CL01 – Designing a "Best Practices" Plan to Ensure Financial Compliance

This material is protected by copyright. Copyright © 2007 various authors and the Association of Corporate Counsel (ACC).
Materials may not be reproduced without the consent of ACC.
Reproduction permission requests should be directed to the Legal Resources Department at ACC: 202/293-4103, ext. 342; legalresources@acc.com

1025 Connecticut Avenue, NW, Suite 200
Washington, DC 20036-5425

tel 202.293.4103
fax 202.293.4701

www.ACC.COM

CLO CLUB- ACC'S ANNUAL MEETING
CLO1: Designing a 'Best Practices' Plan to Ensure Financial Compliance
October 31, 2007; 9:00-10:30 a.m.
Hyatt Regency Chicago

CLO Club Session Format

A sell-out every year, ACC's CLO Club is a signature ACC Annual Meeting event. The CLO Club is roundtable discussion format and provides a sophisticated networking forum that hosts peer-to-peer discussion groups targeted to the unique executive, substantive practice, management, and networking needs of chief legal officers. **Participation is strictly limited to chief legal officers**.

ACC's CLO Club makes the audience the faculty, and this year's Club has been targeted to facilitate conversations between CLOs with smaller law departments (e.g., less than 7 lawyers in the department). Each CLO Club session includes a CLO Host who introduces the discussion topic and helps facilitate broader group discussions and sharing of best practices. Registered participants join a table of 10 participants, and each table is challenged to share ideas on key challenges and best practices, and then craft/refine creative solutions in response to a hypothetical problem that will be provided on-site to each table. The number of discussion tables is limited and advance registration is on a first-reserved basis to encourage collegiality and meaningful and high-quality dialogue.

CLO1 Program Description

Designed for small law practitioners, this program asks CLO Club participants to work within groups of ten to respond to a hypothetical problem: the CEO and CFO have asked the CLO to develop a plan for the company's leaders to take a more proactive role in ensuring financial compliance. They want advice on spotting and preventing financial fraud, who should be on point for what, how to better manage the financial audit process and auditor contract negotiation, and what to do to ensure that the board is properly engaged in reviewing the company's financial processes. After group/team development of a plan to respond to this request, each table will report its proposed game plan for the consideration and discussion of the group. A general discussion of the groups' reported best practices will ensue.

Session Materials

A Hypothetical Scenario Sheet will be provided to CLO Club participants on site. The hypothetical will set the stage for the roundtable discussions on developing a plan for the CLO's role in helping to ensure financial compliance. In addition, attached are select background resources relating to the session topic.

1025 Connecticut Avenue, NW, Suite 200
Washington, DC 20036-5425

tel 202.293.4103
fax 202.293.4701

www.ACC.COM

CLO1: Designing a 'Best Practices' Plan to Ensure Financial Compliance
October 31, 2007; 9:00-10:30 a.m.
Hyatt Regency Chicago

Resource Bibliography

Below is a sampling of resource materials pertaining to the 2007 ACC Annual Meeting CLO Club Session 1 and available for further reference at www.acc.com/vl.

ACC CLO ThinkTank Materials

Executive Report- CLO's Role in Financiel Compliance & Relationships with Auditors
http://www.acc.com/protected/clo/financialcompliance.pdf

Additional Articles; White Papers

Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud (ACC Docket 2006)
http://acc.com/protected/pubs/docket/nd06/house.pdf

Managing an Internal Fraud Investigation and Prosecution (ACC Docket 2007)
http://acc.com/resource/v8313

Recent Trends in Internal Investigations
http://acc.com/resource/v8312

Providing In-House Legal Support to the CFO & Finance Function (ACC Leading Practice Profile 2004)
http://acc.com/resource/v5902

Corporate Governance Programs for Reporting Concerns (ACC Leading Practice Profile 2005)
http://acc.com/resource/v6527

What to do When the Whistle Blows: Do's and Don'ts of Internal Investigations (ACC Docket 2004)

Copyright © 2007 Association of Corporate Counsel
For more information, visit www.acc.com

http://acc.com/protected/pubs/docket/may04/whistle.pdf

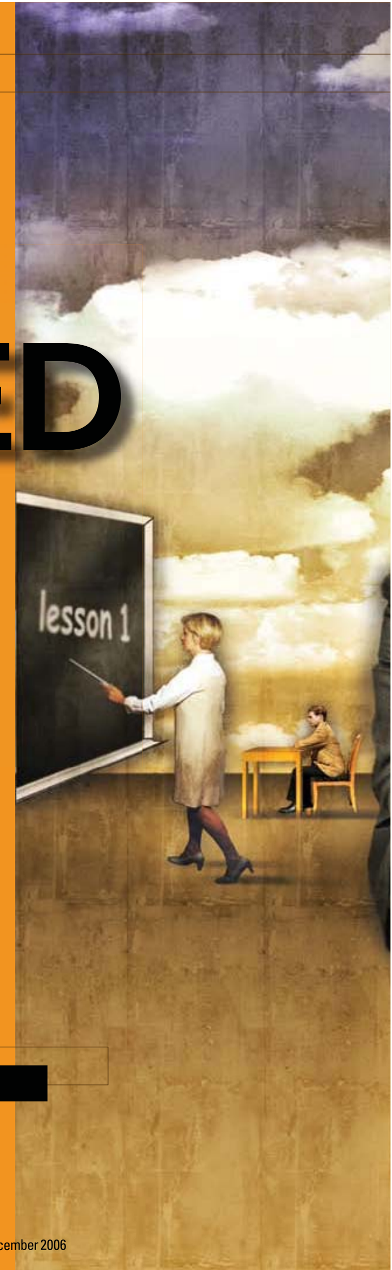
Helping the Audit Committee Manage its Relationship with the Outside Auditor (ACC Docket 2004)
http://acc.com/protected/pubs/docket/may04/tools.pdf

Responding to Auditor Requests (ACC Docket 2005)
http://acc.com/protected/pubs/docket/jun05/toolkit.pdf

Copyright © 2007 Association of Corporate Counsel
For more information, visit www.acc.com

LESSONS LEARNED THE HARD WAY

Ten Flags of Possible Financial Mismanagement and Fraud



BY DEBORAH M. HOUSE

"History is a guide to navigation in perilous times."
—David McCulloch, author and historian

"Those who cannot remember the past are condemned to repeat it."
—George Santayana, author and philosopher

As chief legal officers (CLOs) watch the corporate financial debacles that ushered in this century and continue today, a silent prayer can nearly be heard: "Please. Not here. Not on my watch." For a very small few, such a request is about not getting caught. But for the vast majority, it is probably wishful thinking, closely linked to a silent admission that they do not really understand the CFO's complicated, green-eyeshade world.

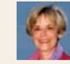
Unquestionably, today's in-house counsel must have a greater knowledge of the accounting rules that affect the company. As Stasia Kelly, ACC board member, general counsel of American International Group, Inc., and former general counsel of MCI, Sears, and Fannie Mae advises: "Ten years ago, I would read an earnings release and trust that the CFO and the accounting folks knew what they were doing. Now, I make sure that I understand all the accounting items in the release, and I ask the questions: Are the one-time events truly one-time events? Are the reserve releases appropriate? Is there an earnings management issue?"[1]

This advice is well taken. However, the need for new expertise does not necessarily mean a return to school to acquire an accounting degree. There is much to be learned from examining history, including the publicly available reports of major corporate financial disasters (Independent Reports).[2] Lessons taken from these experiences instruct us on how to navigate in these perilous times and avoid repeating the past. Find out how to flag the activities that will alert us to potential dangerous waters ahead.[3]

The Stakes Are Too High

Wait a minute, you say. Don't in-house counsel already have enough on their plate? Must we have accounting expertise as well? Shouldn't accounting be left to the accountants? Won't increased knowledge subject me to increased liability? The answers to these questions, respectively, are:

1. You bet!
2. Afraid so.
3. No, it's like leaving war solely to the generals; scary to contemplate.
4. Perhaps, but it will also give you an opportunity to significantly decrease your liability by addressing these issues. The ostrich approach simply does not work well.



DEBORAH M. HOUSE is the vice president and deputy general counsel for legal resources and strategic initiatives for ACC. Previously, Ms. House was a vice president and deputy general counsel at Fannie Mae and has been in private practice in Washington and London. She holds a BS from the University of Illinois and a JD from the Washington College of Law of American University. She can be reached at *house@acca.com.*

When a company goes under for financial mismanagement or fraud, or even if it survives, the human toll is significant. For a significant number of shareholders—many of whom are employees—retirement nest eggs disappear, college savings collapse, and mortgages go unpaid. Employees who have absolutely nothing to do with the financial misdeeds suffer the loss of their jobs or disruptive relocations, and humiliation by association. Those who may or may not have responsibility are the subject of extensive regulatory inquiry and may even be prosecuted.

The company itself fares no better. Even if it does not completely collapse, the practical impact of financial mismanagement—for good or for bad, deserved or undeserved—may be extreme. The corporation's reputation takes a nosedive. The stock plummets and languishes. Managers are replaced in droves. Internal reorganizations run rampant. A severe brain drain occurs as faulted and faultless long-time employees—involuntarily or voluntarily—leave the company for greener pastures. An army of independent investigators descends, and the sky is darkened with consultants who recalculate the company's numbers and redo its policies and systems. All of them bill by the hour in amounts that shock and cause a severe drain on the corporate treasury.[4]

Time previously spent by employees actually doing the work of the company is now focused on responding to investigators, regulators, consultants, plaintiffs, and prosecutors. For some, standing around the water cooler contemplating the company's gloomy outlook may become the favorite pastime. Other employees ruin their health and/or their home life working 24/7 to pull the company back up by its tattered bootstraps.

In-house counsel are not immune to any of this, as they too are shareholders and employees. For some, the price has been even higher. Their reputations are besmirched and they suddenly may find themselves in the deponent chair at the deposition table.

In-house Counsel Have Much to Contribute

The good news is that in-house counsel are well situated to address important aspects of many accounting matters.

- We are often able to see the big picture by having a vantage point that defies traditional corporate silos.
- Many of the factors underlying improper financial management belong to both the legal and the accounting worlds (e.g., what constitutes materiality, whether a conflict of interest exists, or whether risk has passed in a sale of assets).
- The CLO continues to play a significant role in corporate compliance, acting either as the chief compliance officer (CCO), as supervisor for the CCO, or as counsel to the compliance function. This is important because establishing and maintaining a corporate culture committed to compliance, providing compliance training, and monitoring for compliance—tasks often spearheaded by the CCO—are essential to avoiding financial mismanagement and fraud.
- The CLO often manages or participates in relationships relevant to proper financial management, including interaction with the SEC, other regulators, auditors, and the board's audit committee.
- Many transactions used as the tools to perpetrate accounting fraud cannot be accomplished without the participation or acquiescence of in-house counsel (e.g., establishing special-purpose entities that are used to move debt off the balance sheet). Where these transactions are structured and papered by outside counsel, in-house counsel are likely to be managing and consulting with them.
- In-house counsel understand how to establish rules, processes, and systems, combined with the overall corporate knowledge that helps assure compliance. In the post-Sarbanes world, these are essential talents.
- Because in-house counsel regularly deal with the ambiguities attendant to interpreting and applying the law, they may have a greater level of comfort raising questions about accounting concepts that also are not black and white.

To date, the role played by lawyers has gotten some bad

A company that **does not** have a culture committed to **compliance** just **"talks the talk,"** it doesn't **"walk the walk."**

press. As Stephen Cutler, former director of the SEC's Division of Enforcement, observed, "We have seen too many lawyers who twisted themselves into pretzels to accommodate the wishes of company management and failed to insist that their company comply with the law."

Perhaps this image could be transformed for the better if, as lawyer and statesman Elihu Root suggested, in-house counsel would tell their clients "they are damned fools and should stop."[5] Granted the message should be delivered a little more diplomatically, but certainly to the same effect if required. And required it may be—if your company is engaging in activities that may set the scene for or actually constitute financial mismanagement or fraud.

The Ten Flags

An examination of the Independent Reports reveals that companies who are alleged to have engaged in financial mismanagement and/or fraud evidence multiples of the following attributes in their operations and activities. Spotting one or more of these characteristics is certainly not determinative of possible mismanagement or fraud. However, they do serve as warning flags that should cause you to be alert.

1. The company does not have a culture committed to ethical conduct and compliance with the law.

The US Sentencing Commission was created in 1985 for the purpose of developing sentencing guidelines (Guidelines) to assure that comparable misconduct by similar offenders received similar sentences. Organizations are given a sentencing credit if they have an effective ethics and compliance program (Program). However, the Guidelines are not just about sentencing; they also serve as a benchmark for prosecutors and regulators in determining whether they are going to take action against a company.

Under the Guidelines, an effective Program "promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law. . ."[6] The Advisory Group recommending the 2004 revisions to the Guidelines stated that an appropriate organizational culture:

> *. . . is one in which compliance with the law is the expected behavior. Rather than solely emphasizing conduct restrictions and information gathering activities aimed at preventing and detecting violations of law, an organizational culture that encourages a commitment to compliance with the law also includes positive actions which demonstrate that law compliance is a key value within the organization. In general, organizational culture, in this context, has come to be defined as the shared set of norms and beliefs that guide individual and organizational behavior. These norms and beliefs are shaped by the leadership of the organization, are often expressed as shared values or guiding principles, and are reinforced by various systems and procedures throughout the organization.*[7]

Companies that allegedly engage in financial mismanagement or fraud do not have an appropriate corporate culture. This could be evidenced by the lack of an "open working environment," meaning that employees do not have opportunities to raise issues of concern and do not feel free to do so; employees justifiably fear retaliation, and retaliation is tolerated. Another attribute is the uneven application of the company's standards and procedures among the rank-and-file employees and senior management. Executives at these companies may enter into transactions and use corporate assets in a way that conflicts with the company's best interests, violates its standards of conduct, and generously lines their own pockets.

Another common attribute cited in the Independent Reports are arrogant CEOs (and CFOs) who portray a sense of entitlement and tend to "reign" rather than preside over the company's activities, who engage in strategies designed to tightly control the information provided to the board and limit its oversight, and who are not open to good-faith consideration of the views of others, including their own senior management. A company that does not have a culture committed to compliance just "talks the talk," it doesn't "walk the walk." Enron had the corporate slogan of "Respect, Integrity, Community, Excellence." Enough said.

In fact, rather than having a culture committed to compliance, the companies reviewed in the Independent Reports had the antithesis. They had financially driven cultures. Among the cultures cited were those committed to steady or double-digit earnings, consistently meeting Wall Street expectations, or constantly hitting targets that triggered lucrative executive compensation. Sometimes the culture had a mix of all of these characteristics.

2. The company is engaging in inappropriate earnings management.

Unquestionably the application of generally accepted accounting principles (GAAP) allows companies a great deal of flexibility in calculating earnings and other items of financial information. There are numerous legitimate variables in how companies value their accounts (e.g., is it collectible? when is it collectible?), their inventory (e.g., which cost valuation method to use? has the value changed, given new consumer tastes?), their assets (e.g., which depreciation method should be used? what is its useful life? what is the conversion rate for foreign cash?), and even their liabilities (e.g., what will happen to interest rates? what is the possibility of a plaintiff's success in a lawsuit?) Moreover, the line between treating an item as an asset or a liability, for example, can be razor thin.

However, quality financial information should reflect economic reality. When a company manipulates its financial information so that it achieves a desired target to the detriment of economic reality, that constitutes inappropriate earnings management and potentially constitutes fraud.[8] An example of such an activity would be WorldCom's alleged improper capitalization of operating expenses with the intended resultant effect of increasing its earnings per share to meet analysts' expectations. [9]

The questionable practice of inappropriate earnings management was highlighted as early as 1998 by then SEC Chairman Arthur Levitt, who warned that:

> *[Earnings management] has evolved over the years into what best can be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system. . . Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. . . . Managing may be giving way to manipulation; Integrity may be losing out to illusion.*[10]

Inappropriate earnings management has its genesis in the pressure placed on companies to meet Wall Street's projections. Because these projections are based in part on information provided by the companies themselves, meeting them not only speaks to the value of the company's shares, but the company's credibility as well. And the stakes are very high. Levitt cites an incident where a company's failure to "meet its numbers" **by one penny** resulted in a loss of 6 percent of its stock value in one day.

What form may inappropriate earnings management take? The Independent Reports, Levitt, other experts,[11] and the SEC[12] cite a significant number of approaches that are inappropriate if engaged in for improper reasons (e.g., meeting analysts' expectations, triggering executive compensation) and if not reflecting financial reality. They include:

- **Big Bath Charges:** Companies significantly restructure themselves with the intent of cleaning up their balance sheet. Sometimes the cost of such an effort is intentionally overestimated, and this cushioning subsequently becomes income when estimates change or earnings fall short. Analysts tend to treat the "big bath" as a one-time event and focus on future earnings.
- **Creative Acquisition Accounting:** Companies classify a portion of an acquisition cost as "in-process" research and development so that the amount can be written off in a one-time charge, removing any earnings drag. More recently, this has been replaced with goodwill impairment (i.e., marking down the carrying value to the fair market value).
- **Use of Cookie Jar Reserves:** Companies use unrealistic assumptions or intentionally oversize reserves for future liabilities. These reserves are then used to boost earnings during difficult times. Companies also purposefully understate reserve liabilities to improve their overall financial picture.
- **Accelerating (or Delaying) Revenue:** Companies intentionally recognize revenue prematurely or delay its recognition. Companies may accelerate or delay revenue by mischaracterizing contractual benefits and obligations. Accounting treatments may be particularly suspect where companies recognize revenue for one period while attributing associated expenses for another.
- **Accelerating (or Delaying) Expenses:** Companies intentionally prematurely recognize or unjustifiably delay expense recognition. One significant way that companies have accelerated expenses is recognizing a "nonrecurring" expense (a one-time charge-off). Expenses are often delayed by inappropriately capitalizing them.
- **Inappropriate Use of Special Purpose Entities (SPEs):** SPEs have long been used legitimately to isolate financial risk and remove associated debt from the reporting company's balance sheet. However, the SPE has to meet certain criteria relating to ownership, independence, and the transfer of assets. If these criteria are not met, off-balance sheet treatment is not appropriate.
- **Pro Forma Earnings:** This describes a financial statement prepared on a basis defined by the company and not in accordance with GAAP. Some would argue that it is a useful method of clarifying the company's financial picture. Others have dubbed it as "EEBS" for "earnings excluding bad stuff." Significant differences between GAAP and pro forma statements should be scrutinized.
- **Immaterial Accounting Errors:** Earnings management is often achieved through the misuse of the concept of "materiality." A subject near and dear to the hearts of accountants and attorneys alike, as a general rule it must be determined whether omissions or misstatements in a financial statement are material or immaterial deviations from GAAP accounting. If they are determined to be immaterial, then an auditor will allow them to be reported without taking issue with them.

Levitt criticized the practice of using a rule of thumb that deviations within a certain percentage of a registrant's net income or net earnings per share (e.g., under 5 percent) are immaterial. In repudiating this analysis, he noted that, "In markets where missing an earnings projection by a

penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called nonevents simply don't matter. . . . I reject the notion that the concept of materiality can be used to excuse deliberate misstatements of performance."

At Levitt's direction, the SEC subsequently issued an accounting bulletin on this issue. It specifically rejects the notion that materiality determinations may be based on a quantitative analysis alone. Rather, it requires that "all the relevant circumstances" must be considered and concludes that "as a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." Included among the qualitative considerations identified by the SEC are whether the misstatement:

- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations for the enterprise;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- affects the registrant's compliance with regulatory requirements;
- affects the registrant's compliance with loan covenants or other contractual requirements;
- has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation;
- involves concealment of an unlawful transaction;
- may result in a significant positive or negative market reaction; and
- involves a segment of the registrant's operations that is significant to the financial statements as a whole.[13]

ACC Extras on . . . Financial Mismanagement and Fraud

ACC Committees:

More information about these ACC committees is available on ACC Online℠ at *www.acca.com/networks/committee.php*, or you can contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or *windley@acca.com*.

- Financial Services Committee: *http://www.acca.com/php/cms/index.php?id=107*

Annual Meeting Course Materials:

Program material is available from the following courses at ACC's 2005 Annual meeting. *Vampires of the Bottom Line: A Look at Corporate Fraud,* ACCA, 2002.

Description: Discussion of various types of fraud, red flags that may indicate fraud, and factors that can contribute to or deter fraud *www.acca.com/resource/v3355.*

Quick Reference

Indicia of Corporate Fraud, http://www.acca.com/resource/v3685.

3. The board does not function independently or exercise appropriate oversight and permits management to determine the information it receives.

