that uncovers evidence that additional U.S. technology was improperly re-exported to Iraq. It might sometimes be appropriate, on the other hand, to curtail the initial scope of the investigation once information is obtained that casts a new light on the initial red flag or other indication of possible wrongdoing. It is important that an internal investigation be conducted

[6] See FDIC v. Cherry, Bekaert & Holland, 131 F.R.D. 596, 604 (M.D. Fla. 1990) (discussing a split among courts regarding the status of work-product immunity upon the termination of underlying litigation).

quickly, efficiently and effectively, especially if the company anticipates that the government may initiate its own investigation. In many circumstances, the government will not defer its investigation pending completion of the company's internal investigation. Factors that the government considers in evaluating whether to defer its investigation include: (1) the amount of time expected to elapse during the company's internal investigation; (2) the nature of the suspected violation and whether it is potentially ongoing; (3) whether the internal investigation is being conducted by outside counsel; and (4) whether the government will be permitted to see all of the notes and records compiled during the internal investigation.

In developing the action plan, the investigative team must always consider the need for speed. This urgency can arise from several sources. There might be a need to complete the investigation before the government becomes aware of the matter. Management might need the results of the investigation so that it can make informed decisions or required disclosures. In some contexts, (e.g., the employment context), speed might be essential to establishing an affirmative defense.

The action plan should describe the documents to be gathered and identify who should be responsible for gathering the documents. The plan should also identify the witnesses to be interviewed, the nature of the questions to be posed during the interviews, and where the witnesses will be interviewed. The plan should address the order of the interviews and the extent, if any, to which potential witness interviews can be conducted by telephone or other means. In connection with both searching for documents and conducting interviews, consideration should be given to the extent, if any, to which foreign language skills will be required.

One important issue that often arises in developing an action plan is the extent, if any, to which the investigators should contact third party witnesses. In many instances, third parties are likely to possess information significant to the investigation. For example, in an investigation involving revenue recognition, customer personnel might have significant information regarding when sales contracts were executed and whether the sales contracts were accompanied by any side agreements. On the other hand, contacting third parties might endanger the confidentiality of the investigation or jeopardize the company's relationship with the third party. In many instances, an investigative plan can be developed that will enable the investigators to obtain the information they need while minimizing the associated risks.

It is important to stress that the action plan will often evolve during the investigation as documents are gathered and reviewed and as witnesses are interviewed. This evolution can result from a redefinition of the scope of the investigation, from the identification of new avenues of investigation, from the initiation of a government investigation or the receipt of a government subpoena, or from a conclusion that one of the issues initially identified has been resolved and that some of the avenues of investigation initially identified are no longer warranted.

IV. GATHERING DOCUMENTS

Documents are a key part of almost all internal investigations. Documents often contain important information. Government law enforcement officials tend to place great weight on the documents. Documents can assist counsel in obtaining information from witnesses by, for example, educating counsel so that counsel can ask more informed questions or refresh a witness's recollection.

As soon as the company becomes aware of allegations of wrongful conduct, it should consider suspending normal document retention procedures in order to ensure that company personnel do not destroy or otherwise dispose of documents relating to the transaction or the incident that is the subject of the investigation. For example, the legal department might circulate to appropriate personnel a memorandum instructing personnel not to destroy or discard specified categories of documents. Such a memorandum is especially appropriate where the company is aware that the government has already initiated an inquiry or investigation.[7] While communicating the importance of not destroying relevant documents, the memorandum should disclose only as much information regarding the matter under investigation as the recipient needs to know. It is important to consider the possibility that the company may be discarding or overwriting computerized information in the ordinary course of business as back up media are rotated and reused, and tapes are recycled, electronic media storage devices are replaced, and new software is loaded.

A diligent search should be taken to locate and secure the documents that relate to the subject transaction or incident. Before designing the search for documents, it is important to learn the types of documents routinely generated by the corporation, to review the organization chart of the company and identify company personnel likely to possess relevant documents, and to learn the company's practices regarding document retention and storage. Consideration should also be given to obtaining copies of the calendars and message slips of appropriate personnel. Similarly, compliance manuals, training materials, personnel directories, and job descriptions for the period of time that is the subject of the internal investigation should be obtained.

In designing the search for documents, consideration must be given to information saved in electronic form, such as word-processing documents, reports generated by databases, e-mail, and spreadsheets. It may be necessary to search the hard drives of certain PC's. It may also be possible to recover "deleted" materials from the user's hard drive. In many investigations, a thorough search for documents can only be conducted through individual interviews of employees about their individual document retention practices.

In conducting its document search, the company must limit its reliance on individuals who might have participated in the suspected underlying misconduct. In some instances, it is best to have counsel show up at the critical locations and search for relevant documents without prior warning so that the individuals involved in the suspected underlying misconduct will not have an opportunity to destroy or discard significant documents.

There are several reasons why it is important to act promptly to secure relevant documents. The retained documents might contain exculpatory information that would assist in the company's defense. Regulators and law enforcement officials are more likely to take severe action against a company if they learn that relevant documents were destroyed or discarded once red flags had been identified. Under some circumstances, the destruction of evidence might result in an increase in the criminal penalty to be imposed on the company, see United States v. Grewal, 39

[7] If the government has initiated an inquiry or investigation, the intentional destruction of documents might constitute obstruction of justice. If a company issues a memorandum instructing personnel not to destroy or discard documents, the likelihood the government charging company with obstruction of justice can be substantially reduced.

F.3d 1189, 1994 WL 587395 *3 (9th Cir. 1994)(imposing two-level adjustment for obstruction of justice), or might give rise to an adverse inference against the company, see Farrell v. Connetti Trailer Sales, Inc., 727 A.2d 183 (RI Sup. Ct. 1999) (advising the jury that it can draw an adverse inference against the plaintiffs because plaintiffs caused certain evidence to be unavailable to defendants).

The investigation team must organize the documents according to various criteria. Documents are generally classified in a spectrum ranging from irrelevant to crucial. In general, the relevant documents should be organized to facilitate preparation of a chronology, an analysis of key topics (e.g., a particular meeting with officials at which the prospective contract was discussed), and witness interviews. It usually is appropriate to maintain a file containing the crucial documents. This file is often referred to as the "hot document" file. In many instances, it is necessary to rely, at least in part, on a computerized system for organizing and storing documents.