Serving on a board of directors, particularly on the audit committee, is not a task for the faint-hearted. Sarbanes-Oxley, the New York Stock Exchange listing reforms, the Federal Sentencing Guidelines, and other statutory and regulatory provisions have imposed a plethora of new requirements that must be met. Among other things they include: new elements of independence for the board's directors and its committees; executive session meetings; limiting board compensation; active board oversight of company activities; ensuring that audit committee members have appropriate financial expertise; publication of corporate governance guidelines and charters for key committees; board and key committee annual evaluations; and board training. Corporate boards have also been the subject of extreme criticism. The Delaware Chancery Court's decision in the *Disney* case, while finding that the board had not breached its fiduciary duty, lambasted it for having a culture that was "unwholesome" and in which "ornamental passive directors contribute[d] to sycophantic tendencies among directors."[14] The Independent Reports have similarly characterized the respective boards reviewed as "failing in its oversight duties," "deferring to management almost completely," and "not overseeing management's processes and decisions with an appropriately skeptical eye."

At a minimum, a properly operating board should demonstrate the following characteristics:

- Members are prepared and informed, request additional information when needed, and exercise appropriate oversight. They do not let executive management dictate their agenda or direct their course. Appropriate time is dedicated to their activities.
- Director qualifications and the activities and effectiveness of board committees are taken seriously.
- The criteria for executive compensation are carefully considered and established, and the compensation process and associated accounting concepts are monitored.
- Independent advice is acquired when needed.
- Board decisions (including the process) and other activities are appropriately documented.
- Conflicts of interests of executive management and appropriate use of corporate assets are considered and monitored.
- Corporate governance is taken seriously, benchmarked against appropriate standards, and modified as appropriate.

4. The financial or internal audit functions lack qualified personnel.

There are two aspects to this issue: (1) whether financial and audit personnel have the proper qualifications and competencies; and (2) whether they have sufficient staff and other resources.

As to the first, consider the likelihood that a CLO might not have a law degree. "Less than none" is the foregone answer. However, the Independent Reports reflect instances where the CFOs for huge corporations with complex financial activities were not CPAs and did not have other appropriate experience; similar situations existed with regard to the controller and the individual heading the internal audit function. In some instances, there was also rapid turnover or protracted periods during which no one held these positions at all.

As to the second aspect, the failure of a company to invest in appropriate financial or internal audit staffing can be financially disastrous if not fatal. It also reflects a lack of corporate concern with those things for which it should be concerned. The Independent Reports reflect that this was a recurring problem. Most telling is that after the axe fell, a frequent remedial measure was to rapidly staff up the financial and internal audit positions, sometimes to the tune of hundreds of employees.

5. Organizational structures with inherent conflicts of interests.

Many companies carefully establish appropriate standards and procedures to guard against potential conflicts of interests that might arise between the company and its employees' personal interests. However, they do not consider the conflicts of interests inherent in their organizational structures and certain internal practices and the problems these may present. Conflicts of this nature may cause companies to act in inappropriate ways. Examples reflected in the Independent Reports include:

- The personnel responsible for establishing financial standards and monitoring their appropriate use are also the ones responsible for applying them.
- Personnel are charged with monitoring the actions of their superiors (and their superiors' direct reports). For example, where the head of internal audit reports to the CFO who also supervises the financial activities of the company.
- Personnel who report to the audit committee (e.g., internal audit) have their performance evaluated and their compensation determined by the executive management whose activities they scrutinize.
- Where internal audit reports to the audit committee but has its communications with the board tightly controlled by the CEO or CFO.

Delegations of authority for making accounting-related decisions are not clear, if they exist at all. This allows accounting changes to be made "on the top" without the concurrence or knowledge of responsible personnel, and sometimes with their objection.

6. The company lacks adequate internal controls.

Section 404 of Sarbanes Oxley required the SEC to issue rules requiring registered companies to evaluate their "internal controls" and report on that assessment annually. While the SEC's response focused only on internal controls related to financial reporting, given the breadth of what goes into financial reporting, its practical effect was to require companies to take a hard look at many significant systems.

However, where financial control issues have not been identified or have not been corrected—or where the controls are nonfinancial in character and haven't been addressed—the lack of such controls can act as a factor in financial mismanagement or fraud for several reasons:

- It contributes to a corporate culture of "anything goes" rather than a culture committed to ethical conduct and compliance.
- It enables *ad hoc* decisions to be made that are designed to address the most pressing objective at the moment—perhaps an impermissible one.
- It enables individuals to exceed their authority and make decisions which they should not be making or which should not be made without the input of others (e.g., the review and approval of the CLO).
- It permits a Band-Aid® and chewing-gum approach to corporate activities, which may be based on the analysis of the moment, may not be properly documented, and may change radically and without explanation when the next problem arises.
- It disempowers lower level employees who might otherwise rely on the controls, standards and procedures to assure that an activity is carried out properly.

7. The executive compensation system is based on inappropriate incentives and has inadequate checks and balances.

A Delaware court recently noted that "[w]hile there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation is not one of those instances."[15] From a financial mismanagement viewpoint, there are several significant reasons why this should be true.

First, under the Federal Sentencing Guidelines, one required component of an effective compliance and ethics program (which the board oversees) is to provide "appropriate incentives to perform in accordance with the compliance and ethics program."[16] Thus, it is imperative that the board link executive compensation to ethical and legal conduct. Compliance-related performance standards should be both qualitative (e.g., creating and maintaining an appropriate corporate culture) and quantitative (e.g., implementing internal controls, responding to audit findings). Moreover, these standards should be real and truly applied: "A college football coach can be told that the graduation rates of his players are what matters, but he'll know differently if the sole focus of his contract extension talks or the decision to fire him is his win-loss record."[17]

The importance of these standards is underscored by observations such as those of Boeing's chairman and CEO W. James McNerney, who indicated that the incidents that led to criminal investigations of the company, in part occurred because Boeing's previous management didn't place enough emphasis on ethical behavior. As a result, he scrapped an executive-compensation plan under which executives were rewarded for meeting primarily financial goals, and replaced it with one tied to broader criteria, including integrity and ethical leadership.[18]

Second, the board should take steps to assure that compensation is not linked to factors that may encourage inappropriate earnings management. The Independent Reports are replete with examples of earnings management by senior and executive management to achieve higher compensation. Accordingly, compensation linked solely to EPS or other Wall Street expectations may be problematic. The trend is to use specific targets that are less likely to be manipulated, fewer stock options, and more restricted stock and cash compensation. This is a subject suitable for experts, and the board should secure independent advice uncontrolled by management.

Third, the board should exercise independent judgment in evaluating whether appropriate performance standards have successfully been met. Such evaluations might be based on 360-degree reviews, employee surveys, and input from the compliance function.

SEC and Criminal Proceedings Against Inside Corporate Counsel Increasing

By John K. Villa, *ACC Docket "Ethics & Privilege"* columnist

SEC Civil Proceedings

The SEC initiated more than 30 enforcement proceedings against corporate attorneys from early 2002 through mid-2005. In the intervening 12 months, the SEC has initiated four more actions. The new actions allege fraudulent accounting and market-timing schemes and the making of false and misleading statements in filings and press releases. Two of the actions involve the companies' general counsel while the other two implicate senior in-house lawyers. In all of the actions, counsel's role involved the preparation of the false or misleading documentation to support and/or conceal the allegedly fraudulent scheme.

For example, the SEC alleges that the assistant general counsel of a reinsurance company drafted sham reinsurance contracts, and assisted in developing and then concealing side agreements. In a case that arose from a market-timing scheme, the SEC alleged that the general counsel of a hedge fund created entities with accounts having names designed to hide the fund's relationship to these accounts, and prepared annuity contracts that named himself and other employees as annuitants to further conceal the fund's identity.

In a fraudulent revenue recognition scheme, the SEC alleges that a senior in-house attorney drafted the terms of the transaction and supporting documents so as to ensure that the wording did not expose the schemers' efforts to circumvent GAAP, and actively sought to prevent the disclosure of undocumented side agreements. Finally, the SEC alleges that the general counsel of a biotechnology company drafted and approved SEC filings and press releases that failed to disclose or falsely described the regulatory status of a company product. The SEC also alleges that counsel sought outside counsel's advice, but failed to heed that advice. Two of the actions remain pending; two have settled. One counsel faces criminal prosecution for his conduct.

Criminal Proceedings

From 2002 through mid-2005, approximately eight criminal actions were brought against in-house counsel for their roles in fraudulent schemes. Since mid-2005, five more in-house counsel have been indicted. In a departure from prior prosecutions, two criminal prosecutions involve more than one in-house counsel: one involves two inside counsel who were employed by separate but related companies in which they held the position of general counsel; the other involves two inside counsel from the same company, the general counsel, and the associate general counsel.

One of the recent criminal prosecutions alleges a scheme to defraud the company for personal gain; all of them involve the manipulation of the company's financial statements. For example, one prosecution has alleged fraudulent diversion from a public company of millions of dollars through noncompetition agreements executed in connection with the sales of operations. The indictment alleges that the general counsel of the company, along with the general counsel of a related entity, prepared the closing documents and noncompetition agreements that falsely benefited another entity which was not entitled to compensation. Similarly, in another prosecution involving a scheme to mislead investors through fraudulent reinsurance contracts, the indictment alleges that the assistant general counsel crafted the sham contracts and the undisclosed side agreements that were part of the scheme.

The trend line evident in the last 12 months is that both SEC regulatory sanctions and criminal prosecution of inside counsel are increasing sharply, the nature of the conduct that prompts criminal prosecution for one lawyer is not distinguishable from conduct that elicits only SEC sanctions against another lawyer, and it can no longer be said with confidence that only the general counsel is at risk. All of these are disturbing trends and are not likely to change in the future.

Editor's Note: Mr. Villa's study excluded insider trading cases against corporate counsel. Mr. Villa's "Ethics & Privilege" column appears monthly in the *ACC Docket*.

8. There is a lack of candor and provision of information between the company's financial and business operations and internal and/or external audit.

A number of factors establish the foundation for the relationship between the financial and business operations and internal and/or external audit.

- Do senior managers set a good example in their relationship with the audit function (e.g., are they respectful of the function, do they exercise candor and provide full appropriate information in their own responses—and require it in responses they may supervise—to internal and external audit inquiries)?

> Thus, it is **imperative** that the board link executive compensation to **ethical** and **legal** conduct.

- Do the internal/external auditors have the qualifications and level of competency that will create appropriate respect?
- Have adequate resources been allocated to the internal audit function?
- Is senior management's response to audit findings to appropriately address them in a timely fashion?
- Does the organizational structure for internal audit provide it with appropriate independence?
- Does internal audit have a place at the table in the company's power structure and within its operations?

Negative responses to the above questions may foreshadow financial and operational problems.

9. There is too much reliance on the external auditors.

"Run it past the auditors" is a common corporate phrase, as if securing their blessing is the appropriate final word on any accounting decision. However, external auditors may not always have the right answer. Look at KPMG's $22 million settlement with the SEC for its alleged role in Xerox's accounting problems, or Deloitte & Touche's $50 million SEC settlement of charges stemming from its audit of Adelphia Communications. Companies currently under fire for matters relating to stock option dating cite their auditors' approval of their actions. Finally, the Independent Reports are also strewn with instances where external auditors allegedly assured their clients that the actions subsequently criticized were appropriate, or allegedly failed to detect the mismanagement or fraud that was occurring that might have changed audit opinions. They also cite instances where external audit denied having reviewed a matter, although management asserted they had. Moreover, as Lynn Turner, former chief accountant of the SEC put it, the defense of relying on the auditors "isn't plausible anymore."[19]

This is not to say that the expertise of external auditors is not a valuable thing. It is. However, that expertise cannot be relied on as an alternative to having qualified, competent, corporate internal auditors and financial staff who have adequate resources. In short, while external audit's opinions are going to be helpful, total reliance on their advice may be a trip down a dangerous road.

10. Something is rotten in the state of Denmark.

The *Oxford English Dictionary* defines *corporation* as "a body corporate legally authorized to act as a single individual." But while it may be acting as a "single individual," company operations are carried out by many individuals. And those people write memos, make presentations, talk around the water cooler and in the conference room, and blanket electronic pathways with a rich abundance of emails. Some of the content of these communications is honest truth, some part fact and part fiction, and some unfounded gossip.

But it behooves in-house counsel to pay attention to these communications. For, as the palace guard advised Hamlet, sometimes what you observe and what you hear will cause you to know that "something is rotten in the state of Denmark." That information may alert you to the possibility of financial mismanagement or fraud. Examples from the Independent Reports include:

- Excessive use of corporate assets by executive management, including using corporate money for acquisitions of personal real estate, personal property, and payment of other expenses that individuals would normally be expected to pay for themselves.
- Use of corporate assets to make large donations to charitable organizations outside of a corporate-approved program, particularly where the contribution is attributed to the individual.
- Exclusions, intentional or otherwise, of the legal department from important decision-making processes—particularly if they relate to disclosure matters and complex, structured financial transactions.
- "Slush funds" or other initiatives that have no corporate-approved procedures and standards, which are used to reward employees as the CEO deems fit.
- Transactions that are primarily undertaken for accounting reasons and that have no other substantive benefit to the company, particularly at quarter or year's end.
- Transactions personally benefiting company employees (or their significant others) in a way that is detrimental to the company and excessive for the services rendered (if any) by the employee or related third party.
- Patterns of favorable earnings or other financial results that are inconsistent with the overall market or cannot otherwise be legitimately explained. If it seems too good to be true—it usually is not.

What Can In-house Counsel Do?

Quite a bit. For example:

- There should be an open working environment in the legal department where staff can raise important issues without fear of retaliation. This will not only help flush out issues to be resolved for the benefit of the company, but serve as an example to others.
- In-house counsel can use their big-picture vantage point to help assure that all the pieces come together for the greater good. Some of the fraud that was allegedly perpetuated was facilitated by isolating the financial management activities of one corporate unit from the other, or permitting one silo to act without scrutiny.
- In-house counsel can assure that the legal issues underlying proper financial management are properly and reasonably addressed. Delegations of authority should be clear and inviolate except in prescribed circumstances. "Materiality" determinations should consider qualitative factors. Conflicts of interest should be avoided or carefully monitored with appropriate checks and balances. Waivers of corporate standards (e.g., codes of conduct) should be few and far between and disclosed as required.
- The CLO can play a significant role in assuring that the corporate compliance program meets the requirements of the Federal Sentencing Guidelines.[20] Among other things, such a program should: include a corporate culture conducive to proper financial management; establish, communicate, and train personnel about appropriate financial and audit standards; establish compliance-related performance standards and evaluations; and monitor adherence to the program. When problems are encountered, they should be remedied immediately and the program adjusted accordingly.
- The CLO can play an important part in assuring that any internal investigations, including responses to whistleblowers, are appropriately conducted using the right resources—which may mean bringing in outside experts or being subject to criticism for failure to do so.
- Relationships in which the CLO participates—including those with the SEC, regulators, auditors, the CEO, the CFO, and the board—should be conducted in a manner that promotes appropriate financial management. Openness and integrity should be keystones.
- In-house counsel should review complex financial transactions. As part of that process they should raise appropriate questions about the accounting treatment for them. If the transaction is being undertaken simply for accounting purposes, without any other reasonable corporate purpose or benefit, they should take steps to terminate them.
- In-house counsel can assist clients in establishing internal written rules and processes that help promote financial good health. For example, there should be rules for posting on top changes to the general ledger or establishing and using reserves.
- In-house counsel know how to make reasonable legal interpretations. As part of the process, we weigh answers to questions like: What is the plain language of the applicable statutes and regulations? What does (or would) our regulator(s) say about it? Is there case law on point or that is at least instructive? Is the proposed interpretation being driven by a desired result? Would I feel comfortable about the proposed interpretation if I read about it in *The Wall Street Journal*? Lawyers can assist in making sure a modified form of this analysis is brought to accounting decisions as well.

Finally, in-house counsel can raise the questions that need to be raised when they spot one or more of the ten flags. It is ugly work, but somebody has to do it. The alternatives shouldn't happen on your watch.

Notes

1. A. Kelly, *"Tips & Insights on: How to Manage Smoking Guns with Stasia Kelly*, ACC Docket, 92-95, Volume 24, No. 4 (April 2006), *available at http://www.acca.com/protected/pubs/docket/apr06/tips.pdf.*
2. The Reports reviewed for this article included: *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (February 2002); *NASA- Report of the Columbia [Accident] Investigation Board* (August 2003*); Tyco International Ltd. 8K-Current Report* (September 17, 2002); *Report of the Special Examination of Freddie Mac* (August 2003); *Restoring Trust, Report on Corporate Governance for the Future of MCI, Inc.,* (August 2003)*; Report of the Special Audit Committee of the Board of Directors of HealthSouth Corporation* (May 2004); *Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc.* (March 2005)(WorldCom Report); *Summary of the Independent Investigation by the Special Committee of the Board of Directors of Krispy Kreme Doughnuts, Inc.*(August 2005); and *Report of the Special Examination of Fannie Mae* (May 2006).
3. Many of the allegations set forth in the Independent Reports have not been proven or are the subject of settlement agreements or consent orders where wrongdoing has not been admitted or denied. Thus the references in this article are to "alleged" mismanagement and/or fraud.
4. Earlier this year, Fannie Mae CFO Robert Blakely estimated the "costs associated with restatement and related investigations will total over $600 million for 2006." *Fannie Mae Investor/Analyst Conference Call* (May 9, 2006), *available at http://www.fanniemae.com/ir/pdf/issues/2006/050906transcript.pdf.*
5. Stephen M. Cutler, Director, SEC Division of Enforcement, *Remarks before the UCLA School of Law*: *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program* (Sept. 20, 2004), *available at http://www.sec.gov/news/speech/spch092004smc.htm* .
6. USSG §8B2.1 (a) (1&2).
7. The Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (October 7, 2003), available at *http://www.ussc.gov/corp/advgrprpt/AG_FINAL.pdf* .
8. S.D. Makar and M.A. Pearson, *Earnings Management: When does Juggling the Numbers become Fraud?* Association of Certified Fraud Examiners (January/February 2000), available at *http://www.acfe.com/fraud/view.asp?ArticleID=124* ; and S.D. Makar and M.A. Pearson, *Earnings Management Revisited: Further Suggestions in the Wake of Corporate Meltdowns* Association of Certified Fraud Examiners (March/April 2004), available at *http://www.acfe.com/fraud/view.asp?ArticleID=245* .
9. WorldCom Report at 11-16.
10. *See* Arthur Levitt, SEC Chairman, *Remarks before the New York University Center for Law and Business: The Numbers Game* (September 21, 1998), *available at http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt.*
11. *See* R. J. Wayman, *Earnings Management: Accounting Red Flags,* Forbes.com (February 2002), available at *http://www.forbes.com/2002/02/27/0227wayman_print.html.*; and J. Vorhies, *The New Importance of Materiality,* Journal of Accounting (May 2005) *available at http://www.aicpa.org/pubs/jofa/May2005/vories.htm.*
12. *See e.g.,* SEC v. Huntington Bancshares, Inc., Litigation Release No. 19243 (June 2, 2005), available at *http://www.sec.gov/litigation/litreleases/lr19243.htm;* In the matter *of* Global Crossing Ltd., Order Instituting Cease and Desist Proceedings, Making Findings and Imposing a Cease and Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Securities Act of 1934, Release No. 5157 (April 11, 2005), *available at http://www.sec.gov/litigation/admin/34-51517.pdf*; In the matter of KPMG LLP, Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act of 1934 Release No. 50564 (October 20, 2004), available at *http://www.sec.gov/litigation/admin/34-50564.htm*; SEC v. Bristol-Myers Squibb Company, Litigation Release No. 18820 (August 2004), *available at http://www.sec.gov/litigation/litreleases/lr18822.htm*; and SEC v. W.R. Grace & Co., Litigation Release No. 16008 (December 1998), *available at http://www.sec.gov/litigation/litreleases/lr16008.txt.*
13. SEC Staff Accounting Bulletin No. 99- Materiality, Release No. SAB 99, Staff Accounting Bulletin No. 99 (August 12, 1999), *available at http://www.sec.gov/interps/account/sab99.htm*
14. *In Re* the Walt Disney Company Derivative Litigation, Consolidated CA No. 15452, Delaware Chancery Court (August 9, 2005).
15. *Haywood v. AmBase Corp.,* Del. Ch., No. 342-N, 2005 WL 2130614 (August 22, 2005).
16. USSG §8B2.1(b)(6)
17. *See* Stephen M. Cutler, Director, SEC Division of Enforcement, *Remarks to the Second Annual General Counsel Roundtable: Tone at the Top: Getting it Right* (Dec. 3, 2004), *available at http://www.sec.gov./news/speech/spch120304smc.htm.*
18. Andy Pasztor, *Boeing to Settle Federal Probes For $615 Million Deal Allows Defense Giant To Avoid Criminal Charges In Contracting Scandals*, *Wall Street Journal*, May 15, 2006.
19. Greg Farrell, *Jurors: Ex-Enron Execs Not Credible, USA Today*, May 26, 2006.
20. *See* ACC InfoPAK "*Effective Compliance and Ethics Programs for the Small Law Department: Doing More with Less," available at http://www.acca.com/vl/infopak.php?documenttype=InfoPAK.*

1025 Connecticut Avenue, NW, Suite 200
Washington, DC 20036-5425

tel 202.293.4103
fax 202.293.4701

www.ACCA.COM

LEADING PRACTICES IN PROVIDING IN-HOUSE LEGAL SUPPORT TO THE CFO & FINANCE FUNCTION:

WHAT COMPANIES ARE DOING
(June 2004)

Part of an Ongoing Series of
ACC's "Leading Practices Profiles" SM
http://www.acca.com/vl/practiceprofiles.php

Financial reporting and internal control practices are facing increased scrutiny these days. Stakeholders, shareholders, accountants, and regulators want to know that processes are in place and good governance practices are followed when it comes to managing and communicating corporate financial health. Fiscal responsibility and accountability are in demand for all forms of enterprises—whether they be public or private companies, non-profit organizations, or governmental entities.

In response to this heightened attention, organizations are taking stock of their existing financial practices, and enhancing and formalizing processes and policies. Companies are creating internal disclosure committees to review and evaluate financial reports, earnings statements, and related press releases in advance of submitting or communicating this information. Risk managers, often reporting through the finance function, re-evaluate insurance options, the costs of indemnification, and other liability concerns, including policies that are designed to protect the board, financial executives, and lawyers. Many companies also have some form of internal verification, certification, or self-audit process to help ensure that reported information is accurate and complete. Companies are enlarging the roles of their audit committees and the oversight function that they perform, and are formalizing communications pathways for reporting compliance concerns.

In-house lawyers have an important role in helping to design and implement appropriate processes and in serving as key legal advisors to their organizations' finance functions. This includes help in unraveling new rules and regulations, and asking tough questions when situations requiring them arise. It also requires maintaining focus on the organization as the client—even though daily interactions may be with a broad range of individuals responsible for handling or overseeing the company's finances.

A bubbling issue potentially impacting the working relationship of in-house lawyers and financial personnel within some organizations is whether the "up-the-ladder" reporting requirements implementing Section 307 of the Sarbanes-Oxley Act of 2002 might deter or limit interactions

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

between in-house lawyers and finance personnel for fear of disclosure or reprisal.[1] And many in-house lawyers we've spoken to offline about the rules – albeit not those interviewed for this profile -- are concerned that they are not sufficiently expert in understanding financial matters as to be able to reasonably exercise their responsibilities under the new rules and increased stakeholder expectations. Companies interviewed for this Profile offer both those who feel financially "proficient" and those who don't a confident affirmation of the importance of healthy interaction between in-house lawyers and financial personnel as the foundation for their companies' overall legal health; regardless of the level of the lawyer's expertise, our profile company lawyers emphasized the necessity of increased, stronger, and very collaborative interactions between the client's finance and legal functions.

Companies featured in this Profile described strong and robust working relationships between their finance functions and the in-house lawyers supporting them. Mutual respect, a positive tone set at the top, and continuous communications practices are among the critical success factors identified as contributing to the strength of these interactions. The companies described key services performed by in-house lawyers for their CFOs and finance functions, and shared views on impacts of increased focus on financial reporting and controls on their law department practices. They also provided thoughts on practices they are implementing that they consider to be leading practices. Featured in this Profile, are programs for the following six organizations: **IKON Office Solutions, Inc.; National Treasury Management Agency (NTMA); Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF); TOTAL S.A.; Yamanouchi Pharmaceutical Co., Ltd.; and A $40 Billion Financial Institution.**

Section I below summarizes key themes and program insights gathered from discussions with representatives from the companies. Section II describes the programs of each of the six companies in more detail. Section III provides a list of resources identified by company representatives and ACC as resources that may be helpful to others as they review and evaluate their approaches to supporting the financial functions and processes for their organizations.

I. SUMMARY OVERVIEW & THEMES FROM PROFILED COMPANIES

This Profile describes programs for a government treasury management agency located in Ireland, a non-profit organization in the United States, and publicly-traded companies based in France, Japan and the United States. Each of the organizations featured in this Profile described multiple areas where in-house lawyers support their various financial functions. Many described an increase in workload for in-house lawyers supporting audit committees, and for questions on financial practices generally. Most shared that legal guidance to the CFO and finance function is generally provided by in-house lawyers. Companies also emphasized the strength of the working relationships between the legal and finance functions, and the importance of frequent communications and well-defined work processes.

---

[1] See "*You Have the Right to an Attorney,*" by Craig Schneider (CFO.com August 20, 2003) at http://www.cfo.com/article/1,5309,10430|||1,00.html; see also "*The attorney's dilemma: will the SEC's new and proposed rules to turn lawyers into whistle-blowers strain relations between finance executives and corporate counsel?*" by Craig Schneider (CFO Magazine October 2003) at http://articles.findarticles.com/p/articles/mi_m3870/is_13_19/ai_108784410/print. For a pdf link to the Securities and Exchange Commission's implementing rules for Section 307, see the link to 17 C.F.R. Part 205 (Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer) included in the Resource List in Section III of this Profile. Additional material on Section 307 reporting is available at http://www.acca.com/legres/corpresponsibility/attorney.php.

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

THEMES

While the details and practices implemented vary, a number of themes emerged and are listed below.

- **Positive Working Relationships; Cooperation:** Companies described close working relationships between their in-house lawyers and financial personnel. They described continuous communications and open door access as strengths. Also important to companies is setting a positive tone of mutual respect and cooperation "at the top." One entity described its organization as very tight and centralized. Another described its organization as very decentralized. Companies described heightened interest and focus on financial matters and processes, and increased interactions between in-house lawyers and financial personnel.
- **In-house Lawyers Play Leading Roles:** In-house lawyers generally take the lead in providing support to the CFO and finance function. One company shared that outside counsel serves as an "ex officio" member of the company's internal disclosure committee and provides certifications as part of the company's internal sub-certification process for preparing financial reports and filings.
- **Increased Level of Audit Committee Support:** Companies explained that the workload in this area has increased. Among the services related to support in this area are: helping to formalize and establish policies for the audit committee and preparing information for review and consideration by the committee. In addition, in-house lawyers generally attend these meetings, and play important roles in helping to educate and train the committee members on relevant legal requirements and practices.
- **Certification of Financial Reports:** Many of the companies have developed processes in support of certifications of financial reports made by their CEOs and CFOs. In-house lawyers have helped to design overall processes, and developed checklists and responsibility charts relating to these processes. Several companies also described written or verbal internal sub-certifications provided by their chief legal officers as part of the overall process. One company explained that outside counsel providing support on compliance with legal requirements for financial filings makes a certification as part of its overall process.
- **Internal Disclosure Committees:** Some of the companies described creating internal disclosure committees. Members generally include the company's CFO, General Counsel, and business and certain functional leaders from within the organization. Two of the companies shared that in-house lawyers serve as the secretary for their committee. One company explained that in-house lawyers are "embedded in the process," and that outside counsel is included as an "ex officio" member of the committee. Companies shared that key roles for this committee include reviewing and approving draft financial reports, filings and press releases.
- **Reporting Relationship Between Law Department and CFO:** Four companies explained that there is no reporting relationship between the legal department and the company's CFO. For these companies, the chief legal officer or general counsel generally reports to the organization's CEO. Two companies described reporting relationships between members of the law department and the CFO. One company described a direct reporting relationship between the General Counsel and the CFO; another described a double-solid-line matrix reporting system whereby the Division General Counsel responsible for supporting the CFO and financial functions reports on a solid line basis to both the company's General Counsel and to the company's CFO.
- **Setting/Evaluating Litigation Reserves:** Most of the companies described interactions between in-house lawyers and financial personnel to evaluate the adequacy/ establish

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

litigation reserves. Guidance on the definition of materiality levels for reserves is set by the finance function, the legal function, or both. Interactions include ad hoc discussions on emerging matters, quarterly meetings with internal and/or external auditors, and intranet tracking systems.

- **Insurance & Risk Management:** Several companies described providing in-house legal support for clients in these areas. Services include providing guidance on insurance applications, evaluating possible claims, and providing general guidance on insurance-related matters.
- **Traditional Finance/Transactional and Treasury Support:** Companies described a broad range of services provided to their finance functions, including mergers and acquisitions/divestiture advisory work, support on securities matters, support on matters involving project finance, guarantees, bilateral loans, capital markets work, shelf registration matters, debt issuance matters, and a variety of commercial paper-type matters. Companies also described in-house legal support for the procurement process, employment practices and fraud prevention, self-audit function, and on transfer-pricing documentation.

LEADING PRACTICES

The companies were asked to identify aspects of their programs considered to be leading or best practices. Below is a list of program elements that companies viewed to be leading or best practices for their programs. Individual program summaries in Section II provide additional detail on these and other practices and program elements.

- **Culture of Openness & Strong Self-Auditing:** described by one organization's representative as a leading practice that encourages individuals to bring forward information for discussion and evaluation. In addition, the company's self-auditing function is functionally separate from the rest of the finance function and is led by a Head of Control who reports directly to the organization's CEO.
- **Enhanced Certification Process:** for supporting Section 302 certifications pursuant to Sarbanes-Oxley. The company representative describing this process shares that it involves internal reviews of financial filings by the organization's Executive Management Team, which includes the company's General Counsel. In addition, the organization has recently developed simplified plain English guidelines for the overall process, and in-house lawyers played a key role in developing this important tool.
- **Communications:** frequent and quality communications are described by several companies as leading practices that strengthen the overall working relationships between the law and finance functions.
- **Acquisitions Manual:** co-developed by in-house lawyers and the finance department. The Manual highlights best practices to help business development managers understand the essential processes to follow for transactions.
- **Knowledge Management Process:** enables in-house lawyers to obtain instant electronic access via the company's intranet to historical closing records for finance deals, and adds to the ability to provide efficient and effective legal support for the finance function.
- **Overall Compliance Program:** described by one company as allowing for enhanced opportunities to identify information that could potentially affect its compliance function. In addition, this company representative shared that the program allows for enhanced communications directly with the company's audit committee and outside auditors.
- **Matrix Reporting:** identified by one company as a leading practice that enhances alignment with business clients. Under the company's double-solid-line matrix reporting, this company's Division General Counsel-Corporate & Tax Law reports directly to both the company's General Counsel and to the CFO.

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

II. COMPANY PROGRAM SUMMARIES

Following are summaries from discussions with six companies about their law department practices supporting their finance functions.

IKON Office Solutions, Inc.

At IKON, the company's CFO and its General Counsel share a mutual respect for each other's judgment and capabilities, and welcome open discussions on matters within each other's areas of expertise. "This positive tone set at the top carries throughout the legal and financial organizations and creates an environment supportive of having open discussions, delving into issues outside traditional expertise areas, and developing respectful solutions," explains Don Liu, Senior Vice President and General Counsel. Describing his working relationship with IKON's CFO, Liu emphasizes that confidence, comfort, and the ability to advise on legal and financial issues and add value are all important aspects that create a strong foundation upon which to build.

Among the key areas of legal support for the CFO and finance function are services relating to: disclosure and certification processes; business ethics committee matters; litigation reserves; insurance and risk management; financing and treasury matters; and audit committee support. Asked for an estimate of the staffing numbers for in-house lawyers supporting the CFO and finance function, Liu explains "at some point, everyone within the law department supports the finance function."

KEY SERVICE AREAS

Lawyers throughout the legal function provide support to financial personnel in a number of key areas. Below is a summary of some of these services.

- **Business Ethics Committee:** This committee has been in place since well before Sarbanes-Oxley, and now has an enhanced function that includes coordinating all disclosures of ethics issues to outside auditors. The company's CFO and Liu work side-by-side as committee members and, together with the head of the company's Human Resources department, are responsible for reviewing all ethics issues or complaints. "We review even the most mundane, totally unsubstantiated matters. Part of our role is to kick the tires and explore the facts," says Liu, whose role also includes coordinating discussions on committee activities and evaluations with the Board.
- **Litigation Reserves:** Each quarter, the law department's Vice President of Litigation and Liu meet with internal auditors and separately with external auditors to evaluate adequacy of litigation reserves. Among the issues considered in evaluating reserves are: allegations, potential defenses, probability of success, and potential impacts of settlement and/or going to trial.
- **Insurance & Risk Management:** At IKON, the company's risk management group is responsible procuring and maintaining various corporate insurance policies. The Risk Manager reports to the company's CFO. Liu shares that in-house lawyers frequently interact with personnel in this organization to provide information on insurance applications, discuss possible claims that may need coverage, and to provide general guidance on insurance-related matters.
- **Financing and Treasury:** In-house lawyers provide legal and strategic support to the company's Treasurer (who reports to the CFO) on financing matters (e.g., going to the public or private market for financing). A lawyer within the company's law department is

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

designated as being on-point as the legal contact for the treasurer, and Liu shares that both the in-house lawyer and the company's Treasurer have "a close working relationship and tremendous respect for each other."
- **Audit Committee:** Liu describes this area of intersection as one where the workload for in-house lawyers has increased in recent years. The legal and finance functions prepare information for consideration prior to the quarterly meetings of the audit committee. In addition, an in-house lawyer generally attends these meetings to provide background and information on issues. Lawyers supporting the audit committee have also played important roles in helping to educate and train the Board and the audit committee on requirements relating to Sarbanes-Oxley.
- **Certification Process:** The company has developed an overall process to support certifications by the company's CEO and CFO required by Sarbanes-Oxley. As part of this process, managers are required to certify as to their awareness of matters and the accuracy of the company's 10Q and 10K reports. Liu explains that he also reviews these documents and provides an internal certification, based in large part on the certification of another in-house lawyer on his team who specializes in these matters for the company.

NO REPORTING RELATIONSHIP BETWEEN GENERAL COUNSEL AND CFO

Liu explains that he reports directly to the company's CEO, and there is no reporting relationship between him and the company's CFO. "In general, I think it would be a mistake to have such a reporting relationship. There must be an ability to have frank dialogue and disagreements without the fear of retribution," says Liu. "What it all comes down to is the need to have a genuine trust for each other's opinions and judgments so that we can speak bluntly about matters, and I think that we have that here. If we were to have a genuine disagreement on a matter (this hasn't happened yet), then it is important to have a direct line to the company's CEO."

LEADING PRACTICES

Asked which aspects of his law department's practices he would consider to be leading in this area, Liu describes the company's compliance program as a leading practice that has allowed for enhanced opportunities to identify information that could potentially affect the finance function. The program also provides opportunities to have open communications with the outside auditors and the Audit Committee regarding any significant compliance matter or trends as well as to identify any areas of possible improvement in internal controls.

National Treasury Management Agency

The National Treasury Management Agency was established in 1990 to manage Ireland's national debt - which now stands at 37.5 billion, the second lowest debt/GDP ratio in the European Union. Since then, NTMA has expanded its scope to include managing Ireland's National Pensions Reserve Fund (a 10 billion Euro investment fund), and managing certain litigation brought against government entities (generally personal injury cases) with a staff of litigation specialists. NTMA also provides debt management consultancy services to other countries including the new European Union accession states, and most recently has created an affiliate entity, the National Development Finance Agency, responsible for handling government-sponsored critical infrastructure projects in Ireland.

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

The NTMA consists of a number of internal business units, including the Finance, Technology & Risk group. NTMA's two financial services specialists, Anne Counihan (General Counsel) and Aideen O'Reilly (Senior Legal Advisor), provide legal support to all of these business units, and to an independent auditing function within NTMA led by the Head of Control. In addition, Counihan serves as Chief Executive Officer of the National Development Finance Agency. The legal team also provides legal support to that entity.

KEY SERVICES FOR FINANCE FUNCTION

Through the years, the NTMA has developed a number of processes and internal controls to support the Agency's finance function. O'Reilly describes these processes and internal controls as "very much at the leading edge."

"The NTMA's financial controls processes work well on a daily basis. Contributing to the success of these controls is the way that various duties are segregated within the Agency," says O'Reilly. In-house lawyers were consulted in the design phases.

- **Transaction Support:** In-house lawyers negotiate, review and sign off on all transactions undertaken by the NTMA, and the Agency's CEO requires a supporting legal signature prior to signing any contracts or other obligations. NTMA's in-house lawyers review and provide assistance on a broad range of finance documents, including customer mandates, bank mandates, product descriptions, terms and conditions of products, and all capital markets documentation.
- **Procurement Process:** In-house lawyers are involved early in the process, and provide guidance and support on drafting Requests for Proposals for significant services and contracts.
- **Internal Audit Support:** As noted above, the NTMA has a separate audit function led by the Agency's Head of Control, who reports directly to the NTMA's CEO. The Agency also engages outside auditors to carry out an annual audit and in-house lawyers provide support in drafting relevant contractual arrangements and scope of work documents. In addition, the in-house legal team serve as resources to the Head of Control and advise on issues that may arise relating to internal audits.
- **Support for Audit Committees:** O'Reilly and Counihan played important roles in advising how best to implement audit committee structures for the various legal entities involved in the NTMA business groups and in designing mandates for the individual audit committees. As a result, the NTMA designated an audit committee that serves as an advisory specialty committee for the Agency's Advisory Committee (described as a "quasi-board"). The National Pensions Reserve Fund also created an audit committee. O'Reilly and Counihan continue to provide guidance to the audit committees on issues and inquiries.
- **Employment Policies & Practices:** Another area where in-house lawyers provide support to the finance function is in reviewing compliance with developments in employment law and implementation of fraud prevention practices such as 10 days consecutive leave policy, which is audited each year by the Head of Control's team.

LEGAL FUNCTION REPORTING RELATIONSHIPS

There are no direct reporting relationships between the legal and finance functions. Counihan, NTMA's Chief Legal Officer, reports directly to the Agency's CEO. Similarly, the Director of Finance, Technology & Risk and the Head of Control report to the CEO.

WORKING RELATIONSHIPS BETWEEN LEGAL AND FINANCE FUNCTIONS

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

With regard to working relationships, O'Reilly explains "we have a very centralized and tight organization at NTMA. The business and legal functions have historically enjoyed very good working relationships. Our legal team has an open door policy, and with our flat organization, access is a strength." O'Reilly also notes that the post-Enron era has emphasized the importance of the need for CFOs and CLOs to make the appropriate levels of business inquiry. "Gone are the days when a CFO or CLO can sit in silos and let the business units get on with it," she says.

LEADING PRACTICES

Asked about which of the law departments' practices she would consider to be leading, O'Reilly focuses on NTMA's culture and environment of openness and strong self-auditing programs. "Having a culture that promotes and values openness is extremely valuable. Individuals are encouraged to bring matters forward and state their cases so that issues are fully discussed prior to decisions being taken". On the NTMA's documentation of policies and procedures, she explains "the design of the procedures and processes has occurred in a very measured and methodical way. Our documents were drafted on a collaborative basis, and everyone takes responsibility for them." Finally, O'Reilly shares "we are constantly self-auditing". The Head of Control has an audit time table, some of which is self-generated, some is set with input from the audit advisory committee, and some is based on input from the CEO." The legal team is audited as part of the overall internal auditing efforts.

TIAA-CREF

TIAA-CREF's law department is organized along four Division lines designed to align with the company's recently restructured business organization. The law department's Corporate & Tax Law Division, led by Division General Counsel Lisa Snow, provides legal support to the company's CFO and finance functions and to all of the company's corporate staff functions.

To further enhance alignment with its internal clients, the law department has adopted a double solid line matrix reporting system. Under this system, Division General Counsel report on a solid line basis to both the company's General Counsel, George Madison, and to the leader(s) of the business division(s) that they support. For Snow, this includes a solid line reporting relationship to the company's CFO.

"The working relationship between the company's law department and finance functions has historically been close. Matrix reporting and the redesigned organizational structure have been implemented with the goals of enhancing overall alignment and helping to prioritize issues of importance to our client base," explains Snow.

The law and compliance areas at TIAA-CREF have also adopted a set of Operating Principles that describe the need to maintain a corporate focus and to bring broad business and legal perspectives to client business decisions. Snow describes these principles as emphasizing the need to be client-focused, to have a corporate perspective, and to uphold high ethical standards.

PRIMARY LEGAL SERVICES SUPPORTING FINANCE FUNCTIONS

"Overall, there has been an increase in the CFO's workload and the workload of the lawyers supporting the CFO and finance functions," explains Snow. "Much of this relates to Sarbanes-Oxley requirements and the current regulatory environment for financial service organizations."