A careful record should be maintained listing the locations that were searched in connection with the investigation and the individuals who were contacted in connection with the document search. A log should be created identifying the location from which each document was obtained. Where the relevant files are being actively used, consideration should be given to marking (or otherwise making a record of) the documents that were in the file at the time of the document search. The documents gathered should be numbered sequentially (e.g., bates labeled).

V. INTERVIEWING WITNESSES

Interviews are also a key aspect of the investigation process. Along with documents, interviews are the primary source of the information that will be gathered during the investigation. In addition, interviews present an important opportunity for the investigators to assess the credibility of the witness.

Counsel should interview all company personnel likely to have knowledge regarding the relevant transaction or the alleged violation. Before interviewing personnel, counsel should review the relevant documents and interviews, prepare an outline of topics to be covered with the witness, and select the documents that should be shown to the witness during the interview. Questioning witnesses regarding documents can serve several purposes. The author of a document might be able to explain what a document was intended to convey or why a document was drafted in a particular way. Other witnesses might be able to put important documents into context. The document might refresh a witness's recollection or persuade a witness to provide accurate information that the witness might otherwise have been reluctant or unwilling to provide. Counsel should be aware that showing a privileged document to a witness during the interview could result in a court later holding that the privilege has been waived.

Questionnaires should be used sparingly, if at all. In general, the use of questionnaires should be limited to soliciting objective information in order to screen for individuals who need not be interviewed. For example, in an investigation involving insider trading, it might be appropriate to circulate a questionnaire to company personnel asking them whether they were (or might have been) privy to the material nonpublic information prior to a certain date and whether they are aware of anyone else - other than identified individuals - who was (or might have been) aware of that information prior to that date.

Other company personnel should be discouraged from attending employee interviews. The presence of senior officers at interviews could chill the candor of the witness and may undermine the protection of the attorney-client privilege. Additionally, the senior officer's presence can be misconstrued as part of an effort to compare and conform the witness's recollection with the version of the facts advocated by the executive.[8]

In some instances, counsel will need the assistance of experts from outside the company. In order to maximize the likelihood that the interviews will be protected by the attorney-client privilege and/or the work product doctrine, experts should be retained by counsel, and the engagement letter should contain provisions designed to preserve the confidentiality of information shared with and the work product of those experts.

At the outset of each interview, counsel should inform the witness that: (1) senior management (or the board of directors or a special committee of the board of directors) has authorized counsel to state that company employees should cooperate in the investigation; (2) counsel are attempting to determine the truth relating to the matter and the surrounding circumstances; (3) counsel are not asking the witness to provide untruthful or misleading information to any government investigators; and (4) the witness should not destroy or discard any documents relevant to the investigation. If the investigators are attorneys they should also: (1) identify their client, and state they do not represent the individual witness;[9] (2) explain that they are seeking information to assist in providing legal advice and services to the company; (3) indicate that, in order to protect the privileged nature of the interview, it is important that the witness keep the substance of the interview confidential from anyone other than counsel; and (4) state that the company controls the privileges associated with the investigation and has the sole right to determine whether to waive those privileges and disclose the substance of the interview to the government. If the company has already agreed to disclose to the government information obtained in the interview, counsel should advise the witness of this agreement.

This is a delicate part of the interview. In communicating this information to the witness, counsel should be sensitive to the danger that these communications will cause undue alarm on the part of the witness and thereby impede the ability of the company to gather the necessary information.

Consideration should be given in advance (with the company) to whether the witness should be specifically advised that he or she may have personal counsel present at the interview. If appropriate, the witness should also be advised that the company will indemnify him or her for reasonable fees and expenses associated with the participation of personal counsel. In deciding whether the company should agree to pay these fees and expenses, the company should consider the applicable corporate indemnification statutes, the corporate charter and bylaws, the

[8] Under certain circumstances, an employee may be entitled to representation of a fellow employee. See NLRB v. J. Weingarten, Inc., 420 U.S. 251 (1975); Epilepsy Foundation of Northeast Ohio, 331 N.L.R.B. No. 92 (2000).

[9] D.C. Bar Ethics Opinion No. 269, Obligation of Lawyer for Corporation to Clarify Role in Internal Corporate Investigation (January 15, 1997) (where a possible conflict between a corporation and a corporate employee is apparent and there is any ambiguity regarding the lawyer's role, the lawyer should advise the employee of the lawyer's position as counsel to the corporation.).

applicable contract provisions if any, and the benefits that the company may derive by providing separate counsel.

It is preferred to have at least two investigators present for each witness interview. Having two investigators present makes the interview more effective since one of the investigators can take the lead in asking questions and the other can focus on taking notes. In addition, the second investigator can later serve, if necessary, as a witness to corroborate the recollections of the first investigator regarding both the statements of the witness and that the first investigator conducted the interview appropriately.

It is usually appropriate for a senior attorney to conduct the interview. First, obtaining information from a witness is a delicate art that requires substantial experience. Second, the credibility of the witness will often be important. A senior attorney might have a better sense both for assessing the credibility of the witness on behalf of the company and for evaluating whether a government agency and/or a trier of fact would find the witness to be credible.

Both the notes of the interview and the memoranda summarizing the interview should be marked as "confidential," and should note (if true) that they reflect the attorney's mental impressions and are not a substantially verbatim record of the interview. The notes should clearly reflect that the investigators made the appropriate statements to the witness (as discussed above) at the outset of the interview. The interview memoranda should contain and intertwine the attorney's mental impressions and explicit strategy because such memoranda are more likely to be protected as opinion work product under the work product doctrine. In drafting interview memoranda, the investigator should be conscious of the possibility that the memoranda will ultimately be disclosed to prosecutors or to counsel for a plaintiff litigating against the company.

If the witness is represented by counsel, caution should be exercised before agreeing that the interview will be subject to an undefined "joint defense privilege" or other limitation on the ability of the company to use the information obtained in the interview. See United States v. Weissman, 195 F.3d 96 (2d Cir. 1999). Weissman involved two interviews of the chief financial officer of Empire Blue Cross and Blue Shield. Empire was represented at the interviews by both inside counsel and outside counsel and Mr. Weissman was represented by his personal attorney. After learning that Empire was the subject of a grand jury investigation, Empire's counsel later provided its notes of the interviews to the prosecutors and the prosecutors indicted Weissman. There was a factual dispute as to whether the interviews had been expressly subject to a joint defense agreement. The Court of Appeals found that Weissman had failed to establish the existence of a joint defense agreement and that his damaging admissions made during the interviews could be used against him. Id.[10]

During the interview, counsel should ask questions designed to learn everything possible regarding the underlying transaction and the circumstances surrounding it. Thus, the investigator

[10] Weissman also illustrates the importance of documenting the extent to which the company is agreeing to limit its ability to use information obtained in an interview. After noting that neither Weissman nor his counsel were able to locate their notes to corroborate their testimony that the first interview was expressly subject to a joint defense agreement and that the notes of Empire's counsel did not refer to a joint defense agreement, the Court found that Weissman had not met his burden of showing that the first interview was expressly covered by the joint defense privilege. Id. at *43.

should refrain from relying on leading questions. Who, what, when, where, why and how questions are best relied on to elicit complete information. The investigator should listen attentively to the witness and attempt to encourage the witness to relax and tell the story in his or her own words.