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

Asked about the types of services provided to the company's CFO and finance functions, Snow describes a number of "areas of particular intersection," including: Regulatory Financial Reporting; Auditor Independence Rules; new Whistleblower Rules; Tax Reporting; Custodial Banking and Relationships; Contract Administration; and Anti-money Laundering. In addition, lawyers within the Corporate and Tax Law Division devote time to monitoring and communicating legislative and regulatory developments of interest and relevance to their Finance clients.

Legal services in support of the Board have also increased. "Boards in general seem to be more concerned about compliance. Our Boards are proactive and engaged," says Snow. Mr. Madison, the company's General Counsel, generally takes the lead on legal presentations to the Board; however, Snow and other in-house lawyers supporting the CFO and finance functions also serve as resources at Board and Committee meetings and on training programs for the Board.

SARBANES-OXLEY CERTIFICATION PROCESS

The company has recently formalized more fully its internal process for supporting Section 302 certifications required by Sarbanes-Oxley, and the in-house legal team supporting the finance function played a key role in drafting the new guidelines for this process. The new guidelines are described by Snow as "simplified and written in plain English."

Towards the end of each reporting period, the company's disclosure committees prepare draft documents for review. The documents are distributed to the company's Executive Management Team ("EMT"), which is comprised of a group of eight senior managers (including the CFO, the General Counsel, and the heads of Products, Sales, Marketing, Human Resources, Information Technology, and Risk Management). Each of the EMT leaders is expected to sit down with his/her compliance and financial personnel, and with the relevant Divisional General Counsel to review and discuss the documents.

Asked whether lawyers are required to sub-certify in support of the broader certification process, Snow shares that the process does not require it but each EMT leader has the discretion to request sub-certifications from his/her reports. Snow describes the typical process for legal as involving a thorough review of the documents and discussions with the lawyers responsible for supporting other areas to confirm sufficiency of reports and identify any additional issues for consideration.

RELATIONSHIP BETWEEN LAW AND FINANCE

As noted above, Snow describes the working relationship between the finance functions and the law department at TIAA-CREF as close. She also explains her view that "increasingly, in-house lawyers are viewed as more key and central to business determinations. In-house lawyers are invited to the table earlier, and are viewed as adding value."

LEADING PRACTICES

Asked which aspects of TIAA-CREF's law department's practices in supporting the CFO and finance functions she would consider to be leading practices, Snow identifies the matrix reporting and the enhanced certification process as innovative. "From the CEO down, we are trying to instill a culture that if something doesn't look right, it should be elevated within the company," says Snow. She also expresses that she is very proud to work at TIAA-CREF, which she considers to be "particularly committed to integrity."

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

TOTAL S.A.

TOTAL S.A. is an integrated oil company with operations in more than 100 countries. The company's law department includes around 350 lawyers, and legal support for the finance function is provided by the Mergers, Acquisitions and Finance Legal Department led by Jonathan Marsh. The M&A and Finance team includes 7 lawyers, all located at the company's headquarter offices in Paris - La Défense, France.

"At TOTAL, we have a lot of cooperation between the legal and finance functions. Our groups participate on an equal basis on transactions, and we use a cooperative methodology to try to add value to transactions that we work on together,"says Marsh. "Legal and financial departments are often viewed as cost-centers. Our groups share a positive work attitude and work together within our discipline areas to achieve a common goal of helping to reduce costs and add value by structuring transactions to increase tax and other efficiencies and reduce exposures," explains Marsh.

LEGAL SERVICES FOR FINANCE FUNCTION

The M&A and Finance legal department provides three main types of services to clients within the finance function:

- **Mergers and acquisitions advisory work:** includes support on acquisitions, dispositions, joint ventures, etc.. In-house lawyers play important roles advising on deal structure and in helping to develop and negotiate deal documents.
- **Support on core finance issues**: includes support on matters involving project finance, guarantees, bilateral loans, capital markets work, shelf registration matters, debt issuance matters, and a variety of commercial paper-type matters. Legal services include advising on legal issues, reviewing and drafting documents, and helping to negotiate documents.
- **Support on securities law issues**: the company is traded on the Paris and the New York Stock Exchanges, and Marsh describes the volume of work in this area as "significant." Marsh shares that there has been an increase in in-house legal work in connection with SEC and NYSE requirements, and the company has hired an additional lawyer to focus on these issues full time.

DISCLOSURE COMMITTEE; ANNUAL REPORTS

The company created a Disclosure Committee in Fall of 2002 pursuant to SEC recommendations, and Marsh serves as the committee's Secretary. The company's CFO serves as Chairman of the Disclosure Committee, and additional committee members include the company's Treasurer, General Counsel, Chief Accounting Officer, Budget Director, and the Heads of Communications, Investor Relations, and Mergers/Acquisitions and Finance. Marsh explains that the Disclosure Committee meets 6-8 times per year. Among the roles of the Disclosure Committee are evaluating and approving the company's: Annual Reports (for both France and the U.S.); quarterly earnings press releases; and semi-annual road show slide materials for presentations to the investment community on corporate results.

With regard to preparing the Annual Reports, Marsh explains "the Disclosure Committee has tried to harmonize as much as possible information included in both the French and U.S. Annual Reports, and this has included evaluating the various requirements and, in some cases, deciding to include more rigorous requirements in a report that may not otherwise require the detail included."

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

The overall approach is described as "decentralized," with information being developed and approved within the various company branches having responsibility for the information.

The process begins with a responsibility chart that specifies who within the company is responsible for each of the various sections of the document. In addition, each of the consolidated subsidiaries of the group are required to provide management certifications. Marsh explains that around 2000 certificates are reviewed and provided to the company's auditors, and that language in the model certification forms has been expanded to address certain issues and requirements of Sarbanes-Oxley. A third component of the process involves certificates obtained from the President of each branch of the company (such as Exploration & Production; Gas and Power; Trading and Shipping; Chemicals; and Refining & Marketing) whereby the various Presidents certify that the procedures (including adherence to the responsibility chart) have been followed. Once the process of developing the overall reports is complete, the information is then forwarded to the Disclosure Committee for review and approval. In house lawyers in the department consider disclosure issues based on these responses. The responsibility chart is revised periodically with the assistance of the M&A-Finance Legal Department in coordination with in house lawyers in the Group's divisions.

RELATIONSHIP BETWEEN THE LEGAL AND FINANCE FUNCTIONS

"In-house lawyers play integral roles in supporting the finance department. Everyone perceives the business environment as having changed dramatically within the past three years. This has led to both a bit more tension and greater sensitivity. This increased focus and interest seems to be enhancing the cooperation between the groups," says Marsh.

LITIGATION RESERVES

The company has had procedures in place for a number of years to report information on contingent liabilities. Marsh has delivered internal seminars to the company's internal accounting department addressing the definition of materiality and the SEC's views on materiality. In-house lawyers are involved in reporting information to the General Counsel of their various branches at the outset of litigation. The General Counsel of each division then reports the information up to the company's General Counsel, who together with internal litigation personnel and the CFO determine the appropriate path forward for setting litigation reserves and reporting information.

LEADING PRACTICES

Asked for his thoughts on which elements of the interactions between the finance and legal functions might be considered leading practices, Marsh explains "in-house lawyers are very good at informing the finance function about legal developments and ongoing requirements." In addition, the company's Knowledge Management Process enables in-house lawyers to obtain instant electronic access via the company's intranet to historical closing records for finance deals, and adds to the ability to provide efficient and effective legal support for the finance function. A third leading practice identified by Marsh is an Acquisitions Manual, which was co-developed by in-house lawyers and the finance department. The Manual highlights best practices to help business development managers understand the essential processes to follow for transactions.

Yamanouchi Pharmaceutical Co., Ltd.

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

"General Counsel and Chief Financial Officers generally have a great similarity in temperament: both may be characterized as conservative with leanings towards risk aversion, yet beneath this beats the heart of a profit center," explains Jerry Temko, General Counsel for Yamanouchi's European operations. Asked about key areas of support provided by in-house lawyers to the CFO and finance function, Temko describes four areas, two of which he views as more traditional areas of cooperation, and two of which he views as newer frontiers. Among the critical success factors contributing to the positive working relationships between Yamanouchi's legal and financial functions, Temko emphasizes the importance of continuous communications and sharing of information.

KEY SERVICE AREAS

As noted above, in-house legal support for the finance functions at Yamanouchi can be described as concentrating in four areas. Legal services for the company's audit function and for the risk management/insurance function are characterized as traditional areas of intersection. Newer, is support for transfer-pricing initiatives flowing from Organisation for Economic Co-operation & Development (OECD) rules on arms-length transactions. And, the newest frontier described by Temko is in providing support on presentations to the investment community.

- **Audit Function Support:** In-house lawyers play a key role in helping to define and evaluate the adequacy of litigation reserves. The process includes input from operations lawyers for the various regions on matters that exceed certain levels of materiality set by the company's auditors. Lawyers report capsule descriptions of relevant matters, and log them on an intranet website page. In addition, legal and financial personnel meet on a quarterly basis to review the adequacy of litigation reserves. The overall process is described by Temko as "ongoing."
- **Risk Management/Insurance Support:** Risk management personnel are responsible for performing self-assessments of the company's programs, and in-house lawyers provide guidance and support in connection with these efforts. In addition, in-house lawyers coordinate and provide guidance to financial personnel on matters involving insurance applications and policies.
- **Transfer-pricing Documentation:** In-house lawyers interface with financial personnel in helping to structure and draft agreements consistent with the OECD transfer pricing rules affecting multinational companies.
- **Presentations to Investment Community:** Temko describes legal support for the CFO and financial personnel in this area as the "newest frontier." Among the services provided by in-house lawyers in connection with presentations to the investment community are guidance on disclaimers on forward-looking statements, and providing guidance on presentation materials and press releases generally. Temko explains the importance of dialogue and achieving balance in this area and notes that the role of the lawyer in reviewing these types of presentations is traditionally a defensive and protective one; whereas, financial personnel and the CFO are focused on sharing information in the best light.

GENERAL COUNSEL REPORTS TO CEO

Asked whether there is a reporting relationship between Yamanouchi's General Counsel and the company's CFO, Temko explains that there is not and that the company's General Counsel reports to the CEO. In describing reporting relationships generally in Europe, Temko notes that some companies, particularly in the U.K., are separating the role of General Counsel and Corporate

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

Secretary, and that it is more common in Europe for there to be a reporting relationship between the General Counsel (or Corporate Secretary) and the CFO.
LEADING PRACTICES

In response to a question asking for thoughts on which elements of Yamanouchi's practices in this area he would consider to be leading practices, Temko identifies continuous communications and information sharing as leading practices. "The finance and management team prioritize sharing information on strategic goals for the year forward, and the management team publishes its objectives. In addition, in-house lawyers participate in financial meetings that include discussions on legal issues," says Temko. "The similarities in temperament and the strong communications between the functions contribute to the success of these working relationships."

$40 Billion Financial Institution

The relationship between in-house lawyers and the CFO and finance department for this $40 Billion Financial Institution is described by the company's Executive Vice President, General Counsel & Secretary as "very good prior to Sarbanes-Oxley, and stronger, closer, and more collaborative following Sarbanes-Oxley." Important to the success of the working relationship between the groups is a genuine spirit of cooperation and a focus on timely and meaningful communications.

Key areas of interface between the law department and the finance function include matters relating to litigation reserves, disclosures, and certifications. A number of processes have been implemented to support these initiatives, and in-house and outside lawyers play important roles.

COMMUNICATION IS KEY

The underlying principle for the company's approach to internally disclosing material matters is that "there should be no surprises." The company's Executive Vice President, General Counsel & Secretary (General Counsel) explains that in-house lawyers are encouraged to follow a "heads-up/early warning" process on all matters potentially involving litigation reserves or disclosures. This process includes discussions with the General Counsel about these matters, and direct communications between the in-house lawyers handling the various matters and finance personnel to encourage efficient sharing of information. In addition, litigation managers and the company's Controller meet on a quarterly basis to discuss the adequacy and need for litigation reserves.

To help establish internal guidelines on the definition of materiality for purposes of internal communications, the company's General Counsel asked for input from the finance function. The resulting guideline was then communicated to managers and in-house lawyers throughout the company to help ensure that matters that meet the criteria are discussed.

DISCLOSURE AND CERTIFICATION PROCESSES

Another important process developed to support disclosure and certification requirements pursuant to Sarbanes-Oxley involves disclosure committee and audit committee discussions and reviews of financial information. The company's General Counsel describes the role of in-house lawyers as "embedded in the process;" however, he also emphasizes that in-house lawyers focus on legal concepts and processes rather than on numbers and accounting details.

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

- **Disclosure Committee:** The company's Disclosure Committee is chaired by the company's Controller, and consists of managers for the major departments within the company. The General Counsel is a committee member and serves as the committee's Secretary. In addition, outside counsel has an ex officio committee membership status. Among the key roles of the Disclosure Committee are evaluations and discussions of potential disclosure items for the company's 10-K and 10-Q filings, and for earnings releases.

- **Audit Committee:** The Audit Committee of the Board of Directors provides an oversight role for the disclosure and certification processes. As part of its process and oversight roles, the audit committee participates in telephone conferences to evaluate information prior to 10-K, 10-Q, and earnings release filings.

  To help guide the audit committee's due diligence, the company's General Counsel and finance function have developed a suggested question list. The list includes questions for the Controller, Internal Audit, Credit Management, the CEO and CFO, Independent Auditors, and for the General Counsel and Outside Counsel. Categories covered on the list include questions on credit losses and other allowances, questions on the CEO and CFO certifications, and general questions on process and quality of the documents. In addition, the list includes a question for in-house and outside counsel asking whether there are any additional matters that counsel feel the committee should consider. A copy of the Earnings Release Question List may be accessed via link in the Resource List in Section III of this Profile.

CERTIFICATIONS

Asked whether the CEO and CFO require sign-off from the General Counsel as support for their certifications, the General Counsel explains that a stand-alone certification is not required. As mentioned above, the committee oversight process includes dialogue and discussion with the General Counsel as to matters within his awareness. In addition, for the company's 10-Q and 10-K filings, outside counsel performs a compliance review of the documents and is asked to represent and certify that the compliance review is complete and that the documents are in compliance with SEC requirements. Business managers on the Disclosure Committee are also asked to certify that descriptions of matters within their areas of responsibility in draft SEC filings are appropriate.

NO REPORTING RELATIONSHIP BETWEEN GENERAL COUNSEL & CFO

The relationship between the company's General Counsel and CFO is described as collaborative while also very much a lawyer-client relationship. There is no reporting relationship between the two. The General Counsel reports directly to the company's Deputy Chairman, as does the CFO. Asked about thoughts on a different reporting structure where a reporting relationship might exist, the General Counsel shared his view that such a structure could present conflicts and potentially be a disservice to a company. "As a General Counsel, my duties of loyalty and representation are to the company."

ACC thanks Renee Dankner, former senior counsel to Mobil, for her work on this profile.

III. RESOURCE LIST

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.

Please note that this listing does not constitute a recommendation or endorsement for any product, service or company. Please find below a list of resources identified by companies interviewed or by ACC as possible resources that may be of interest in evaluating and developing in-house legal practices for supporting the CFO or finance functions.

COMPANY RESOURCES

$40 Billion Financial Institution
Earnings Release Question List
http://www.acca.com/protected/forms/audit/release.pdf

ARTICLES; PUBLICATIONS

Article: "*You Have the Right to an Attorney,"* by Craig Schneider (CFO.com August 20, 2003).
http://www.cfo.com/article/1,5309,10430|||1,00.html

Article: "*The attorney's dilemma: will the SEC's new and proposed rules to turn lawyers into whistle-blowers strain relations between finance executives and corporate counsel?"* by Craig Schneider (CFO Magazine October 2003).
http://articles.findarticles.com/p/articles/mi_m3870/is_13_19/ai_108784410/print

Article: "*SEC Enforcement Investigation-What You Need to Know,"* by Gregory H. Matthews, Kenneth B. Winer, Samuel J. Winer, and Gregory R. Bruch (ACC Docket Nov/Dec 2003)
http://www.acca.com/protected/pubs/docket/nd03sec.pdf

Article: "*Post-Enron Developments in Disclosure Requirements,"* by John J. Huber and Thomas Kim of Latham & Watkins (Feb 26, 2002)
http://www.acca.com/public/article/enron/disclosure.pdf

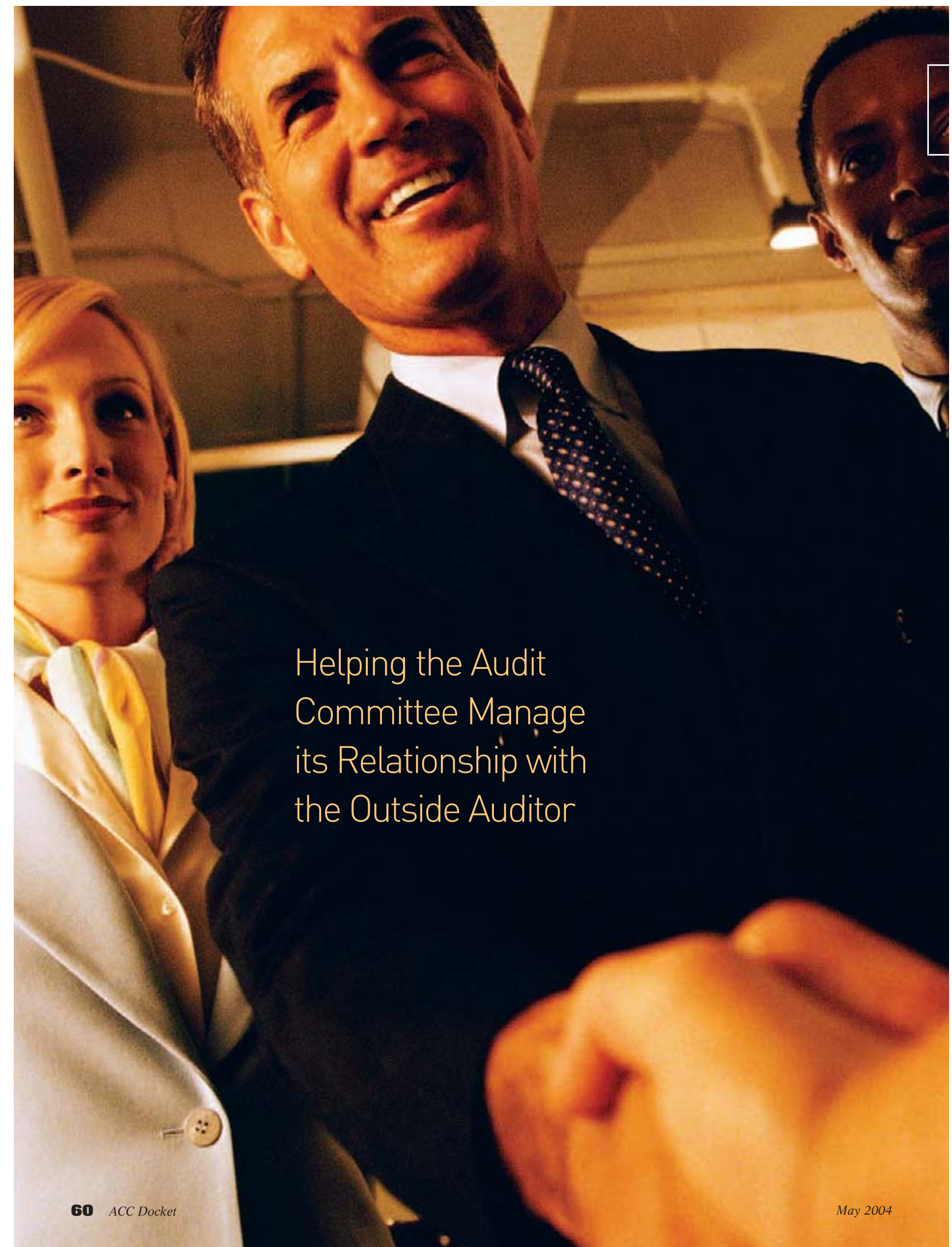
ADDITIONAL RESOURCES

THE SEC RULE ON ATTORNEY CONDUCT: 17 C.F.R. PART 205
http://www.acca.com/protected/legres/corpresp/205standard.pdf

Association of Corporate Counsel
http://www.acca.com/legres/corpresponsibility
(click on Sarbox Section 307 for background articles, executive summaries of SEC's rule, ACC's comments to the SEC during the rule making process, etc..)

Association of Corporate Counsel
Memo to Members: "*ABA adopts New Model Rules Affecting In-House Practice"*
http://www.acca.com/protected/comments/abamodelrules.pdf

Copyright © 2004, Association of Corporate Counsel
For more information on leading practice profiles: http://www.acca.com/vl/practiceprofiles.php.



By Michael D. Cahn
and Michael J. Scanlon

Tools You Can Use

IT SEEMS INNOCENT ENOUGH—one of your company's subsidiaries in Indonesia has been outsourcing its bookkeeping for the past few years. No problem, right? But then you learn that the same firm that has been providing these bookkeeping services is an affiliate of your outside auditor. The antennae start to go up. You wonder: Is this an auditor independence problem? Does the outside auditor know about this potential conflict? Should the audit committee get involved in this situation? Assuming there is an independence concern, what are the consequences and how can you remedy the situation?

Michael D. Cahn and Michael J. Scanlon, "Tools You Can Use", *ACC Docket* 22, no. 5 (May 2004); xx-xx. Copyright © 2004 Michael D. Cahn and Michael J. Scanlon, and the Association of Corporate Counsel. All rights reserved.

Michael D. Cahn is Senior Associate General Counsel–Securities for Textron Inc., in Providence, RI. He is a member of ACC's Board of Directors and is a former Chair of ACC's Corporate & Securities Law Committee. He can be reached at mcahn@textron.com.

Michael J. Scanlon is a Senior Associate at Gibson, Dunn & Crutcher LLP in Washington D.C., where he is a member of the firm's corporate transactions and securities regulatory groups and specializes in corporate governance and matters involving auditors. He can be reached at mscanlon@gibsondunn.com.

Resolving questions concerning the outside auditor's independence has always been an important part of the audit process, but until recently it might have been seen as somewhat routine. However, developments over the past few years—in particular, the passage of the Sarbanes-Oxley Act of 2002—have made the issue of auditor independence a primary concern for audit committees and company management. Because the Act makes the audit committee "directly responsible" for the appointment, compensation and oversight of the outside auditor, the audit committee must play a more active role than ever in overseeing a company's relationship with its outside auditor.[1]

In-house counsel can also play a crucial role in assisting the audit committee in this task. As a starting point, you should ensure that the audit committee understands the auditor independence rules, including the requirements for audit committee pre-approval of services to be provided by the auditor. Imparting this understanding is no easy task given the complexity of the auditor independence rules as applied in today's complex business environment. But this may not be enough. It also is imperative that you help ensure that the individuals who will have frequent interaction with the auditor—such as your chief financial officer and controller—also fully understand the auditor independence rules and the consequences that will result if the auditor's independence is deemed impaired. Achieving that level of understanding is a daunting task, but one for which you can provide significant assistance.

AUDITOR INDEPENDENCE BEFORE AND AFTER SARBANES-OXLEY

Many people share the common misperception that the auditor independence rules came of age with the passage of the Sarbanes-Oxley Act. While Sarbanes-Oxley affected some important changes to these rules, the guidelines governing an auditor's relationship with its client evolved well before the Act's passage. For decades, the Securities and Exchange Commission (SEC) has required that all audited financial statements included in annual reports or registration statements filed by public companies be audited by independent auditors. The criteria for determining the independence of auditors developed over the years in informal fashion, with the SEC staff issuing non-binding guidance from time to time in the form of no-action letters or interpretive releases. However, in 2000, after a sometimes contentious rulemaking process, the SEC issued a comprehensive set of rules governing auditor independence. These rules were modified and expanded in 2003 with a further round of SEC rulemaking that was mandated by Sarbanes-Oxley; as a result, the independence rules that are in effect today are largely a combination of the 2000 and 2003 rules.[2]

The SEC's current rules governing auditor independence include both general and specific criteria for assessing an auditor's independence. Starting with the general standard, an auditor will not be recognized as independent "if the accountant is not, or a reasonable investor knowing all the relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement."[3] This general standard dictates that the auditor must be independent in fact and appearance, and lays the foundation for the specific categories of relationships that are further proscribed by the rules. The general standard also applies in circumstances that are not expressly covered by any of the rules addressing the specific categories of relationships. Consequently, even though the rules may not appear to cover your particular situation, you must consider how the general standard might apply before concluding that your auditor's independence will not be deemed impaired.[4]

Prior to 2000, the SEC's auditor independence rules were uniquely focused on this general standard. While one could turn to various resources in the pre-2000 era to analyze the manner in which the SEC would apply the general set of criteria in any given situation, the analysis of such issues was based more on lore than law. To infuse this critical analysis with a greater level of certainty, the SEC formally identified specific categories of prohibited relationships as part of the 2000 and 2003 auditor independence rulemaking process.[5] These specific standards govern the following types of relationships between the outside auditor and the audit client: (1) financial relationships, (2) employment relationships, (3) business relationships, and (4) the provision of non-audit services by the outside auditor to the audit client.

THE RULES ON FINANCIAL RELATIONSHIPS IMPOSE LIMITATIONS ON DIRECT AND MATERIALLY INDIRECT INVESTMENTS, INVESTMENTS IN COMMON WITH AUDIT CLIENTS, BROKER-DEALER RELATIONSHIPS, DEBTOR-CREDITOR RELATIONSHIPS, AND INSURANCE PRODUCTS ISSUED BY CLIENTS.

The rules also identify numerous sub-categories of relationships within each of the broader categories that may be deemed to impair independence. In considering the relationships identified in these subcategories, you always should bear in mind that the rule's use of the term "audit client" includes all affiliates of the audit client, which generally means any entity that controls, is controlled by, or is under common control with, your company.[6] Thus, when evaluating whether the rules apply to a particular situation, you should consider the relationships between your company and the auditor, as well as the relationships between your auditor and subsidiaries, equity investments (including joint ventures), and other controlled entities. Similarly, the definition of "audit firm" in the SEC's rules includes not just the firm that is actually auditing your company but also associated entities of that firm, which might operate under different names in various countries.[7]

Financial Relationships

The rules on financial relationships impose limitations on direct and materially indirect investments, investments in common with audit clients, broker-dealer relationships, debtor-creditor relationships, and insurance products issued by clients.[8] For example, under the SEC's auditor independence rules, your audit firm and its accountants clearly cannot hold direct investments—stocks, bonds, notes, options, or other securities—in your company during the period of the audit engagement. Your auditor's independence may also be deemed to be impaired if the audit firm makes an investment in your company through an intermediary under its control.

Employment Relationships

The rules also prohibit employment of current professional personnel of an outside auditor from being employed by the audit client or serving on the audit client's board of directors. This prohibition may seem obvious enough, but situations may inadvertently arise that implicate this rule. For example, let's say that a senior financial officer at one of your subsidiaries in Malaysia resigns during a critical financial reporting period, and local management of your subsidiary asks a senior accountant from your auditor's affiliate in Kuala Lumpur to temporarily perform the manager's duties until the press of work subsides. This may sound innocent enough, but you now have a significant auditor independence situation on your hands.

Similarly, the auditor's independence could be deemed impaired if a close family member of a partner or a professional employee of the auditor serves in an accounting role or financial reporting oversight role (a position where he or she has influence over the content of your accounting records).[9] In addition, as part of Sarbanes-Oxley, Congress expanded the conflict of interest principles governing employment by former audit firm personnel, providing that independence will be impaired unless there is a one-year cooling off period before a member of the audit engagement team can begin working with the client in certain key financial positions.[10] The "one-year" cooling-off period is somewhat of a misnomer, however, because the rules adopted by the SEC to implement this provision can extend the cooling-off period to up to 23 months, depending on when the individual left the audit firm and whether he or she was working at the firm at the time the firm commenced its audit procedures for your current audit.[11]

Business Relationships

The auditor independence rules also severely restrict the extent to which your company is permitted to enter into business relationships with its auditor. Specifically, an auditor's independence will be deemed impaired when the auditor has a direct or material indirect business relationship with an audit client.[12] This aspect of the rules is sometimes difficult to apply in practice given the rule's subjective construction of what constitutes a material indirect business relationship. As a general matter, however, you should be alert to the potential for an independence violation when you see that your company is being asked to provide a product or service to your auditor that you know to be material either to the auditor or to your company.

Joint business ventures and prime/subcontractor relationships between an auditor and your company also are off limits under this provision of the auditor independence rule. Despite the apparent breadth of its prohibitions, the rule is not intended to limit ordinary course transactions.[13] For example, if your company is selling off-the-shelf software to numerous customers, you would be permitted to sell the same product to your auditor—unless the auditor is materially reliant on the software, in which case further consideration would need to be given to whether the sale would present an independence problem.

Non-Audit Services

The portion of the auditor independence rules that has received the most attention since the passage of Sarbanes-Oxley pertains to restrictions on an auditor's ability to provide non-audit services to its client. Most of these scope of service restrictions, however, had already been implemented by the SEC as part of its 2000 rulemaking. The provisions include restrictions on the several types of non-audit services (*see* "Don't Go There," this page, for a complete list). Congress affirmed the restrictions on these services when it passed the Sarbanes-Oxley Act, and merely added expert services to the list of prohibited engagements.[13] In addition, Congress authorized the Public Company Accounting Oversight Board (PCAOB) to supplement the proscriptions on non-audit services.[14] Importantly, Sarbanes-Oxley clarified that audit firms may continue to provide tax services to their clients, although some qualifications to this principle that have been articulated by the SEC. (See "A Tax Service by Any Other Name . . . ," next page, for a discussion of these limitations.)

Don't Go There

RESTRICTIONS ON NON-AUDIT SERVICES

The SEC's auditor independence rules set forth 10 particular non-audit services that will be deemed to impair the auditor's independence. Although the rules governing these restricted services are not absolute in all cases (for example, some of the restrictions include an exception if it is reasonable to conclude that the results of these services will not be subject to audit procedures during a financial statement audit), the circumstances where these types of services can be provided by your outside auditor are very limited. Thus, your company should refrain from engaging the independent auditor to perform the following services, unless it is clear that the circumstances would permit such an engagement:

- Bookkeeping or other services related to your accounting records or financial statements,
- Financial information systems design and implementation,
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports,
- Actuarial services,
- Internal audit outsourcing services,
- Management functions, including acting (temporarily or permanently) as a director, officer or employee of your company or performing any decision-making, supervisory or ongoing monitoring function for a company,
- Human resources functions,
- Broker-dealer, investment adviser or investment banking services,
- Legal services, *i.e.*, services that could be provided only by someone qualified to practice law in the jurisdiction in which the service is provided, and
- Expert services unrelated to the audit, including the provision of an expert opinion or other expert service. (In legal proceedings, however, the independent accountant is permitted to provide factual accounts of work performed and can explain positions taken during the performance of any services provided for your company.)

When formulating rules implementing the auditor independence provisions of Sarbanes-Oxley, in 2003, the SEC modified some of the exceptions to the scope of service restrictions. For example, the rules eliminated an exception that allowed bookkeeping services if the services were provided in an emergency situation. On the other hand, the SEC's rules now allow an auditor to provide bookkeeping, appraisal or valuation services, actuarial services, and internal audit services, when "it is reasonable to conclude that the results of these services will not be subject to audit procedures" during a financial statement audit.[15] In these situations, the SEC has indicated that it is comfortable with the auditor providing the otherwise prohibited service because the auditor will not be auditing its own work.[16]

Another important exception set forth in the rules allows audit firms to evaluate the internal control systems of their audit clients for purposes of recommending changes to these systems and processes. This is a significant development because under Section 404 of Sarbanes-Oxley, your auditor must attest to management's evaluation of your company's internal control over financial reporting. By allowing the auditor to evaluate these internal controls in advance of the attestation and recommend changes where appropriate, this exception should minimize the number of instances in which a company is surprised by an adverse attestation report from the auditor. Your auditor, however, still cannot design or implement your internal accounting systems or risk management controls because these services would be deemed to impair independence.

A Tax Service by any Other Name . . .

The Sarbanes-Oxley Act provides that an accounting firm does not impair its independence by providing tax services that are pre-approved by the audit committee. In its release adopting auditor independence rules under Sarbanes-Oxley, the SEC reiterated its own position that an accounting firm can continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients without impairing its independence. However, the release warns that merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence. In particular, the release notes that an accountant's independence could be deemed to be impaired if the accountant is retained to structure a transaction initially recommended by the accountant—the sole purpose of which is tax avoidance and the tax treatment may not be supported by the Internal Revenue Code and related regulations.

TACKLING AN EXPANDED PRE-APPROVAL ROLE

The Sarbanes-Oxley Act's most important modification to the auditor independence regime is the enhancement of the audit committee's role in overseeing and monitoring the auditor's independence. Prior to Sarbanes-Oxley, the audit committee was responsible for evaluating the outside auditor's independence in view of the services provided by the auditor.[17] With the passage of Sarbanes-Oxley, Congress considerably expanded this responsibility by making the audit committee "directly responsible" for the appointment, compensation, and oversight of the outside auditor. Congress also made one element of this oversight responsibility more concrete by requiring that the audit committee preapprove the audit and all non-audit services provided by the outside auditor.[18]

Obviously, understanding the scope of the auditor independence rules is critical for all persons involved in the audit process. As in-house counsel, you can assist the audit committee in this task by imparting your understanding of the applicable regulations when an auditor independence issue arises. A firm grasp of the auditor independence rules also ensures a smooth execution of the pre-approval process, and will enable you actively to assist your audit committee in developing a sensible and practical pre-approval strategy for the committee.

Before engaging the auditor to perform audit or non-audit services, the audit committee now must pre-approve the provision of those services. Previously, no such affirmative oversight steps were required.[19] This rule means exactly what it says—the approval must be obtained *before* the auditor is engaged for the service; subsequent ratification is not sufficient.[20] The audit committee can

implement a pre-approval process in one of two ways: by expressly pre-approving the specific engagement at an in-person or telephone meeting of the committee, or by establishing pre-approval policies and procedures that set forth the manner in which specific services are approved and in some instances, the manner in which certain categories of services are pre-approved. Many large corporations favor the latter option because it affords the audit committee greater flexibility in pre-approving outside auditor services.

CRAFTING AN ACCEPTABLE PRE-APPROVAL POLICY FOR YOUR AUDIT COMMITTEE IS NOT AS SIMPLE A TASK AS YOU MIGHT EXPECT. NOT ONLY MUST A POLICY ADDRESS THE SEC'S PRE-APPROVAL RULES, BUT IT MUST ALSO COMPORT WITH INFORMAL GUIDANCE ISSUED BY THE SEC STAFF.

The Pre-Approval Three-Step

Crafting an acceptable pre-approval policy for your audit committee is not as simple a task as you might expect. Not only must a policy address the SEC's pre-approval rules, but it must also comport with informal guidance issued by the SEC staff.

Fundamentally, a pre-approval policy must satisfy three basic requirements: (1) the policy must be detailed as to the particular services to be provided by the outside auditor; (2) the policy must evidence that the audit committee is informed of each service that is being pre-approved, and; (3) the policy cannot delegate the audit committee's responsibilities to management.[21]

Detailing the Service

When crafting a pre-approval policy, you should describe the services that are being pre-approved under the policy with as much detail as possible. One fairly common practice that audit committees already employ to satisfy this requirement is to attach an appendix to the policy specifying the services that are being pre-approved. In the appendix, services should be broken into categories—audit, audit-related, tax, and other services—and should be accompanied by a specific description of the services that the auditor will provide. For example, if the audit committee is seeking pre-approval for a service that falls under the audit-related category, such as audits of your company's employee benefit plans, it is helpful to specify the actual plans that will be audited. Similarly, if the appendix includes a category for tax compliance services, you should consider including as much detail as possible regarding the type of tax compliance services—*e.g.*, state tax filing services, expatriate tax services, or VAT tax services—rather than simply including it as a line item designated as "tax compliance" services. These recommendations are based on indications from the SEC staff that a pre-approval policy will not be viewed as acceptable if the policy provides for what the SEC views as broad, categorical approvals, such as "tax compliance" services.[22]

As a means of providing the appropriate level of detail in the policy and demonstrating effective oversight of the outside auditor, many audit committees are drafting pre-approval policies that include the terms of engagement and the fee thresholds for the various types of services for which preapproval is being sought. While the fee threshold cannot be the only basis used to pre-approve services, it is acceptable and useful to have fee thresholds that correspond to the different services. In addition, to avoid perpetual pre-approval, most policies provide that the pre-approval granted under the policy will extend for a period of one year, unless otherwise indicated. While it is not always easy to draft a policy that is sufficiently detailed, there is a simple rule of thumb: Read the description of the service in the policy, and ask yourself whether management would need to make a judgment call regarding whether an engagement falls within the pre-approved category. If this judgment call has to be made, then—according to the SEC staff—the policy may not be sufficiently detailed as to the particular services provided.[23] In such a case, the audit committee would need to pre-approve the specific engagement.

Keeping the Audit Committee Informed

By including a sufficient level of detail regarding a particular service, you will also help to ensure that the policy satisfies the second pre-approval policy requirement—keeping the audit committee

informed about the particular services to be provided by the auditor. The SEC staff has stated that when seeking pre-approval of services that are listed in a policy, it is appropriate to provide the audit committee with detailed back-up documentation regarding the specific services that are to be provided.[24] It is not exactly clear what the SEC staff has in mind when it refers to such documentation, but it might, for instance, include a detailed description of the particular work to be done, supplemented by materials such as draft engagement letters and existing summaries or outlines for the planned projects. To keep the audit committee informed, the policy can also include a provision that the audit committee will be presented with materials at its regularly scheduled meetings that provide an update on the status of pre-approved services and fees charged for those services.

IF YOUR COMPANY HAS NUMEROUS SUBSIDIARIES AND/OR JOINT VENTURES, YOU SHOULD BE THINKING ABOUT WHETHER OR NOT THE PROVISION OF SERVICES TO THESE AFFILIATES BY THE AUDITOR WOULD IMPLICATE THE PRE-APPROVAL REQUIREMENTS.

Restriction on Delegation to Management

The third pre-approval policy requirement is that the policy not delegate responsibilities to management. To satisfy this requirement, many audit committees draft pre-approval policies that contain a specific disclaimer that the audit committee is not delegating any of this pre-approval responsibility to management. The audit committee also may wish to provide that all engagements of the auditor be subject to formal engagement letters and that, in instances where the audit committee has pre-approved the service but has not itself executed the engagement letter, only certain company officers, such as the CFO or Controller, will have the authority to execute such engagement letters. This limited delegation of authority to your CFO or Controller should provide that all proposed engagements of the auditor will be approved by one of those officers or some other gatekeeper designated by the audit committee to execute such letters. Upon receiving a request for a specific engagement, this designated officer should determine if the engagement already has been pre-approved by the audit committee. If it has not, then the officer must seek pre-approval from the audit committee before the auditor can be engaged. Because the audit committee cannot delegate its pre-approval authority to management, this officer must present the engagement to the audit committee if there is any question as to whether the engagement is authorized.

Going Beyond Pre-Approval Basics

In addition to incorporating the SEC's three basic requirements into the audit committee's pre-approval policy, there are several other steps that you should consider. For example, if you want to build additional flexibility into the policy, include a provision that allows the audit committee to delegate specific pre-approval authority to one or more members of the audit committee. Under the SEC rules, if this delegation option is elected, the member or members approving the specific engagement must then report on this action at the next audit committee meeting.

Similarly, if your company has numerous subsidiaries and/or joint ventures, you should be thinking about whether or not the provision of services to these affiliates by the auditor would implicate the pre-approval requirements, and, if so, how the services that are intended to be provided to these affiliates should be pre-approved. In other words, what do you know about the services to be provided? And, what should the audit committee know about these services? Your knowledge of the auditor independence rules will be particularly helpful in these situations as you learn about the services and consider whether there are or may be any issues surrounding the services that could implicate the auditor independence rules.

Additionally, consider whether your pre-approval policy should cover audit services provided to an affiliate by an audit firm that is not associated with your principal outside auditor. Pre-approval for such services is not required under the auditor independence rules, but section 301 of Sarbanes-Oxley does mandate that the audit committee is

responsible for the "appointment, compensation, and oversight of the work of any *registered public accounting firm* employed by the issuer . . . for the purpose of preparing or issuing an audit report or related work."[25] Thus, for example, as expressed in recent guidance from the SEC staff, if a subsidiary of your company in another country uses an audit firm that is not affiliated with your principal outside auditor to provide statutory audit services, and that firm is registered with the Public Company According Oversight Board (PCAOB), your audit committee should be approving the appointment of that firm to provide audit services to the subsidiary.[26] As noted by the SEC staff, however, failure of the audit committee to pre-approve audit services provided by another audit firm will not affect the independence of the principal auditor.[27]

IN THE EVENT AN AUDITOR INDEPENDENCE SITUATION ARISES, YOU SHOULD BE PREPARED TO PLAY A CRITICAL ROLE IN MANAGING THE SITUATION. THE MOST IMPORTANT STEP IN THIS PROCESS IS TO ESTABLISH AND MAINTAIN COMMUNICATION.