It will sometimes be necessary to interview a witness more than once. At the beginning of the interview process, counsel might not be sufficiently familiar with the facts to appreciate the significance of a witness's statements. After conducting the interview, counsel might become aware of statements by other witnesses or of documents that pose new questions for the witness. As a result of information gathered during the internal investigation, the scope of the investigation might broaden to include topics that were outside the scope of the investigation when the witness was previously interviewed.

The investigators may request that the witness contact them if the witness recalls any additional information or discovers any additional documents or if the witness is contacted regarding the transaction by the media or by government officials. While it would be improper and illegal to instruct a witness not to talk to U.S. government officials, it is appropriate to discuss with the witness that the witness has the right to decline to answer questions without first contacting the company or consulting with an attorney. In conducting the interview, investigators should be careful not to attempt to influence the witness's answers. To the extent possible, the investigators should avoid telling one witness what another witness has told them or otherwise educating the witness regarding the transaction, although it will often be necessary to refresh the witness's recollection regarding facts of which the witness once had knowledge.

Company counsel should not provide an employee with a copy of the interview memorandum. While having the employee review the memorandum might enhance the accuracy and utility of the memorandum, a witness who reviews an interview memorandum might be found to have adopted the memorandum as a witness statement, which might render the memorandum discoverable under U.S. law.

Similarly, it rarely is advisable to tape record witness interviews or to have a court reporter transcribe the interview. Such a record of the interview is less likely to be treated as protected by the attorney-client and/or work product privileges than a memorandum that has been prepared by counsel and that contains the mental impressions of counsel. The Federal Rules of Criminal Procedure require production of contemporaneously recorded statements after a witness has testified on direct examination at trial. FRCP 26.2. Because the witness has not yet had an opportunity to review the documents and refresh his/her recollection or because the witness might be prey to a misguided temptation to distort the truth, an initial interview is the moment when a witness is most likely to misstate the facts. The company's ability to defend itself in a later law enforcement or private action could be substantially impaired by a record of these initial misstatements. The one exception to this rule would involve a situation where the company is the victim of the employee's conduct and the company wishes to memorialize verbatim an employee's admissions.

In many cases, former employees will be among the key witnesses. The interview of a former employee might be protected by attorney-client privilege if the witness is being interviewed regarding information obtained when the witness was an employee of the company represented by counsel. While the law is not completely settled, a number of courts have held that the attorney-

client privilege can apply to communications between a former employee of a company and counsel to a company, at least if the former employee had been employed by the company when the relevant conduct occurred. In re Allen, 106 F.3d 582, 605 (5th Cir. 1997); In re Coordinated Pretrial Proceedings in Petroleum Prod. Antitrust Litig., 658 F.2d 1355, 1361 n. 7 (9th Cir. 1981).

VI. Preparing A Report Of The Investigation

The report of the investigation usually includes: (1) identification of the circumstances that prompted the investigation and a statement that the investigation was conducted in anticipation of litigation and for the purpose of providing legal advice; (2) a description of the action plan that was implemented (e.g., the locations searched, witnesses interviewed); (3) a summary of the relevant background facts (e.g., a chronology of the relevant events, a description of the relevant individuals and entities, an outline of the relevant agreement and/or transactions); (4) with respect to the key facts, a discussion of the evidence; (5) an outline of the relevant law; (6) an application of the law to the evidence gathered during the investigation; and (7) identification of the corrective measures that should be considered (or have been taken) as a result of any issues uncovered during the investigation. In many instances, the report should also include an introductory section (or executive summary) that briefly sets forth the investigator's conclusions and recommendations.

To an extent, the preparation of draft portions of the report is integral to the conduct of the investigation. As the investigation is being commenced, the investigators should begin preparing a working chronology. This chronology should be annotated both to show the document(s) and interview(s) on which each entry is based and the document(s) and interview(s) that appear to be inconsistent with each entry. Then, as the investigation progresses, the chronology should be frequently revised to reflect new facts. Such a working chronology will help counsel better understand the facts and their implications and will also prompt certain new lines of questioning with the witnesses.

In order to protect the privileged nature of the chronology, its distribution should be carefully limited and it should never be shown to a witness.

The evidence relating to key facts is often ambiguous and/or conflicting. The description of this evidence in the report should be balanced and complete. It usually is appropriate to discuss incriminating evidence in the report even if the investigators believe that the incriminating evidence is outweighed by the exculpatory evidence. See, e.g., In re John Doe Corp., 675 F.2d 472, 489-92 (2d Cir. 1982) (a decision had been made to exclude from the report a reference to the possibility that a payment to an attorney was for the purpose of bribing local governmental officials, and the court held that this decision might have been for the purpose of creating a misleading report). A balanced report is more informative to the company officials who must act on the report and more credible to law enforcement officials who may later review it. A report that includes exculpatory as well as incriminating evidence is also more fair to the individuals and entities that may be criticized in the report.

To the extent appropriate, the report should include positive findings. For example, even if the investigation determines that a sales manager had caused U.S. technology to be reexported to Iraq, it might still be accurate to report that the company had established compliance procedures prohibiting such reexports, that these procedures were reasonably designed, that this prohibition

had been stressed in specific training programs, that one factor in determining bonuses was the extent to which sales management promoted a good compliance atmosphere, that senior management had no prior involvement in the incident, and that when senior management learned of the incident, they promptly authorized an internal investigation, disciplined the sales manager, and took steps to enhance the compliance system.

Careful consideration should be given to whether some or all portions of the investigation should be reduced to writing. Reducing the report to writing can offer a number of benefits. Written reports often contain substantially more content and more precise analysis, and are easier for company management to digest, than oral reports. The Board of Directors may feel more comfortable relying on a written report than on an oral report. If disclosed to the government, a written report can help persuade the government that a thorough investigation had been conducted and either no wrongful conduct occurred or that government action is otherwise not warranted.

There are also a number of problems associated with reducing a report to writing. The process of writing a report can be expensive. If disclosed to the government or to others outside the corporation, the written report can be used against the company. Production of the written report is likely to jeopardize the privileges associated with the investigation. In subsequent litigation, adversaries will seek to discredit the report by identifying arguable omissions or inaccuracies in the report.

Careful consideration should also be given to whether the company should disclose the results of the investigation to the government. Under some circumstances, companies have a legal obligation to report to the government or otherwise disclose that they have engaged in conduct that is unlawful. The New York Stock Exchange requires that member firms promptly report to the NYSE whenever the member, or any employee associated with the member, has violated any provision of any securities laws or regulations or any rules of a self-regulatory organization or has engaged in conduct inconsistent with just and equitable principles of trade. NYSE Rule 351. Under some circumstances a publicly owned corporation may have an obligation under the federal securities laws to disclose in its periodic reports or on a Current Report on Form 8-K a violation of law that is material to the operations or financial condition of the company.[11, 12] The Department of Commerce has promulgated regulations imposing on U.S. persons an obligation to report requests that the person take any action which has the effect of furthering or supporting a restrictive trade practice or boycott. 15 CFR §760.5.

[11] See SEC v. Fehn, 97 F.3d 1276, 1290 (9th Cir. 1996); Roeder v. Alpha Industries, Inc., 814 F.2d 22 (1st Cir. 1987); In re Par Pharmaceutical, Inc. Securities Lit., 733 F. Supp. 668, 674 (S.D.N.Y. 1990). But see United States v. Matthews, 787 F.2d 38, 39 (3d Cir. 1986); United States v. Crop Growers Corporation, 1997 WL 10029 (D.D.C. January 3, 1997); Ballan v. Wilfred American Educational Corp., 720 F. Supp. 241, 249 (S.D.N.Y. 1989); In re Teledyne Defense Contracting Deriv. Litig., 849 F. Supp. 1369 (C.D. Cal. 1993).

[12] In general, a failure to disclose a felony is not a misprision of a felony under 18 U.S.C. §4 absent some "affirmative step to conceal the crime." United States v. Cliambrone, 750 F.2d 1416, 1417 (9th Cir. 1985). See also United States v. Cefalu, 85 F.3d 964, 969 (2nd Cir. 1996).

In a criminal context, self-reporting can increase the likelihood of the company's obtaining lenient treatment. As set forth above, a number of government law enforcement agencies have formal programs that offer leniency to companies that report violations before the government begins an investigation. Absent such a program, prosecutors may nevertheless exercise their discretion and decide not to prosecute a company that has voluntarily reported a violation. See John Gilbeaut, "Getting Your House In Order," ABA Journal 64, 68 (June 1999) ("As a practical matter, if a company self-reports, a prosecutor probably isn't going to charge the corporation.") (quoting the U.S. Attorney for the Northern District of Illinois); Dominic Bencivenga, "Reporting Wrongdoing: Taking Time To Investigate Is Considered Delay," New York Law Journal at 5 (March 7, 1996) ("Corporations wanting to avoid indictment must be proactive, and [prosecutors] will not look kindly at a [reporting] delay.) (quoting the U.S. Attorney for the Southern District of New York). The federal sentencing guidelines for corporations provide for a corporation to receive credit for having an effective program to prevent and detect violations of law only if, after becoming aware of offense, the corporation does not unreasonably delay reporting the offense to appropriate government authorities. §8C2.5. Voluntary disclosure to the government might also assist the corporation in receiving credit for full cooperation in the investigation and for acceptance of responsibility for criminal conduct. For example, after Salomon Brothers (in the case discussed above) voluntarily notified the government of misconduct, provided to the government detailed information regarding the firm's internal investigation, provided documents to the government, and made employees available for interviews and testimony, the U.S. Attorney announced that criminal charges would not be pursued. See Press Release, U.S. Attorney For the Southern District of New York (May 29, 1992).

A vivid example of the potential benefits of self-reporting can be found in the antitrust field. The Antitrust Division of the Department of Justice has established a program which, under certain circumstances, allows corporations and corporate officers to obtain leniency if the corporation or corporate officer reports antitrust activity of which the Division was previously unaware. See Stephen J. Squeri, "Minimizing Damage to Your Client Through Corporate Compliance Programs and the Antitrust Division's New Corporate and Individual Leniency Programs," at 6.005-6.011 to be found in Materials on Antitrust Compliance (Business Laws, Inc. 1993). In some circumstances, corporations can obtain leniency by self-reporting even if the Antitrust Division has already begun an investigation. Id. In 1999, the Department of Justice obtained criminal fines totaling $500 million against two pharmaceutical firms, but did not criminally prosecute a third pharmaceutical company which had participated in the antitrust conspiracy. The Deputy Assistant Attorney General for the Criminal Division explained that the third company was treated leniently for having provided the information that the Division "needed to crack the largest antitrust conspiracy uncovered to date." Press Release, Department of Justice, "F. Hoffman–LaRoche Agrees To Pay $500 Million, Highest Criminal Fine Ever (May 20, 1999).

If the company decides to make some disclosure to the government, it might attempt to limit the extent of the disclosure. In some circumstances, the government might agree that it is sufficient if the company identifies the nature and extent of the offense and the individual(s) responsible for the criminal conduct. In general, however, the government will often press to see both the report of the internal investigation and/or the materials generated and collected in connection with the investigation. Outside legal counsel should always be consulted prior to making a disclosure to the government.

If the company decides to disclose a written report to the government, there is a substantial risk that all of the company's privileges with respect to the investigation will be deemed waived. A majority of the courts addressing the issue have held that disclosure of a report to a law enforcement agency waives any privileges that would otherwise attach to the report under U.S. law. See In re Subpoena Duces Tecum (Fulbright and Jaworski), 738 F.2d 1367 (D.C. Cir. 1984); Westinghouse Electric Corp. v. Republic of the Philippines, 951 F.2d 1414 (3rd Cir. 1991); In re Martin Marietta Corp., 856 F.2d 619 (4th Cir. 1988). The Eighth Circuit has held that voluntary disclosure of an internal investigation report does not waive the privileges that would otherwise attach to the report. Diversified Industries, Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977)(en banc). The U.S. Court of Appeals for the Second Circuit has held that there may be situations in which the agency and the disclosing entity may enter into an explicit agreement that the agency will maintain the confidentiality of the report. In re Steinhardt Partners, L.P. 9 F.3d 230 (2d Cir. 1993).