You also can aid the audit committee in its oversight of the outside auditor by communicating with the outside auditor before final adoption of the pre-approval policy. Any concerns voiced by the auditor regarding the policy can be discussed with the audit committee at that time and any changes, if merited, can be made. Once the audit committee is satisfied with the policy, the audit committee must formally adopt it; separate board approval of the policy is not required.

It is important to note that your work is not done when the policy is adopted. You should pay particular attention to the manner in which the policy is being implemented over the next few years in order to identify ways to improve and enhance the policy, both from the perspective of the audit committee and management. In addition to monitoring whether the policy is providing a useful and efficient oversight tool, you also should work with the audit committee, management, and the outside auditor to monitor adherence to the standards set forth in the policy.

NAVIGATING INDEPENDENCE CONCERNS

Some events are just beyond your control. No matter how clear your understanding of the auditor independence rules and how effective the audit committee's oversight of the relationship with the outside auditor has been (including through application of the pre-approval policy), you may still have to confront a potential auditor independence issue. This is particularly true given the complexity of both the auditor independence rules and today's business environments. In addition, it is not inconceivable that auditor independence issues could arise as a result of the PCAOB audit firm inspection process, as this supervisory body examines the manner in which firms are providing non-audit services to audit clients.

In the event an auditor independence situation arises, you should be prepared to play a critical role in managing the situation. The most important step in this process is to establish and maintain communication—with your audit committee, with management, and with the auditor—to achieve a satisfactory outcome.

When an auditor independence issue first arises, you must develop the facts quickly. The best way to do this is to work closely with your CFO, Controller and their staffs to mitigate any existing problems and to head off similar issues that might be unfolding. You also should ask the outside auditor to develop its analysis regarding the situation as quickly as possible. When communicating this request to the auditor, you should advise the auditor that it might be asked to present its analysis to the audit committee. If, after gathering the facts, you determine that the issue appears of significant magnitude, you may want to engage outside counsel to investigate the situation or suggest that the audit committee do so.

If an interpretive issue regarding application of the rules remains outstanding once you have ascertained all the facts, it is worth bearing in mind that the SEC staff has indicated that it is willing to consult on auditor independence issues.[28] Thus, it

From this point on . . .
Explore information related to this topic.

ONLINE:

- ACC's committees, such as the Corporate and Securities Law, are excellent knowledge networks and have email lists to join and other benefits. Contact information for ACC committee chairs appears in each issue of the *ACC Docket*, or you can contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or windley@acca.com, or visit ACCA Online℠ at www.acca.com/networks/ecommerce.php.
- *The Rise and Fall of Enron: Principles for Director Focus,* available at ACCA Online℠ at http://www.acca.com/legres/enron/NACDENRON.pdf.
- *Summary and Analysis of Sarbanes-Oxley Act,* available at ACCA Online℠ at http://www.acca.com/legres/enron/sarbanes_oxley_act.pdf.
- John K. Villa. "How Will Recent Changes in Corporate Governance, Public Auditing, and the Role of In-house Counsel Affect You?" *ACCA Docket* 20, no. 9 (October 2002), available at ACCA Online℠ at http://www.acca.com/protected/pubs/docket/on02/ethics2.php.
- Bart R. Schwartz and Jonathan L. Freedman, "Audit Committees of Boards of Directors: How Much Responsibility Do They Have? How Much Responsibility Should They Have?", *ACCA Docket* 20, no. 5 (May 2002) available at ACCA Online℠ at http://www.acca.com/protected/pubs/docket/mj02/audit1.php.
- Broc Romanek, Linda L. Griggs and Sandra Leung, "New Compliance Challenges Under The Sarbanes-Oxley Act of 2002," *ACCA Docket* 20, no. 10 (November/December 2002), available at http://www.acca.com/protected/pubs/docket/nd02/sarbanes2.php.
- *Report of the American Bar Association Task Force on Corporate Responsibility*, available at ACCA Online℠ at http://www.acca.com/public/policy/corpresp/aba.pdf.
- John K. Villa, Jeffrey M. Smith and Michaela Allbee, "Recent Proposals for Changes in Corporate Governance, Securities Disclosure, Public Auditing and the Role of Corporate Counsel: A Snapshot as of July 22, 2002", available at ACCA Online℠ at http://www.acca.com/public/reference/enron/villa.pdf.
- *After Enron: Issues for Boards and Audit Committees to Consider*, available at ACCA Online℠ at http://www.acca.com/public/article/enron/After_enron.pdf.
- Mischa Buford, "Corporate Compliance Considerations," available in the Virtual Library℠ on ACCA Online℠ at http://www.acca.com/protected/article/compliance/corporate.pdf.
- *Congress' Conference Report on Sarbanes-Oxley*, at www.senate.gov/~banking/docs/reports/reports.htm.
- Sarbanes-Oxley Act of 2002, available at http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.
- U.S. Securities & Exchange Commission ("SEC") page about its Sarbanes-Oxley rulemaking, at www.sec.gov/news/press/2002-128.htm.
- Marian Exall and John D. Capers, Jr., "Audit Committees Under the Sarbanes-Oxley Act: Establishing the New Complaint Procedures," *ACC Docket* 21, no. 1 (January 2003), available at ACCA Online℠ at http://www.acca.com/protected/pubs/docket/ja03/audit.pdf.
- Peter Loughran, James Scoville and Erin Callahan, "Corporate Governance and Directors' Duties: United States, GLOBAL COUNSEL CORPORATE GOVERNANCE HANDBOOK, 2003," available on PLC Law Department at www.practicallaw.com/A27021.

ON PAPER:

- JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES (ACCA and West 1999, with annual updates).

If you like the resources listed here, visit ACC's Virtual Library℠ on ACCA Online℠ at www.acca.com/resources/vl.php. Our library is stocked with information provided by ACC members and others. If you have questions or need assistance in accessing this information, please contact Staff Attorney and Legal Resources Manager Karen Palmer at 202.293.4103, ext. 342, or palmer@acca.com. If you have resources, including redacted documents, that you are willing to share, email electronic documents to Managing Attorney Jim Merklinger at merklinger@acca.com.

may be appropriate to have your outside counsel or your outside auditor approach the SEC staff on a "no-names" basis regarding the relevant matter to obtain a preliminary opinion on the issue at hand. Regardless of how you proceed, all involved need to work quickly and in a coordinated fashion to determine whether you, the auditor, or most importantly, the audit committee believes that an auditor independence issue exists. Efficient coordination and communication among you, the audit committee, the auditor, and the respective counsel are at a premium in these situations.

Delivering The News

In addition, when faced with an independence issue, you must be prepared to apprise your audit committee of the potential penalties and implications in the event that an auditor independence violation is found. The consequences of such a violation can be extraordinarily serious. The independent auditor's opinion on your company's financial statements, or consent to use such opinion, must be included in your annual report on Form 10-K and in any registration statement, and the independent auditor also must review all unaudited financial statements included in your interim reports filed on Form 10-Q. Thus, if your current auditor's independence is deemed to be impaired under the SEC's rules, you must move very quickly, and at considerable expense, either to resolve the independence issue with the SEC or to retain a new audit firm. This may cause the filing of your periodic reports or registrations statements to be delayed. Even more troubling is the potential that your past SEC filings could be in jeopardy if it turns out that your auditor was not independent at the time of those filings. This unfortunate turn of events could result in a series of tribulations, including potential SEC enforcement action. In view of the potentially severe consequences that could flow from an auditor independence violation, the value in taking the preventive steps and identifying a strategy for addressing a genuine auditor independence issue is of the utmost importance.

Some audit committees may feel overwhelmed by the scope and depth of their additional responsibilities, including those associated with the regulation of auditor independence issues. In-house counsel can take important steps to assist audit committees in managing their burdens in relation to the auditor independence rules and in managing their relationship with the outside auditor. These steps include explaining the auditor independence rules to the audit committee, assisting the audit committee in establishing effective compliance procedures, and being prepared in advance with a strategy in the event an auditor independence issue arises. ■

NOTES

1. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §301; Exchange Act Rule 10A-3(b)(2). While the SEC's auditor independence rules apply to public companies and the application of these rules are most relevant to in-house counsel at public companies, there is a movement afoot in several states to adopt state-specific "Sarbanes-Oxley"-like legislation, which could very well impact the manner in which private companies are forced to view the auditor independence rules.
2. The auditor independence rules as modified in 2000 and 2003 are codified in Rule 2-01 of Regulation S-X.
3. 17 C.F.R. § 210.2-01(b).
4. There is also a preliminary note to the SEC's auditor independence rules to be aware of. The note sets forth four principles the SEC suggests you should consider when evaluating auditor independence issues. There is a popular misconception that these principles are part of the rules; for example, it is often stated that the auditor cannot perform "advocacy services" for the audit client. But, while there is a restriction on legal services, there is no express prohibition on "advocacy" services per se. Taking these four principles to their logical conclusions, however, it would be difficult to see when an audit firm could provide services to a client in any given situation. Partially in view of concerns about the overbreadth of the principles in application, the SEC elected not to codify them in the rules. While the principles may provide useful guidance in some situations, they are difficult to apply in practice.
5. 17 C.F.R. § 210.2-01(c).
6. 17 C.F.R. § 210.2-01(f)(4).
7. 17 C.F.R. § 210.2-01(f)(1).
8. 17 C.F.R. § 210.2-01(c)(1).
9. 17 C.F.R. §§ 210.2-01(c)(2) and 2-01(f)(3) (defining "accounting role or financial reporting oversight role").
10. *See* Sarbanes-Oxley Act of 2002, § 206.
11. 17 C.F.R. § 210.2-01(c)(2)(B)(iii).
12. 17 C.F.R. § 210.2-01(c)(4).
13. *See* 65 Fed. Reg. 76008, 76043 (Dec. 5, 2003).
14. *See* Sarbanes-Oxley Act of 2002, § 201.
15. *See* Sarbanes-Oxley Act of 2002, § 201(a). Any additional limitation on non-audit services proposed by the PCAOB will be subject to notice and comment rulemaking and approval by the SEC.
16. *See* 17 C.F.R. §§ 210.2-01(c)(4) (i), (iii), (iv) and (v).
17. *See* 68 Fed. Reg. 6006, 6012 (Feb. 5, 2003).

18. *See* Item 9(e)(4) of Schedule 14A (superceded) (previously requiring the audit committee to state in its report whether it has considered if the provision of non-audit services provided by the outside auditor is compatible with maintaining the auditor's independence).
19. *See* Sarbanes-Oxley Act of 2002, §§ 201, 202.
20. *Id.*
21. The pre-approval requirement includes a narrow exception, providing that a waiver from the pre-approval requirement is permissible where the services: (1) do not in the aggregate account for more than five percent of total revenues paid by the audit client to the auditor in the fiscal year in which the services were performed; (2) were not recognized as non-audit services at the time of the engagement; and (3) are promptly brought to the attention of the audit committee and approved prior to completion of the audit by the audit committee. *See* 17 C.F.R. § 210.2-01(c)(7)(i)(C).
22. 17 C.F.R. § 210.2-01 (c)(7)(i)(B).
23. *See* U.S. Securities and Exchange Commission, Office of Chief Accountant: *Application of the January 2003 Rules on Auditor Independence, Frequently Asked Questions* (Office of Chief Accountant FAQ) (August 13, 2003).
24. *Id.*
25. *Id.* at FAQ 24.
26. Sarbanes-Oxley Act of 2002, § 301 (emphasis added).
27. *See* Office of Chief Accountant FAQs, at FAQ 21.28.
Because the audit committee's obligation to oversee the hiring of registered public accounting firms arises under Section 301 of Sarbanes-Oxley, which mandates the national exchanges to adopt listing standards that comply the requirements of this provision, it is conceivable that the failure of the audit committee to pre-approve audit services provided by another registered public accounting firm could affect your company's compliance with applicable listing standards. Currently, however, neither the NYSE or NASDAQ listing standards provide any guidance indicating that this would be the case.
29. *See* 68 Fed. Reg. at 6015 (encouraging, in the context of the legal services prohibition, that accounting firms consult with the staff where certain independence issues arise). The SEC rules also include an exemption from independence violations where the parties did not know of the circumstances giving rise to the lack of independence; the independence impairing event was corrected as promptly as possible after the firm became aware of it; and the firm has a quality control system in place that satisfies certain criteria. *See* 17 C.F.R. § 210.2-01(d).

By M. Jack Rudnick and John P. Langan

Managing an Internal

Corporate FRAUD Investigation and Prosecution

Routine reports of corporate malfeasance, jury verdicts against formerly untouchable senior officers, the emergence of a new cottage industry in corporate compliance—all spawned by the collapse of Enron and fueled by the enactment of Sarbanes-Oxley. The business of corporate fraud and white collar crime has risen to new heights.

Now more than ever, in-house counsel should know how to properly investigate and pursue internal allegations of fraud, theft, and corporate malfeasance. Otherwise, counsel may find themselves on the wrong end of the next audit committee inquiry, an inquiry focused not on the underlying problem, but on how in-house counsel responded to it. In this atmosphere of intense scrutiny, no one is safe from criticism.

The bad news is that lying, cheating, and stealing are as old as mankind, and fraudulent schemes come in many shapes and sizes. They are as creative as the sinister minds that dream them up. The good news is that, from an in-house counsel's perspective, the proper approach to investigating and handling such schemes is consistent and almost formulaic. This is true despite the fact that a surprisingly wide array of legal expertise comes into play when addressing corporate fraud: civil and criminal litigation; corporate governance and compliance; employment law; insurance coverage and recovery; corporate finance and regulation; and tax law, among other areas.

Aided by a hypothetical example,[1] this article spells out the steps in handling a case of theft or corporate malfeasance—from initial detection and internal investigation, to criminal and civil prosecution, through post-prosecution review of better controls and remedial safeguards. A few simple suggestions can help you avoid the common problems that arise in such cases and manage the matter in your position of responsibility.

M. JACK RUDNICK is the vice president and general counsel of Welch Allyn, Inc., a global manufacturer of medical devices in upstate NY, where he established the legal department in 1992. He is past president of ACC's Central and Western New York Chapter and has been teaching a corporate counsel course at Syracuse University College of Law for the last eight years. He can be reached at *rudnickj@welchallyn.com*.

JOHN P. LANGAN is managing partner at Hiscock & Barclay, a 175-lawyer firm in NY, and an experienced trial lawyer in the area of fraud-based litigation. He is a founding member of the Federal Court Bar Association for the Northern District of New York, where he continues to serve on the board and as an officer. He has handled numerous seven-figure fraud and embezzlement cases for public and privately held companies. He can be reached at *jlangan@hiscockbarclay.com*.

Typical Fraud Scheme

Mark was doing well in his career. He was a valued and trusted senior officer of the company, having worked his way up the corporate ladder over two decades. He now enjoyed the title of senior vice president of finance of one of the company's most profitable divisions. Sure it was a lot of responsibility, but Mark liked his job.

The problem started when Mark caught up with a college buddy who was the CFO at a similarly sized company in the mid-west. His friend was making triple what Mark was making and with far less responsibility. It was just wrong! Mark made the added mistake of mentioning the discussion to his wife, Ashley. Admittedly, the timing was bad since Mark and Ashley had just agreed to forgo buying that great beach-front property from Ashley's parents, and college tuitions would start soon for his twin daughters. Just an extra $100,000 per year in income could make the difference between a comfortable existence and a stressful life.

It was with this thought that Mark went to work the next day. He started his daily business of overseeing the financial operations of the company. This included such complex projects as reviewing the finances of major merger targets, along with such mundane tasks as approving invoices for endless outside vendors used by the company. Boy, was the company spending a lot of money on outside accounting and law firms! And those rates for the top partners—yet another group of professionals making more money than Mark. That's when he got an idea.

How hard would it be to dummy up a few invoices from an approved, but infrequently used vendor, submit them for approval, intercept the processed check, and deposit it in an account opened using a fictitious corporate name? Who would notice, considering all the money the company spent last year? He would only do it once or twice, more as an experiment than anything else. Who would get hurt?

Ten years and $1.5 million later, Mark was now a highly paid senior officer, even without considering the tax-free nature of his "side" income. Colleges were paid for, he and Ashley owned a great condo in the Bahamas, and they had a nice stock portfolio for retirement. Yes, life was good until an accounts-payable clerk called the outside vendor about one of its recent invoices. It was an innocent inquiry, but the response from the vendor—that it had not performed services for the company in years—was unexpected.

Initial Detection

Detecting Mark's scheme is the first step. The accounts-payable clerk had a few choices when she stumbled upon the suspicious information. She could have ignored it because rules enforcement was not a focus at the company. She could have shared the information with Mark, sensing that he was involved but not wanting to "get him in trouble." She could have been afraid to disclose the information based on the company's historical ambivalence toward corporate ethics or lip service to confidentiality protections surrounding the company's "anonymous" fraud hotline.

This is where written policies and procedures, and an effectively communicated compliance program, are necessary. Gone are the days that a company can rely on the auditors to detect wrongdoing. Companies must now establish a formal Code of Ethics/Conduct which is routinely updated and communicated to employees. The code should be formulated with the aid of outside employment counsel and emphasize the real protections afforded anyone who comes forward with information. An anonymous tip or hot line must be established and routinely published to employees, along with rules governing the confidentiality of the communication.

Also important are employment policies clearly stating that the company owns the communication systems used by the employee, including email and voicemail received and generated by employees. The policy should state that the company has the right in its sole discretion and without prior notice to monitor and review data composed, sent, or received through its computer systems, and that the monitoring activity may limit the level of privacy employees can expect.

A working and effective compliance program is also critical. Adopting systems for routine auditing, establishing mechanisms for reporting suspicious information, and creating a top-down atmosphere of strict ethical behavior so it becomes part of the company's core culture are all at the heart of a good compliance program. Such a program will help detect Mark's theft against the company at an early stage, or deter it all together based on an atmosphere of zero tolerance.

A good compliance program can be particularly important where the wrongdoing is not just a crime against the company, but one against the public at large. Change our

hypothetical from Mark embezzling funds to a small group of employees, led by Mark, illegally removing and disposing of large amounts of asbestos from a portfolio of commercial properties owned by the company. Or perhaps a key financial officer of a public company discovers he or she has been responsible for misstating the company's earnings and then decides to cover the mistake to keep their job.

In either case, laws have been broken and government prosecutors will be interested in whether the crime is an isolated incident of a few, or part of the core culture of the company. The answer may impact the level of criminal liability facing the company, and even whether senior management is drawn into the investigation and criminal charges.

The *United States Sentencing Commission Guidelines Manual*,[2] in conjunction with the *Federal Sentencing Guidelines*,[3] set forth the elements of an effective corporate compliance program. Summarily stated they include:

- prevention and detection procedures;
- high level of oversight;
- due care in delegating substantial discretionary authority;
- company-wide training and communications with periodic updates;
- auditing, monitoring, and reporting including allowing for anonymity and confidentiality mechanisms;
- consistent enforcement; and
- response and prevention.[4]

The 2004 amendments to the *Guidelines* now include a list of modifications synchronizing them with *Sarbanes Oxley* and the emerging number of public and private regulatory requirements.

An effective program under the *Guidelines* will help the company mitigate any potential fine range, in some cases up to 95 percent, if there is also prompt reporting to the authorities and non-involvement of high level personnel in the actual offense.[5] It can also help investigators conclude that the conduct was isolated, and not caused by the company's senior management. At a minimum, suspicious information, such as the call about Mark, will be reported to the appropriate compliance officer and the wrongdoing detected early.

In our hypothetical story, suspicions about Mark have been reported using the anonymous "hotline." Proper controls are in place for in-house counsel to monitor credible reports from the hotline. The information has been reviewed by in-house counsel, a few calls made, and internal financial records reviewed. It appears clear, at least initially and before talking with others within the company, that a stream of payments approved by Mark were never received by the vendor. Now what? The next few moves will be critical in conducting a proper and effective investigation.

The Investigation

The team investigating the situation should be carefully selected, usually a senior auditor at the company, someone from corporate security, in-house counsel, and other trusted individuals. They should have no conflict of interest (such as persons reporting to Mark might have) that could in any way impact their neutrality or judgment. They will gather documents and evidence, interview employees and perhaps outside vendors, and pursue all leads to determine the extent of the wrongdoing.

It is important that the investigatory team starts with an open mind, and not let preconceived notions of what the facts might be dictate the conclusions reached. Memoranda generated should avoid using the term "fraud," "theft," "cover up," "incompetency," or other conclusory terms, and files should be labeled using similarly neutral language. Investigative team members should be reminded that they are "writing for publication" so they should avoid vindictive remarks or other personal commentary and record just the facts. Final conclusions should not be expressed until after the suspected employee's response to the charges has been obtained and evaluated.