Accordingly, if a company decides voluntarily to disclose to a governmental agency the report of its investigation, the company should seek an agreement with the government expressly stating that: (1) the disclosure is being made at the request of the agency; (2) it is the intention of both the disclosing entity and the agency that the disclosed materials will be kept confidential; (3) it is the intention of both the disclosing party and the agency that the disclosure should not act as a waiver of the attorney-client privilege and the work product doctrine as to any other materials; and (4) it is the intention of both the disclosing party and the agency that with respect to any other entity the disclosure should not act as a waiver of the attorney-client privilege and the work product doctrine. Some law enforcement agencies may even agree to support the company if the company later has to argue that the voluntary disclosure to the government should not be deemed a waiver. For example, in connection with a company's agreeing voluntarily to disclose the results of an internal investigation to the Securities and Exchange Commission, the SEC may now agree to intervene in a private discovery dispute and file papers urging that the disclosure should not be deemed to have waived the privilege.

If a company decides to disclose the report of the internal investigation to the government, and the report is critical of specific individuals and companies, disclosure of the report might result in a claim for defamation, invasion of privacy, publicity in a false light, tortious interference with economic interests, or infliction of mental distress. See Pearce v. E.F. Hutton, Inc., 664 F.Supp. 1490 (1987) (former E.F. Hutton branch manager sued E.F. Hutton and former Attorney General Griffin Bell in connection with a report of an internal investigation prepared on behalf of E.F. Hutton).

In any event, steps should always be taken to protect the investigation and any written investigation materials from discovery. Any documents or other written materials prepared as part of an investigation should be marked privileged and confidential, and their distribution should be limited.

VII. TAKING CORRECTIVE ACTION BASED ON THE INVESTIGATION

The company must assess what corrective action, if any, should be taken in light of the information gathered during the internal investigation. Throughout the course of the investigation, counsel and the company should be alert to whether there might be an ongoing, recurring or other prospective violation of law or of the company's policies and procedures. If it

appears that there might be an ongoing or recurring violation, then the company should take measures necessary to prevent any further violations. These measures can consist of instituting new procedures, instituting new training sessions, and/or disseminating compliance materials.

Furthermore, the company should consider whether any employee and/or agent should be disciplined and whether the investigation has revealed any areas in the compliance program that should be enhanced. In many instances, the decision to sanction the employee is difficult. The employee may be a valuable employee who has (lawfully) enabled the company to earn substantial money in the past. The disciplining of the employee may have an adverse impact on employee morale and may expose the company to legal liability. In addition, the disciplining of the employee may increase the likelihood of the government learning of the unlawful conduct. The imposition of discipline might trigger a reporting obligation,[13] the disciplined employee might go to the government, or the disciplining of the employee might otherwise attract attention (e.g., the disciplined attorney might file a wrongful discharge action). In any subsequent litigation or governmental investigation, the disciplining of the employee may be considered an admission.

On the other hand, there are important reasons to impose sanctions on employees who violate company policies. The policies will lose their force if they can be violated with impunity. The employees might engage in future violations. If the company does not sanction employees who act improperly, the government will likely conclude that the company condoned the misconduct or lacks a meaningful compliance policy. The availability of an affirmative defense to a sex or race harassment claim may also depend upon whether sanctions were imposed. Under the Faragher/Burlington Industries analysis, the employer must show that it exercised reasonable care to prevent and promptly correct the harassing behavior. The effectiveness of the corrective steps taken must be assessed, such as whether or not the alleged harasser was removed as the immediate supervisor for the victim and whether, if there are prior incidents of harassment by the alleged harasser, the employer terminated, suspended, or at a minimum, severely reprimanded the alleged harasser upon finding that the alleged conduct occurred.

The sanction should reflect the seriousness of the offense, the extent to which the employee has been put on notice that the conduct at issue was contrary to company policy, and the need to protect the company from future violations. In some instances, the company can appropriately respond to an infraction with additional training and education coupled with a reprimand and/or warning. In other instances, the company can appropriately sanction the employee by suspending the employee, denying the employee a promotion, demoting an employee, or denying the employee a bonus. In other instances, especially instances involving criminal conduct that puts the company at risk or poses a substantial threat of future violations, it may be appropriate to terminate an employee. With respect to claims of employment harassment, the remedial steps

[13] For example, the Form U-5 promulgated by the National Association of Securities Dealers (the "NASD") requires that member firms of the NASD, with respect to terminated employees, report whether the employee "[c]urrently is, or at termination was . . . under internal review for fraud or wrongful taking of property or violating investment-related statutes, regulations, rules or industry standards of conduct." Similarly, the New York Stock Exchange requires members of the exchange to promptly report whenever an employee of the member is the subject of any disciplinary action taken by the member against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of $2,500 or any other significant limitation on activities. NYSE Rule 351.

must be "reasonably calculated" to halt the harassment. In considering the appropriate discipline to be imposed, the company should also consider the legal standard likely to be applied in evaluating whether the discipline was excessive (e.g., is the employee an at will employee or can the employee only be fired with just cause). The sanctions should be applied fairly and consistently.

In most instances, the employee should be provided advanced notice of the tentative findings of the internal investigation and should be given a fair opportunity to respond to that notice. In addition to the benefits intrinsic in providing a fair procedure to an employee before discipline is imposed, providing the employee with a fair opportunity to respond to the notice will benefit the company by permitting it to make a more informed decision regarding the sanction, if any, that is appropriate.

Disciplinary action that results in the termination of the employee responsible for alleged misconduct may lead to the employee bringing a lawsuit for wrongful discharge. Courts differ as to the legal standard to be applied in determining whether the disciplined employee has a cause of action against the company. Compare Cotran v. Rollins Hudig Hall International, Inc., 17 Cal. 4th 93, 69 Cal. Rptr.2d 900; 948 P.2d 412 (1998) and Sanders v. Parker Drilling Company, 911 F.2d 191 (9th Cir. 1990) (applying Alaska law). In Cotran, a company had terminated an employee after finding that the employee had sexually harassed certain fellow employees. The terminated employee sued his former employer alleging that he had been terminated without just cause. The trial court ruled that the issue was whether the employee had actually engaged in the alleged sexual harassment, found that the terminated employee had not engaged in sexual harassment, and held that the employee had therefore been terminated without just cause. The Supreme Court held that the employee had been terminated with just cause as long as at the time of the decision to terminate the employment, the employer, acting in good faith and following an investigation that was appropriate under the circumstances, had reasonable grounds for believing plaintiff had done so. 17 Cal. 4th at 109. In Sanders, two employees of Parker Drilling Co. informed Parker's safety managers that several fellow employees were routinely smoking marijuana on the job and during break periods. The company asked for and obtained written statements from the two employees stating this accusation. The company then confronted the plaintiffs who denied using drugs. Based on this information, Parker terminated the plaintiffs. The Ninth Circuit held that to carry its burden of showing just cause for termination, Parker had the burden of showing that the discharged employees had engaged in the alleged prohibitive conduct and that Parker's subjective good faith belief that it possessed good cause was insufficient. 911 F.2d at 194-95.

Finally, a company considering remedial action should consider taking additional remedial steps, such as making compensatory payments to individuals or entities that were overbilled; making job offers to job applicants against whom the company had discriminated; and correcting disclosure statements that have been released to the investing public.

Director and Officer Liability Trends

DIRECTOR AND OFFICER LIABILITY TRENDS

INTRODUCTION

"Director and Officer Liability Trends" was a featured breakout session at the seventh annual National Directors Institute, hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The panel discussion was led by Foley Partner Gordon (Chip) Davenport III along with Michael Rice, Chief Executive Officer of Aon Financial Services Group, and Dan Fortin, Senior Vice President of CNA Financial Corporation.

The panel presentation featured an overview of the latest trends in director and officer (D&O) litigation and the D&O insurance marketplace. Panelists discussed how insurance companies evaluate the companies for which they write D&O policies as well as steps a company and its directors and officers can take to secure the best possible D&O insurance coverage.

TRENDS IN LITIGATION AND THE D&O INSURANCE MARKET

The important factors in determining the price and scope of D&O coverage are frequency of claims and severity of claims. The year 2007 saw a decrease in the number of federal securities class action claims. The average settlement size of federal securities class action claims also decreased from $38 million in 2006 to $25.8 million in 2007. The result is a strong buyers' market for D&O insurance — coverage is broader and premiums are down. D&O renewal rates have decreased each quarter for the past 17 quarters. In the fourth quarter of 2007, the renewal premiums for all industries were down 18.9 percent. Similarly, renewal premiums for Fortune 500 companies were down 22.9 percent.

However, the early numbers for 2008 may have an impact on this buyers' market. Based upon the last five months of 2007 and the first two months of 2008, the annualized rate of federal securities class action claims is 240. Although this increase in frequency may lead to increased premiums, such changes are not likely to occur in the current year. Generally, it takes about a year for external events such as frequency of claims to impact pricing. This is due in large part to the fact that most D&O insurers insure their books of business with reinsurers. These policies typically have a term of one year. When they expire, D&O insurers may need to respond to an increase in the frequency of claims by increasing premiums for the next year's terms.

When selecting a D&O insurer, a company and its directors and officers should have a good understanding of the D&O insurance marketplace and its players. Several factors should be considered during the selection process:

- There are approximately 40 insurers with an appetite for public and private company D&O insurance.

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- While D&O pricing acts in a commodity-like fashion, no two carriers write the same policy. As a result, D&O insurance cannot be viewed as a commodity, and a careful analysis of the insurer's policy form is critical.
- Although there is no Standard and Poor's (S&P) AAA-rated carrier that writes D&O policies, the financial strength of the carrier is important and needs to be considered.
- Due in part to the decrease in frequency of claims, D&O insurers are bypassing reinsurers and keeping more of the risk. As the frequency of claims increases, carriers without reinsurance policies will change pricing quickly as losses increase.

Similarly, a company and its directors and officers should have a good understanding of the hot topics that D&O insurers are facing. When dealing with public companies, D&O insurers are concerned with:

- Exposure to subprime-mortgage-related liability
- Stock option grant practice
- Mergers and acquisitions (M&A) plans and procedures
- Sarbanes-Oxley Act compliance and enterprise risk management
- Board/senior management turnover
- Existing litigation and U.S. Securities and Exchange Commission (SEC) investigations
- Stock price volatility and industry volatility
- Increasing shareholder activism
- Foreign Corrupt Practices Act (FCPA) adherence
- Global warming

When dealing with private companies, D&O insurers are concerned with:

- Audited financials
- Employee count/growth
- "Securities" exposure for exempt offerings
- Initial public offerings (IPO) plans
- Quality and independence of board and senior management

D&O INSURANCE FROM THE INSURER'S PERSPECTIVE AND IMPLICATIONS FOR DIRECTORS

When purchasing a D&O policy or renewing an existing policy, companies and their directors and officers can increase their understanding by viewing the process from the perspective of the D&O insurer. First, it is important for companies to understand how D&O carriers price premiums: by using a combination of objective and subjective criteria to price premiums. The objective criteria include:

- Whether a company is owned publicly or privately or is a nonprofit
- Market capitalization
- Assets
- Revenue
- Industry
- Location
- Beta
- Credit rating

Once these objective factors are analyzed, subjective factors are considered. These are factors that a company can emphasize to distinguish it from others with similar objective factors and to obtain better pricing and coverage. In addition, a company has a greater ability to influence how a D&O carrier views these subjective factors, which include:

- Financial performance
- Stock price performance, short sales, and volume
- Corporate governance
- Investor profile
- Internal controls, compliance, and code of conduct
- Claim activity, legal proceedings, and investigations
- Accounting practices
- Insider trading practices

Along with these subjective factors, there are other "intangibles" that can help buyers secure better pricing and coverage. For example, relationships play a significant role in pricing, terms, and claims. It is therefore in a company's best interests to develop a good relationship with its insurer. As part of this relationship, a company should conduct objective risk assessment and should address negative risk factors proactively. By doing so, the company will find that a D&O carrier may be more willing to reduce pricing and give broader coverage.