The investigating team must keep in mind at all times that civil litigation, and perhaps a criminal referral, will follow almost inevitably from the work they do. Investigative findings, comments and opinions about mistakes made by the company, theories of wrongdoing that do not pan out, and suspicions against employees that are never substantiated—a more sensitive group of documents can hardly be imagined. Therefore, all reasonable steps should be made to maximize the privilege protections of this information.

In that regard, it is imperative that the company document at the outset that the investigation is being launched and overseen at counsel's direction. All subsequent requests for action should come from a lawyer in writing to maximize the protections afforded. In this way, counsel can oversee the investigation while also watching out for the broader interests of the company.

The company should consider directing the investigation through *outside* counsel to avoid any confusion over the multiple roles often played by in-house counsel. Investigative material, including opinions and conclusions reached by the team, must be labeled as privileged, and separate files should be maintained to segregate the privileged material.

Although the initial information from a routine audit or an anonymous tip is not likely afforded privilege or protection under the work-product doctrine (because it was not gathered at the behest of an attorney or because litigation is pending), subsequent information may be protected

> If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all.

from discovery if any future investigation is properly handled.[6] The courts will look to the level of involvement of the attorney in directing the investigation or audit.

How likely is it, really, that the facts of the case and statements can be protected from disclosure in subsequent civil litigation? The work-product doctrine generally protects only mental impressions, conclusions, opinions, or legal theories of an attorney.[7] Thus, purely facts or statements, regardless of whether an attorney collected them, are usually not afforded protection under the work-product doctrine.

The facts, however, may be protected under the attorney-client privilege. To assist in thwarting later legal challenges, counsel overseeing the investigation should make every effort to create a paper trail showing that the reports and/or facts derived from the investigation were created:

- for the purpose of securing legal advice;
- by an employee who was acting at the direction of a supervisor;
- at the direction of a supervisor who sought the information to obtain legal advice for the corporation;
- within the scope of the reporting employee's corporate duties; and
- solely for the eyes of those persons within the corporate structure who need to know the information.[8]

Confronting the Suspected Employee

Confrontation of the employee needs to be carefully planned, witnessed, and documented. It should occur at the end of the investigation when all other available facts are gathered. At the interview, the employee's response or "story," including any admissions or concessions, must be documented. This may involve asking the employee to sign a written statement with the account provided. Depending on how the situation develops, this evidence can prove invaluable in later civil or criminal proceedings. It can also prove useful in defending against later complaints of the employment action taken by the company.

Using investigatory resources to learn background information about the suspected employee prior to the interview is an effective tool that should be used cautiously. If there is a legitimate, non-discriminatory basis for personal background investigation (*i.e.*, asset and real property search, court records, etc.) because the company has a good faith basis to believe the employee has engaged in criminal conduct and the investigation will further help determine whether the suspicions are true, then proceeding with the investigation may be warranted. Watch for particular state privacy laws and provisions of the *Fair Credit Reporting Act*[9] to ensure you do not run afoul of existing law. Use good judgment as to whether investigative tactics (including those of third parties hired by you) are appropriate. If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all. Make sure to tailor the information sought to a legitimate business purpose in furtherance of the investigation; don't go on a fishing expedition.

If the employee raises new information in the interview that requires further investigation, but the company is concerned about retaining the employee in active status, he or she can be suspended with or without pay pending completion of the investigation. If the employee refuses to cooperate with the investigation, he or she should be reminded that cooperation is an essential function of the job and a failure to cooperate may provide an independent basis for discipline, including termination. Carefully drafted Codes of Conduct or implementing policies will specifically address this issue so the independent basis for action will be clear. Similarly, they will make it clear that retaliation against any other company employee participating in the investigation is strictly prohibited and will serve as an independent basis for action.

When should company counsel advise Mark that he should consult with private counsel? While this is an issue on which in-house counsel may differ, our perspective is not until the confrontational interview has been held. Until that point, it may be argued that the company does not yet have the employee's side of the story, so a final determination of culpability has not yet been reached. Once the employee has answered questions, given his statement responding to the charges, and provided whatever other information that may prove useful to the investigation, it may well be in the company's interest to have the employee engage experienced counsel. Care should be taken, however, to make it clear to the employee that counsel interviewing him/her are counsel to the corporation and not the employee by providing the employee with the "corporate Miranda."[10]

One factor in deciding how to approach the employee will be whether the company needs him or her to address the wrongdoing going forward—such as when a key financial officer is in a unique position to reconstruct the misstated earnings in past financial reports. Will cooperation be forced or voluntary? How badly does the company need the targeted employee's help to further investigate the extent of the fraud or correct the damage? Is the employee at the center of the scheme or a lesser player? These questions must be addressed in formulating your approach.

Action Based on Investigative Findings

Your investigation is complete, you have confronted the employee, obtained whatever helpful information may be gleaned from the employee, and the investigative team has reached the conclusion that fraud has been committed. Once the company has confirmed that wrongful conduct has occurred, action must be taken.

Options for handling the employee include disciplinary action short of termination, suspension with or without pay, or termination. Before communicating the decision to the employee, make sure that an experienced employment lawyer reviews the basis for it. The company must be able to comfortably articulate a non-discriminatory business reason for the decision—preferably something that the average person would understand and accept as reasonable.

The decision and the basis for it should also be communicated to company officers, the board, the audit committee, and any key supervisors. Throughout the investigation, be prepared for an emotional reaction from the company's senior officers or board—anger, frustration, or even an irrational demand for a course of action that is not in the best interests of the company. In-house counsel must manage these issues carefully so that cooler heads prevail.

Until now, things have been handled with great confidentiality. But news of the employee discipline or termination cannot be contained and the company is wise to consider the nature of any response to the natural questions that arise. At this point, the company must decide how to handle the public relations aspect of the situation, at least internally. A consistent message must be formulated and used by management.

Insurance Coverage

In the midst of handling a fast moving internal investigation, containing the information within the company, and absorbing the emotional body-blow of learning that one of your own is a thief or liar, it may be easy to forget the steps needed to preserve the company's insurance rights. After all, this is not a slip and fall claim which would naturally trigger in-house counsel's focus on insurance. The company's risk manager may not even be part of the investigative team. Failing to take proper action relative to insurance can be a costly mistake, one the second-guessers will seize upon to lay blame when the dust has settled.

ACC Extras on…Employee Law, Embezzlement, and Fraud

- *Internal Fraud: Weeding out the Enemy*
  - Practical Law Article—International Resource
  www.acc.com/resource/v4649
- Indicia of Corporate Fraud
  - This **quick reference** includes a list of pointers to consider when dealing with internal fraud concerns.
  www.acc.com/resource/v3685
- *Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud*
  - This *ACC Docket* article covers 10 red flags you need to be aware of when on the lookout for financial mismanagement and corporate fraud.
  www.acc.com/resource/v7714

So when do you act and what do you do? It depends on the language of your policy and outside coverage counsel should be consulted. Generally speaking, the answer is:

> When you know of circumstances that could form the basis for a company loss, in-house counsel should promptly notify the company's risk manager and all brokers handling the company's insurance and bonding policies.

Counsel must follow up with these brokers or directly with the carriers to insist upon *written confirmation* that the necessary parties have received proper notice.

A typical error is trying to determine which policies might provide coverage and narrowing your list of parties to be notified. With the complexity of insurance coverage these days, this is a mistake. Insurance policies that may be triggered include the company's general liability policy, commercial crime/fidelity policy, commercial property policy, and perhaps even an employee fidelity bond. The usual insurance policy conditions to keep in mind include:

- the requirement that the insured provide timely notice of the incident;
- the insured's obligation to provide a high enough level of cooperation with respect to the insurer's investigation; and
- the requirement that the insured should avoid committing any act which could prejudice the insurer's ability to subrogate the claims against the culpable parties. Exclusions often seen are claims for fines, sanctions, and penalties, and also claims arising out of any dishonest, fraudulent, criminal or malicious act, or omission of an insured.

As discussed later in this article, the company at an early stage will have already engaged its own outside counsel to investigate the fraud and perhaps commence a civil action against the wrongdoers. This may well be at odds with insurance policy language, which gives the carrier input or even control over the selection of counsel to pursue the loss. The problem arises because the normal insurance loss involves a past event impacting a simple monetary claim that can be quantified and assessed.

But allegations of internal malfeasance are different. First, the company does not usually know whether it has suffered a loss, or the extent of the loss, until a thorough investigation has taken place—an investigation that for a wide array of reasons should occur under the watchful eye of the company's hand-picked outside counsel. Second, investigation of the claim is fast-moving and complex, it is not conducive to the delays associated with insurance carrier dealings, nor is it of a nature to be handled by a panel counsel insurance defense lawyer. And lastly, there is more at stake in an internal fraud situation than the actual monetary loss—company exposure to allegations of criminal wrongdoing, government compliance obligations, internal employment and HR issues, public image, and business risk issues, etc.

It is for these reasons that we advise companies to select and move forward with the outside counsel of their choice with respect to conducting the investigation, and address later any complaints of insurance carriers over what attorney was selected. We acknowledge that a dispute over the selection can arise with the carrier but, in our experience, rarely does if counsel is selected with experience in such matters.

Indeed, in cases where an insurance claim has been paid and the loss subrogated, we have never seen a carrier reject the continued retention of the original counsel selected by the company (normally a firm that has been involved for months in developing the complex facts and evidence supporting the claim). So long as the company is providing a sufficient level of cooperation and communication with its insurers, the issue can usually be resolved on an amicable basis.

Civil Litigation

At the core of most employee theft cases are common law claims for fraud, conversion, breach of fiduciary duty, as well as statutory violations such as racketeering. Obviously, maximizing the likelihood of recovering at least some of the stolen property or locating other assets to be seized is at the heart of this strategy. But early litigation also provides a mechanism for obtaining provisional remedies such as temporary restraining notices, orders of attachment, or accelerated motions for other preliminary injunctive relief. Assets can be frozen and important evidence preserved.

Indeed, a number of benefits can drive the company toward litigation as a necessary strategy. For better or worse—in cases of this type—message-sending plays a role in the process. Mark has stolen seven figures from the company and everyone is watching to see how it is handled: Anything less than an aggressive response can be viewed as weakness and an invitation for future trouble.

And then there are the criminal authorities to consider. How significant was the criminal wrongdoing later referred to the government if it was not sufficient to warrant a civil action? The investigators and prosecutors want to know that the company takes these matters seriously. The presence of a timely and aggressive civil action helps to answer any doubt in this regard.

Others are watching, too. The board, audit committee, and shareholders are looking to ensure that the company does everything within its power to recover stolen corporate property or right other wrongs. Among them are the company's insurance carriers which may later seek to pay a claim of loss and subrogate in the civil action. Those involved in that decision and later civil prosecution want to know that their insured was diligent in taking appropriate action. These are among the many considerations in commencing a civil action.

As the case proceeds, the company may well face the question of whether to settle with one individual and "flip" them to secure valuable testimony against another involved in the wrongful conduct. This strategy almost always comes into play. The question of when, with whom, and under what circumstances should the company agree to settle their claims with one wrongdoer is dependent on the circumstances presented.

No doubt, the company has much to offer in terms of avoiding protracted civil litigation, and the cooperator has something of value in return, since proving fraud presents a host of challenges and direct testimony of the scheme can be very helpful. This is where the defendant's selection of experienced criminal or civil counsel will help negotiations and a sensible resolution. Less experienced

Gone are the days that a company can rely on the auditors to detect **wrongdoing.** Companies must now establish a **formal Code of Ethics/Conduct** which is **routinely updated** and communicated to employees.

counsel often cannot see the "end game" and the larger problems facing his or her client.

At some point toward the end of the civil case, the company will be forced to answer the question of what it needs to settle the claims. Interestingly, the answer to this question is almost always the same. The common elements to any settlement involving claims of employee fraud and wrongdoing are:

- admission and contrition;
- confirmation of scope of wrongdoing;
- compensation, symbolic or otherwise;
- cooperation in pursuit of other wrongdoers; and
- conditional release with protections for later default.

Disclosure of Scope

Part of the purpose of the lawsuit is to use discovery to confirm the extent of the wrongdoing. This element of settlement can be among the most important to obtain. If the company is not satisfied they have received it, settlement discussions should break off. The company simply must know the extent of the scheme and that the actions being taken will fully address it: Any suggestion that some of the cancer remains should be unacceptable to the company and its counsel.

Of course, criminal prosecution cannot be threatened as a means to settling a civil claim.[11] If the company has elected not to pursue criminal charges, the parties can proceed right to the interview. But if a criminal investigation is pending, how can the company obtain the type of candid disclosure mentioned above without appearing to be leveraging one action against the other? The answer is timing. The settlement of the civil action can be conditioned on the disclosure and interview needed.

A deal can be struck while the criminal case is pending that an interview will follow once Mark's criminal liability has been addressed. With a criminal case pending, the settlement agreement can provide that a failure to participate fully in the interview will revive the civil claims and trigger large financial penalties. Part of Mark's motive will be to appear cooperative with the company to the criminal authorities.

How can you know if the disclosure is complete and accurate? First, by the time the interview is held, your investigating team should have a very good understanding of what happened. Witnesses should have been interviewed, documents collected, witness statements taken. Whether the story Mark tells "rings true" and is consistent with the other evidence is the first way to check the disclosure. The second is, where legally permissible, by use of a lie detector test, which, by and large, is remarkably effective in confirming the information.

Make sure to select a reputable examiner, preferably someone who the government authorities rely upon. An excellent website is maintained by the American Polygraph Association (APA),[12] which allows for a database search of members by geographical area. According to the APA, "a valid examination requires a combination of a properly trained examiner, a polygraph instrument that records as a minimum cardiovascular, respiratory, and electrodermal activity, and the proper administration of an accepted testing procedure and scoring system." Some states have an official licensing procedure but many do not.[13]

Mark's criminal or civil counsel may wish to weigh in. The better examiners are known and respected by the criminal defense bar, so selecting an expert should not be difficult. Again, timing can address the issue of coordinating the examination with resolution of the criminal case so that Mark is comfortable answering questions. The civil settlement should provide that a failure to properly pass the test unwinds the settlement and leaves the company able to pursue its civil remedies.

One final thought regarding lie detector tests: The company should avoid the temptation to rely on them to investigate the charges. Use the test solely for securing compliance with the terms of settlement. This is because *The Employee Polygraph Protection Act* of 1988 (EPPA)[14], forbids adverse employment action against an employee refusing to take the test. Asking the targeted employee to take an exam will restrict the company's ability to terminate him later without opening the door for counter charges that the lie detector results played a role in the decision.[15]

Usually the **resolution of the civil action** occurs in pieces, with one of the wrongdoers **flipping early** and others continuing to litigate.

Compensation

The ultimate sum settling the civil claims is a function of:

- the amount stolen;
- the impact of the theft on the company;
- the level of culpability of the wrongdoer;
- the total financial net worth of the employee and his or her spouse; and
- a cold assessment of what assets are subject to judgment execution in the civil action.

The settlement amount is, to some extent, a symbolic figure designed to punish as much as anything else. Of course, if the loss has been paid by the carrier and the claim subrogated, the carrier will be involved in fixing or at least accepting the settlement sum.

Cooperation

Usually the resolution of the civil action occurs in pieces, with one of the wrongdoers flipping early and others continuing to litigate. Perhaps Mark was working with someone at the outside vendor's accounting group and they were sharing the ill-gotten gains. No matter, an important element in settling claims with the first party who flips is that they will cooperate fully in any existing or future civil litigation.

In order to minimize the bias arguments that will inevitably arise in later litigation, counsel is wise to secure a comprehensive sworn statement of facts which establish and preserve key testimony of the cooperating party as part of the civil settlement. Cooperation means participating in the civil action willingly and honestly, not fabricating testimony just to be helpful to the company.

Conditional Release

The release given in the civil settlement must be conditioned upon the promises and representations by the employee discussed earlier (*i.e.*, passing the lie detector test, honest disclosure of scope, accurate personal financial disclosure, and cooperation with subsequent investigation and post mortem review). Default in meeting any of these obligations should include the right to unwind the settlement even if the claims would otherwise be time barred. They should also carry with them the right to some additional financial penalties to further ensure compliance.

As discussed in this article, a civil settlement has many moving parts and may appear more complicated than it is. Settlements of this type are almost formulaic in that companies always want the same things and the points of leverage are the same against the offending parties. An outside counsel with experience in this area will have the necessary sample documents as you frame your approach.

Government Notification and Referral

There is some debate as to whether a company has an affirmative duty to report internal criminal activity of its employees if the conduct does not violate other laws or regulations governing the company.[16] The comment to ABA Model Rules of Professional Conduct Rule 8.3 suggests that attorneys should "encourage a client to consent to disclosure where the prosecution would not substantially prejudice the client's interests." State laws may demand reporting, and a wide array of regulations governing a company's operations may mandate it as well.

There is, of course, risk whenever the government is contacted about internal company activity. Government investigators and prosecutors are not prone to taking direction from in-house counsel or anyone for that matter. An innocent referral can lead anywhere, including to the prosecution of company employees or vendors not originally considered part of the wrongdoing. And of course, it can lead to the company itself becoming the subject of an investigation. These issues must be carefully addressed before the referral is made and other regulatory agencies are notified.

For these reasons, part of counsel's ongoing assessment is to look at the fraudulent activity from an outsider's perspective—asking whether there are other victims of the criminal activity besides the company and/or whether there are other regulations violated. What if Mark's dummied invoices were from an environmental testing firm that was charged with ensuring that toxic material was properly handled? Years of forged invoices were generated while Mark was supposed to make sure that proper testing and disposal occurred. Now the company has two issues to investigate—how much did Mark steal and was the testing performed?

Even if the company has concluded that the work was performed, the criminal referral will raise this same

question and the government will want it answered to its satisfaction. The company must consider notifying relevant government agencies in a manner that assures regulators that the situation is being handled responsibly. It is a delicate moment because the company cannot control the regulators' reactions. But ignoring the situation should not be among the options considered because it is a sure way to create suspicion and a negative reaction down the road.

On the question of timing, there is built in flexibility which allows the company to investigate the allegations first, before making a determination that criminal wrongdoing or regulatory violations have occurred. The last thing the company wants is to accuse an employee of a crime only to find later that it was wrong or it could not prove the charges (exposing the company to retaliatory claims of defamation, unfair employment action, or malicious prosecution). The investigation period gives the company time to take stock and make some strategic decisions about whether making a referral is warranted or desirable.

There can be a fair amount of strategy in making a successful referral including evaluating whether one is warranted, addressing issues of selecting the prosecuting agency, addressing which regulatory bodies should be notified and in what manner, deciding when to make the referral, determining the key point of communication for the company, and setting the tone for the aggressiveness of the referral as a victim of the crime.

In making a referral, counsel must be prepared for a complete and unrestricted look at evidence gathered from the investigation. This is so because asserting any claim to privilege, while well within the company's rights, will be viewed as uncooperative. The US Sentencing Commission voted in March 2006 to eliminate the language from the Federal Sentencing Guidelines that required corporations to waive the attorney-client privilege if they wanted to earn credit for cooperation. Even with this change, however, companies should be prepared for the government's assumption that the privilege will be waived and the prosecutor's negative reaction if it is not. The last thing the company wants is to raise questions in the government's mind as to its own level of cooperation and involvement in the wrongdoing.

Properly managed, a criminal referral will minimize the chance that the government will blame the company for the acts committed while also establishing a solid working relationship with the investigators and prosecutors. A strong relationship is marked by mutual cooperation and respect, a level of trust that the company is being forthright in disclosing information and addressing the situation, a diligent pursuit of the investigation and prosecution, at least periodic communication, and keeping a balanced perspective in terms of other priorities of the prosecutor's office and the company.

Admission and Contrition

It may sound trite, but after all the time, trouble, expense, and public embarrassment of addressing internal fraud and theft, companies often times insist on obtaining a formal admission of wrongdoing and an "I'm sorry" from the employees. With the amount of leverage involved, this element of settlement normally can be achieved rather easily. People in Mark's position usually have little bargaining position.

In most cases, the criminal authorities can be substantially aided in their investigation by the work already done by the company's existing legal team—particularly when the fraud is complex and document-intensive. Sharing information is an inevitable part of the cooperative relationship. The company must assume that information provided to the government will be later shared with the employee's criminal defense counsel, if it falls under Federal Rule 16 or constitutes *Brady* material.[17]

As discussed before, relevant fact-based records may be the subject of disclosure requests in later civil litigation. But the more sensitive documents to consider are the investigative reports which may be generated by the company's internal team or referral memorandum provided to the government which lays out the company's findings. Both documents are likely to contain opinions and conclusions, along with other potentially sensitive information such as lie detector test results and evidence which is critical of the company in allowing the malfeasance to occur. The company should review and consider the content of these documents before finalizing them for government review.