ENSURING THE BEST COVERAGE FOR D&O LIABILITIES

There are several key issues that a company and its directors and officers should consider and address to obtain the best possible D&O policy:

- D&O coverage is just one type of coverage that a company and its directors and officers should consider when evaluating "executive risk" coverage. Other types include coverage for errors and omissions (E&O), employment practice, fiduciary liability, A-side coverage, and intellectual property (IP).
- The insurance market changes constantly. Insurance companies issue policies that vary from year to year on price and on terms and conditions. Therefore, it is important for a company to continually compare its coverage to the current best available coverage on the market. A company should strive to review and compare its policy to others in the market every year.
- Some brokers are better than others. A company's broker should have expertise in executive risk coverage and experience with executive risk placements, and should be knowledgeable about the executive risk markets.
- Although it is important to utilize a good broker, a company should not completely rely on that broker. A company and its directors and officers should be active buyers. They should thoroughly analyze renewal proposals for price and, more important, the terms and conditions of the policy. They should create a list of targeted improvements to their policy and should negotiate actively for improvements to weak spots.
- Price is not the only factor to consider when purchasing a D&O policy. A company and its directors should review the details of coverage terms and conditions, the strength of the carrier, and the reputations of carriers for handling claims.
- A company and its directors and officers should build relationships with their carrier. Such relationships may result in better coverage terms.
- If a company is switching carriers, it should pay attention to continuity of coverage issues such as prior acts coverage, tail coverage, and notice of circumstances under the company's old policy.
- A company and its directors and officers should evaluate and address their particular risk exposures. These may include international exposures, IP exposures, or risks related to private placements or professional services.
- A company and its directors and officers should know the details of the coverage they purchase. Such details include the types of coverage, the amounts of coverage, the premiums, and the different carriers in the market. The most important details, however, are the coverage terms and conditions.

As mentioned above, a company and its directors should pay attention to key coverage terms. Some examples of important coverage terms that may be negotiated include:

CRIME/FRAUD EXCLUSION
There are important differences in the fine print of this exclusion (which appears in every D&O policy) that determine when the exclusion kicks in and the type of conduct to which it applies. It comes into play frequently in securities cases, which frequently include allegations of fraud.

PUNITIVE DAMAGE COVERAGE
Some policies cover punitive damages and some do not. Also, some states do not allow this coverage, but there are terms that can be negotiated into a D&O policy to maximize the possibility that punitive damages will be covered.

REGULATORY INVESTIGATION COVERAGE
Many D&O policy forms do not cover, or provide only limited coverage for, regulatory investigations, which can be quite expensive.

SEVERABILITY
This provision determines who loses coverage if the carrier rescinds the policy. If the policy is rescinded for failure to disclose material facts in the application, the presence or absence of a severability provision will determine whether coverage will be lost by only those responsible for the nondisclosure lose coverage or by everyone — the company and all officers and directors.

HAMMER CLAUSE
This clause gives the insurance company leverage to force a settlement by capping coverage if the insured does not agree to settle.

FOR MORE INFORMATION
For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi2008 or contact the panelists directly.

Internal Investigations

INTERNAL INVESTIGATIONS

INTRODUCTION

"Internal Investigations" was a featured breakout session at the seventh annual National Directors Institute hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The session was moderated by Bryan B. House of Foley and Robert Huff of Aon Consulting. Panelists were Kirk G. Forrest of Minerals Technologies, Inc.; Dawson Horn III of Altria Corporate Services, Inc.; Amy Jones of McDonald's Corporation; Jonathon Crook of Eversheds LLP; and Scott I. Shaffer of Deloitte Financial Advisory Services LLP.

ONE SIZE DOES NOT FIT ALL

Internal investigations come in all shapes and sizes, and they come from many sources. Not all investigations will rise to the level requiring that the general counsel be involved. Often, there may be small matters that rise through the internal audit function in the ordinary course. It is important, however, that the internal audit group has a reporting role to the general counsel (or the chief compliance officer, if the company has such a position). The internal audit function also should have a direct line to the audit committee. Other investigations may come through the company's "hotline," and still others regarding minor employee misconduct may be led by the human resources department.

It is not efficient or necessary for the general counsel to be involved in all these types of investigations. There should, however, be a mechanism that would allow these types of investigations to be elevated to the level of the general counsel if the discovered facts warrant such action. If the initial reported issue has an impact on a company's financial statements, senior management's credibility, or the company's reputation generally, it becomes a "big ticket" item and the general counsel needs to play a central coordinating role from the outset.

BIG TICKET INVESTIGATIONS AND PRIVILEGE

Well before a big ticket investigation ever commences, it is important to be properly prepared for such an endeavor. While not all investigations will require outside assistance, a general counsel should have a short list of "go-to" law firms and consultants for these types of matters before they arise. Once the investigation has been initiated, the general counsel or a designee must ensure the proper and efficient flow of information within the company. One of the most important reasons for this centralization of control relates to maintaining the attorney-client privilege to the

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extent possible.[1] The protection of privilege will require all communications and actions to be filtered through the office of the general counsel or through the general counsel. The general counsel also may consider hiring consultants and experts directly rather than allowing an outside law firm to do the hiring.

In furtherance of this paramount objective, it may be necessary to also limit the amount and type of information that is communicated to the board of directors and the executive officers.[2] This may be a fine line to toe, as it is important to limit the exposure of the board and officers, but the general counsel should keep each adequately informed so as to not surprise either with the progress or results of the investigation. A general rule to be followed during all internal investigations: All vital and potentially damaging communication within the company should be conducted orally, with two lines of communication open at all times, one to the general counsel and one to the CEO. If the CEO or other executive officers are implicated in wrongdoing, this could alter the reporting process and require that the general counsel communicate directly with the chairman of the audit committee, for example.

The involvement of government regulators makes privilege decisions much more difficult. To be viewed as cooperative, companies often feel they must waive privilege. In late 2006, Deputy Attorney General Paul McNulty issued a memorandum setting forth additional guidance on the doctrine of attorney-client privilege and the work product doctrine, "one of the oldest and most sacrosanct privileges under U.S. law," and noted that the waiver of the corporate attorney-client privilege is not a prerequisite to finding that a company has cooperated in a government investigation.[3] This memo was a step back from an earlier, harsher position suggesting that refusal to waive privilege could lead the government to view the company negatively. The privilege waiver issue often arises in the context of U.S. Securities and Exchange Commission (SEC) investigations when a company wants to disclose the results of its internal investigation to the SEC in an effort to avoid or limit SEC charges. The law, at least in most jurisdictions, rejects the

[1] The company must give special and expert attention to the preservation of the privilege in international matters. In such cases, it may be important to have local counsel who understand the privilege issues and can communicate them effectively to the overseas employees and company officials.

[2] For more information on the doctrine of corporate privilege, please see *Ryan v. Gifford,* 2008 WL 43699 (Del. Ch. Jan. 2, 2008), which held that the company waived its corporate privilege when the special committee presented its findings to the board of directors while the director defendants were in attendance, along with their personal outside counsel, at the board meeting in their individual, not fiduciary, capacities along with their personal outside counsel.

[3] The McNulty Memorandum, issued December 12, 2006, softens the inflammatory guidance resulting from the previous two memoranda discussing the attorney-client privilege. The McNulty Memorandum sets forth the requirements to which investigators and prosecutors must adhere when investigating a matter. The standard for requiring disclosure of privileged material: "[T]here is a legitimate need for privileged information to fulfill their law enforcement obligations." The memorandum can be read in its entirety at http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf.

doctrine of "selective waiver" and holds that privilege as to those materials (or even the entire subject matter) has been waived.[4]

OUTSIDE EXPERTS AND CONSULTANTS

When dealing with intensive, closely monitored inquiries by government or regulating authorities, companies should consider hiring outside specialized legal counsel as well as a sophisticated accounting firm to ensure that the matter is handled properly and thoroughly. It is important to trust the competency, professionalism, and fiscal responsibility of the outside experts. Although it is important to contain and monitor the costs of such outside advisers during an internal investigation, it is equally important to keep the costs in perspective relative to the greater picture and potential ramifications of a negative result.

At the commencement of the investigation, it is important to the sanctity of the examination to preserve the relevant data within the company. This can be accomplished in two main ways. First, it is important for the company to have a proper and comprehensive electronic document retention policy. The company should build on that policy to institute a legal hold for all company employees with respect to any documents that may be relevant to the investigation. This is becoming increasingly important as courts are becoming much more willing to penalize companies that improperly handle the preservation of electronic documents. A company's in-house information technology staff will be critical to this effort. Second, conducting employee interviews as soon as possible after the commencement of the investigation also can preserve the mental impressions and verbal communications necessary to the completion of the investigation.

While companies should use consultants and experts for document collection and analysis when necessary, there are ways to control costs. The key is proper "scoping" of the work the consultants will do. General counsel should demand a work plan from these kinds of consultants, and the general counsel should have regular meetings or conference calls with the consultants to follow the progress being made. Because internal investigations often are dynamic, it may be necessary to change the work plan; regular communication should help prevent unwelcome surprises.

CONFLICTS WITH THE COMPANY'S AUDITOR

The company may want to retain specialized accounting experts for matters relating to complicated financial matters. Retention of an independent accounting firm for a specific "deep-dive" audit often is necessary to truly understand a matter and to keep it cloaked in legal

[4] For more information on the doctrine of selective waiver and proposals to codify the doctrine, please see proposed Rule 502 to the Federal Rules of Evidence and *In re Initial Public Offering Securities Litigation,* 2008 WL 400933 (S.D.N.Y., Feb. 14, 2008).

privilege. In these complicated financial investigations, it is not wise to use the company's regular auditor — for at least two reasons. First, very often these investigations will raise questions regarding what the auditors knew and when they knew it. Therefore, the regular auditor's conflict of interest would seem to preclude that auditor from assisting in the investigation. Second, there typically is no legal privilege between a company and its regular auditor, so the company should hire outside experts to maintain privilege. Both of these issues are complicated because the auditor often will want to know what the company has found in course of the investigation and whether it can continue to rely on management and/or the previously issued financial statements.

Again, communication is key. Counsel and/or the consulting experts may need to regularly update the auditor regarding the progress of the investigation. To maintain privilege to the extent possible, these conversations should be oral. This is particularly true because the company may have to disclose potentially damaging facts in these communications.

FOR MORE INFORMATION

For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi or contact the moderators and panelists directly.

Relevant Information from ACC Website

Sample Investigation Guidelines

- *Year:* 2007
- *Description:* Excerpted from Program 002 2007 ACC Annual Meeting: The following guidelines apply to an internal investigation of potential violations of law or XYZ Company Compliance policies.
- *Link:* http://www.acc.com/resource/index.php?key=8993

Recent Trends in Internal Investigation

- *Author:* Theodore Banks, Tom Giller, Scott Lassar
- *Year:* 2007
- *Description:* The "new job" of in-house and outside counsel involves acting as a private eye of sorts. Tracking down allegations of wrongdoing, which range from the improper use of the company car by a manager, to securities fraud by the CEO, has developed into a legal sub-specialty that is taking up a lot of lawyer's days. Here, the authors point out the recent trends in corporate America that will possibly effect how this area of the law will continue to evolve.
- *Material Type:* ACC Docket Article
- *Link:* http://www.acc.com/resource/v8312

Managing an Internal Corporate Fraud Investigation and Prosecution

- *Author:* John P. Langan and M. Jack Rudnick
- *Year:* 2007
- *Description:* In order for in-house counsel not to find themselves the subject of the next audit committee inquiry at their company, it is vital that they know how to properly investigate and pursue internal allegations of such "white collar" crimes as fraud, theft, and corporate malfeasance. The fact that the allegation is never the only focus of a possible audithow your legal department responded to the claim is as well should be enough to get you to read the steps in handling such cases outlined here.
- *Material Type:* ACC Docket Article
- *Link:* http://www.acc.com/resource/v8313

Successful partnering between inside and outside counsel "Chapter 35 Internal investigation " Non-Destruct Memorandum (shorter version)

- *Year:* 2005
- *Description:* Successful partnering between inside and outside counsel " Chapter 35 Internal investigation " Non-Destruct Memorandum (shorter version)
- *Material Type:* Sample Form & Policy
- *Link:* http://www.acc.com/resource/v5560

Detailed investigation checklist

- *Year:* 2005
- *Material Type:* Sample Form & Policy
- *Link:* http://www.acc.com/resource/v7061

Internal Investigation of Suspected Wrongdoing By Corporate Employees

- *Author:* Gregory J. Wallance & Jay W. Waks
- *Year:* 2000
- *Description:* "The following discussion concerns the investigative tools, applicable privileges, and preservation of confidentiality. As with compliance programs, an internal investigation must address the question of whether violations of law by executives or employees should be disclosed to a government agency."
- *Material Type:* Article
- *Link:* http://www.acc.com/resource/v3539

How to Respond to a Government Investigation: Protecting Applicable Privileges

- *Year:* 2005
- *Material Type:* Quick Reference
- *Link:* http://www.acc.com/resource/v6305

IRS Exempt Organization Implementing Guidelines

http://www.irs.gov/charities/charitable/article/0,,id=181194,00.html

The IRS annually publishes its internal guidance for implementing the Exempt Organizations portion of the Tax Exempt and Government Entities Division Strategic and Program Plan (sometimes referred to as the *EO Work Plan*). Implementing guidelines are available for:

- Fiscal year 2008
- Fiscal year 2007
- Fiscal year 2006
- Fiscal year 2005