While the "defensive" thinking discussed above is part of making an appropriate referral, counsel should remember the numerous positive advantages of triggering a prosecution against the offending employee. On the plus side, the presence of a parallel criminal prosecution when pursuing civil claims is obvious. The civil case may be temporarily delayed or even stayed by the criminal case, but the resulting conviction can provide invaluable support in pursuing the civil action.

Many times, the elements of the crime admitted or forming the basis for the conviction are the same as in the civil litigation, giving the civil team irrefutable admissions or even collateral estoppel/issue preclusion impact on key elements in the civil case. Huge savings in time and money can be achieved in letting the criminal case play out on a parallel course with the civil case.

At minimum, pressing the civil action during the prosecution of a criminal case can give rise to Fifth Amendment testimonial assertions which, in turn, generate valuable negative inferences in the civil action. An unrebutted negative inference can, under appropriate circumstances, provide strong evidence supporting a dispositive motion and an accelerated victory in the civil action.[18]

And of course, a pending criminal prosecution presents the opportunity to avoid the need for any civil litigation at all, when a monetary recovery is secured by way of restitution in the criminal case. The opportunity to avoid protracted and embarrassing civil litigation against the offending employee by obtaining a comprehensive Judgment of Restitution in the criminal case is no doubt appealing.

Setting aside these home-run impacts, the advantages of the company drafting behind a criminal investigation—with its much larger breadth and jurisdictional reach—is clear. Voluntary witness interviews, grand jury subpoenas, and the full weight of a state or federal prosecutor's office behind an investigation can help gather evidence at a speed and in a manner that cannot compare with the discovery mechanisms available in civil litigation.

Deciding where to refer the criminal complaint in terms of government agency depends on a number of factors including the nature and proof of the wrongdoing. In addition to the cold assessment of what state or federal laws have been broken, other considerations come into play including:

- jurisdictional reach of the prosecuting office;
- resource availability of that office;
- strength and reputation of the office in pursuing complex white collar cases; and
- the relationship the company and its outside counsel enjoy with the offices under consideration.

In making the referral, it is important to establish a clear and single line of communication between the company and the government. The best contact point is the lead company counsel overseeing the internal investigation, since it allows for the regular oversight of questions posed by the government, assurance that complete and accurate information is provided, and the ability to monitor the direction and scope of the investigation from a more objective vantage point.

The last point is one of timing and controlling information. On the theory that some control is lost once a government investigation is triggered, in-house counsel are well served to know as much as they possibly can before making the referral, first completing the entire investigation before referring the matter to those outside the company. Most investigations of this type—involving claims of employee theft or fraud—are conducted as a high priority item that is expeditiously handled by the internal investigative team.

As the investigation proceeds, in-house counsel should assume that the corporate rumor mill will eventually pick up that something is going on. The challenge is to conduct a complete investigation before filing charges of criminal wrongdoing, while not waiting so long that valuable evidence is lost or the company becomes the subject of criticism for not making a timely referral. Daily assessment of these competing goals must occur, with outside counsel assisting the senior decision-making team in terms of when to contact the authorities.

Remedial Steps—Can it Happen Again?

Typically, a company has spent six figures in detecting, investigating, pursuing, and fully addressing the wrongdoing. The matter has gone on for months, if not years, and there is enough embarrassment to go around. It is natural to want to close the case and move on. But counsel is well-advised to conduct a complete post-mortem of the events leading to the fraud.

The company's board and shareholders, the audit committee, corporate security, and the company's outside insurance carriers, among others, have a vested interest in understanding how Mark's scheme was able to be formulated and successfully carried out. What improvements can be made to avoid it ever happening again?

This is where securing Mark's post-resolution cooperation can be particularly helpful. If the criminal case ends in some form of plea deal and a good working relationship has been established with the prosecuting authorities, the company can often secure this type of interview as part of the restitution package. As discussed earlier, such a meeting should certainly be negotiated as part of any civil settlement.

And who better to advise you regarding what controls need adjustment than Mark, the person who found a way around them? This meeting should be held after all other aspects of the case have been resolved so that Mark feels comfortable speaking freely. Often, someone in Mark's position is relieved to talk frankly outside the criminal and civil proceedings.

Take advantage of the opportunity presented for real candor to get the most from the interview. Prepare your outline of questions so that you understand every step of

the scheme, what controls were compromised, and how the fraud was successfully perpetrated.

Once you have a full understanding of what happened, ask Mark what would have stopped him and what suggestions he has for improving controls. There is often a twisted pride in the accomplished theft and a desire of the wrongdoer to tell his secrets. Take advantage of it. Of course, others in accounting, operations, human resources, and elsewhere can be helpful in developing a short list of improvements to the company's internal controls.

Minimizing Risk Through Prudent Corporate Governance

Much can be learned from managing an internal fraud investigation and prosecution, as painful as such an experience can be. New controls and procedures can be identified, adopted, or improved upon. Lessons can be learned that can substantially improve the operations of a business.

In any organization, however, the human factor makes corruption a risk at any level—a risk that can never be fully eliminated. Because the complex machine of corporate decision-making ultimately boils down to people, there are no controls or safeguards that can 100 percent assure protection against greed. The best minds behind formulating new controls and firewalls can always be outsmarted by the criminal imagination.

The best we can do is minimize the risk through prudent corporate governance and operations, and be ready to take appropriate action when wrongdoing is suspected.

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

Notes

1. The "story" described below is a fictional account; however, it is loosely based on the post-conviction explanation of a senior corporate officer for his seven-figure embezzlement scheme carried out over a ten-year period.
2. Available at: *www.ussc.gov/2005guid/gl2005.pdf*.
3. 18 U.S.C. § 3553.
4. *See* United States Sentencing Commission Guidelines Manual, § 8B2.1 *et seq*. (2005), available at: *www.ussc.gov/2005guid/gl2005.pdf*.
5. *See www.ussc.gov/corp/ORGOVERVIEW.pdf*.
6. *See First Chicago Int'l v. United Exchange Co. Ltd.*, 125 F.R.D. 55 (S.D.N.Y. 1989).
7. *See* Fed. R. Civ. P. Rule 26(b)(3) (2006) and your respective state's statute.
8. *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 609 (8th Cir. 1977); *see, e.g.*, *First Chicago*, 125 F.R.D. 55; *see, e.g.*, *Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487 (7th Cir. 1970). Every precaution should be made to adhere to these points, especially the last one because dissemination of the information to a third-party with no need to know the information may constitute a waiver of the privilege.
9. 15 U.S.C. § 1681 et seq.
10. *See* Model Rules of Prof'l Conduct R 1.13(a); see also *www.law.cornell.edu/ethics/comparative/index.htm#1.13*, for a comparison of each state's rule. To prevent ethical violations and/or disqualification from representing the corporation, before interviewing an employee, "Miranda" style warning should be set forth to the employee. The lawyer should ensure that the employee is fully aware of and understands the following vital points: that the lawyer does not represent the employee; that the employee's statements may not be privileged, especially when they relate to the organization's business; and that the employee is advised to obtain independent counsel.
11. *See e.g.*, Model Rules of Prof'l Conduct R. 8.4 (2004); *see also www.law.cornell.edu/ethics/comparative/index.htm#8.4*, for a comparison of each state's rule.
12. Available at: *www.polygraph.org*.
13. For a list of licensing offices, see *www.polygraph.org/statelicensing.htm*.
14. 29 U.S.C. § 2001 *et seq*.
15. For a brief summary outlining the "checklist" for both employers and polygraph administrators *see www.polygraph.org/eppa.htm*.
16. *See, e.g.*, 18 U.S.C. § 4 (Misprision of Felony statute); *Shehorn v. Daiwa Bank, Ltd*,, No. 96 C 1110, 1996 U.S. Dist. LEXIS 7905 (N.D. Ill. 1996) (applying 18 U.S.C. § 4 to corporations).
17. *See* Fed. R. Civ. P. Rule 16 (governing pretrial conferences, scheduling and case management); *see also Brady v. Maryland*, 373 U.S. 83, 83 S. Ct. 1194 (1963). In a criminal proceeding, evidence in possession of the government material to either guilt or punishment of the accused is deemed "Brady material." Any evidence that can be designated as such must be turned over to the accused in accordance with the Due Process Clause of the U.S. Constitution. While viewed by some as a broad form of additional discovery for the criminal defendant, it is actually just a narrow way in which an accused can obtain information bearing only on his guilt or sentencing.
18. *Securities and Exchange Commission v. Global Telecom Services, L.L.C.*, 325 F. Supp. 2d 94 (D.C. Conn. 2004); *see also*, *Willingham v. County of Albany*, No. 04-CV-369 (DRH), 2006 U.S. Dist. LEXIS 46941 (N.D.N.Y. July 12, 2006).

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

Trend One: There Will Be More Internal Investigations

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

More Whistleblowers

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

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

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

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

THEODORE L. BANKS is chief counsel and director of compliance policy at Kraft Foods in Northfield, IL. He has been involved with corporate compliance programs for more than 20 years and has directed many substantial corporate transactions and litigated cases, including the $19 billion acquisition of Nabisco by Kraft, and the $8.7 billion IPO of Kraft Foods Inc. He can be reached at *tbanks@kraft.com.*

TOM GILLER is the senior director of regional compliance and investigations at Kraft Foods Global, Inc. Prior to joining Kraft in 1998, Giller worked as environmental, safety, and litigation counsel at Safety-Kleen Corp., and a trial attorney in the Environmental Enforcement Section of the US Department of Justice. He can be reached at *tgiller@kraft.com.*

SCOTT R. LASSAR is a partner in the Chicago office of Sidley Austin LLP. Prior to joining the firm, he was the United States Attorney for the Northern District of Illinois. He has tried over 35 cases in federal court as a prosecutor and in private practice, including trials involving securities and commodity trading, accountant's liability, trade secrets, and federal criminal violations. He can be reached at *slassar@sidley.com.*

Improved Compliance Programs

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

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

More Government Investigations

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

More Demands for Investigations by Auditors

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

ACC Extras on… Investigation Trends

Webcasts

- "The Nuts and Bolts of Internal Investigations: An Important Element of Effective Corporate Governance"
  This **webcast** will focus on the nuts and bolts of conducting an effective internal investigation. It also will discuss some of the more difficult questions that need to be addressed in virtually every internal investigation.
  www.acc.com/resource/v7325

CFE Online

- "Whistleblower/Internal Investigations & How to Respond to the SEC"
  In this **online CLE program**, learn how to establish an effective process for receiving and evaluating whistleblower reports, your ethical obligation when faced with these reports, how to use whistleblower reports to meet your legal obligations, and how to deal with SEC while maintaining your legal ethics and loyalty to your client. *www.acc.com/resource/v7790*

Other Resources

- Internal Investigation Process
  This **quick reference** chart will show you the process of an internal investigation. *www.acc.com/resource/v7949*

- Internal Investigation Procedure
  This **sample form** enumerates the procedure of an internal investigation.
  www.acc.com/resource/v7950

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

Board Members Will Demand Investigations

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

O.R.

Key Subjects to Include in Your Internal Investigation Guidelines

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

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

Trend Two: Less Pressure to Waive Attorney-Client Privilege

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

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

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

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

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

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

As a degree of calm returns after the corporate scan-

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

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

Trend Three: Fewer Oral Reports

The trend toward less pressure to waive privilege may lead to more written reports of internal investigations. Previously, one way to deal with the pressure to waive privilege had been to avoid creating written reports. If a written report was turned over to the government, almost all courts have found that the attorney-client privilege is waived to everyone.[13] Corporations were naturally reluctant to make an investigative report available to plaintiff's attorneys who read about the investigation in the newspaper or in an SEC filing.

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

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

O.R.

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

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

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

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

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

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

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

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

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

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

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

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

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

Trend Six: More Trouble for The Investigators

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

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

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

Guidelines for In-house Counsel

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

- Make sure appropriate members of the legal staff, and other persons likely to be involved in investigations, get training on how an investigation should be conducted and that there is documentation of who received the training.
- Consider developing on-line refresher training as well as reference documents to help guide people conducting investigations.
- Ensure that persons assigned to investigate an allegation can do so objectively and do not have an interest in the outcome of the matter.
- Adopt an internal investigations policy that covers the key investigation principles, which are outlined in the sidebar, "Key Subjects to Include in Your Internal Investigation Guidelines," found on pg. 28.
- Establish policies and communications designed to ensure there is no retaliation against persons who, in good faith, report suspected misconduct.
- Treat the fact-finding process and the decision-making based on the investigation as distinct parts of the process. Typically, this means that the investigators should present the facts to the board or senior management to then decide what action is appropriate based on those facts.
- Have qualified outside counsel available to assist with or conduct an investigation if internal resources are not adequate or appropriate. Have a different firm, preferably one that does no other work for the company, available to investigate matters of the highest sensitivity.
- Whenever a serious allegation of wrongdoing is made, move quickly to secure evidence—suspending normal document retention periods for potentially relevant documents, and investigate—and document the steps you take to diligently investigate the allegation.
- Monitor legal developments to avoid surprises.

O.R.

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

Notes

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

TOOLKIT >>

Responding to Auditor Requests

The ripples and repercussions from Enron, WorldCom, Tyco, and the other financial reporting scandals have touched many professions. Coping with the requirements of the Sarbanes-Oxley legislation (SOX) has radically affected how accountants and auditors tackle their jobs. Now attorneys are also getting swept into the tide toward more scrutiny, and have taken on added obligations for assisting the auditors in preparing a clean bill of health.

In January 2003, the Securities and Exchange Commission published new rules, designed to implement section 307 of SOX. Taken in their entirety, the SEC rules, the American Bar Association Statement of Policy, and the SOX legislation affect all lawyers who represent public companies, including in-house counsel.

You may be wondering: why should auditors come to me, of all people, for information about their companies' financial statements? There are three main areas in which they may need to solicit your help—and in which you will often be bound to provide answers. These areas are:

- Ensuring that the financial statements are free of material misstatements;
- Confirming that accrual items are appropriate; and
- Ensuring that loss contingencies are adequately disclosed.

On a less diplomatic note, the American Accounting Association notes that "lawyers have never been known for simplified language, and, therefore, reading a legal representation letter can often be a cause of great frustration for an auditor." Ahem.

The new system is still in its early days, and will doubtless evolve along with developments in case and statutory law. Auditors seem to be setting a higher standard in asking for assurances from counsel than the reasonable assurances that auditors themselves provide in their letters. Eventually, refinements will need to reflect the changing role of in-house departments and the mixed roles of in-house counsel.

Meanwhile, your task of conveying and interpreting this information is a critical one. The position may be complex, and you need to understand the parameters of what you should and should not disclose.

Some Basic Legal Guideposts

- The American Bar Association, Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (1976) (ABA Statement of Policy)
- Securities and Exchange Commission, Regulation S-K, Item 103, "Legal Proceedings" (S-K 103)
- American Bar Association, Model Rules of Professional Conduct, Rule 1.6, "Confidentiality of Information" (MRPC 1.6)
- The Sarbanes-Oxley Act

THE SCOPE

When you are asked for a response, you will probably come up with several immediate questions of your own:

- Should I insist on a written request?
- How far do my responses need to go?
- Should I give my client a draft of the response before I send it to the auditor?
- Which matters can I leave out?

But do you need to respond at all? The answer is yes, if the initial letter requesting you to provide information to the auditor has been signed by an authorized agent of your client. However, you must of course fully explain to your client any legal consequences of your disclosures—and keep in mind that an adverse party might assert that an evaluation of potential liability is an admission. In some larger law departments, as general counsel you may have to rely on others. Cover your bases, and consider showing your client a draft of your response before you send it to the auditor. It might even be a good idea to share the draft response with your company's chief accounting officer.

Once you are ready to respond, how far should you go? Remember that your response carries the liability of an opinion, so you should prepare it with the same care an outside lawyer would use to respond to similar requests from auditors. If your response is limited to material items, as described in the ABA Statement of Policy, then say so loud and clear. Otherwise you might pick up liability.

Now is the time to draw lines in the sand. You should spell out the scope of the engagement, mention the date of your response, and disclaim any undertaking to update it. (If auditors eventually request updates, you should try to provide them in writing rather than verbally. A limited bring-down letter approach might work.) You are basically only responsible for information relating to legal consultation and representation. Make sure to distinguish between what you have learned in a legal context and what you have gleaned in a business capacity. Unless you tell them otherwise, the auditors can assume that your answers are limited to matters to which you and your department have given serious attention.

Materiality

The overriding function of an audit is for independent auditors to obtain reasonable assurance that financial statements are free of *material* misstatements.

Materiality is a key concept, and you may expressly state that you are only addressing material items in your response. While the ABA Statement of Policy allows you to limit your information to material items, the issue is: What is material?

A range of definitions applies to materiality, a concept that may be open to differing interpretations in various circumstances. For instance, a small error in calculation could suddenly become material if it created an event of default under a line of credit. The assumptions used to determine materiality are often critical. They can mean the difference between a company's missing or making its numbers.

Litigation proceedings may qualify as material if they either:

- Pass a reasonable investor test; or
- Exceed 10 percent of the consolidated current assets of the company and its subsidiaries.

If you conclude that legal proceedings are material, you will need to include:

- The name of the court or agency where they are pending;
- The date instituted;
- The principal parties;
- A description of the factual basis; and
- The relief sought.

Contingencies

To issue a clean audit report, the independent auditors must be satisfied that loss contingencies have been adequately disclosed. At the same time, they also need to be satisfied with the accounting methods. Accountants keep a sharp lookout that companies are not accruing for general or unspeci-

Probable vs. Remote

1. ABA Statement of Policy

Unfavorable Outcome Probable:

- Prospects for claimant not succeeding are extremely doubtful.
- Prospects for your client succeeding are slight.

Unfavorable Outcome Remote:

- Prospects for your client not succeeding are extremely doubtful.
- Prospects for claimant are slight.

2. FAS 5

- *Probable*: The future events are likely to occur.
- *Reasonably Possible*: The chance of the future event occurring is more than remote but less than likely.
- *Remote*: The chance of the future event occurring is slight.

Note that there is a subtle difference between the ABA Statement of Policy and FAS 5. (And remember how the accountants were complaining that the attorneys did not use clear and simple language?)

TOOLKIT>>

fied business risks. They make sure companies are not stockpiling reserves against general contingencies, as these can be used to smooth earnings or distort the financial picture. As the accountants delve, they look to lawyers for information about contingencies which the lawyer may have advised on or attended to.

It is proper for you to provide information on loss contingencies if you have already devoted considerable time and effort to claims for threatened or pending litigation. You even have a contractual obligation to speak out if the client has specifically identified a claim and asked you to comment to the auditors.

In such cases, you should tell the auditors:

- The nature (identification) of the proceedings;
- The stage of the proceedings;
- The claim(s) asserted; and
- The position taken by the client.

This is not a time to wax lyrical. You should normally refrain from expressing your own judgment or opinion as to an outcome, except to say whether you consider it probable or remote.

Beware of estimating dollar amounts of potential losses from claims in most cases! Unless you are feeling thoroughly confident that there is little chance you are off the mark, as an attorney you should not be making estimates for most unasserted claims, and you should definitely not be contributing your opinion about the adequacy of reserves. Although some finance teams may urge lawyers to approve amounts reserved, you may need to remind them that it would not be appropriate in your role. Consider sitting down with the financial person and stating that it is up to him or her to use judgment in setting the reserves.

PROFESSIONAL RESPONSIBILITY

You may recall that several of the recent accounting scandals, such as the Enron debacle, derived from off-balance sheet transactions that had never been fully disclosed. The ABA Statement of Policy addresses your own professional obligations in the realm of public disclosure. For example, it is up to you to draw attention to the following issues, if they are likely to become material:

- Amounts of revenues, expenses, and cash flows arising from off-balance sheet arrangements;
- Nature and amounts of any interest retained, securities issued, and other indebtedness in connection with such arrangements;
- Nature and amounts of any other obligations or liabilities arising from such arrangements; and
- The triggering events or circumstances that could cause them to arise.

Suppose you do the right thing: You offer advice advocating public disclosure, and your sound advice is ignored. The bad news is that the Code of Professional Responsibility might actually require you to resign, to avoid any taint of a cover-up. At least you do not have to make a noisy withdrawal by blowing the whistle, disavowing the work, or notifying the authorities. (Be aware that this area is still under debate.) In the meantime, auditors can take it as a given that the attorney has considered, and advised the client on, disclosure requirements for an unasserted possible claim.

The ABA has updated and clarified the area of professional responsibility for attorneys in its Statement of Policy. It has developed these updates as general guidelines, which you can now incorporate by reference. It expressly states, however, that its updated language does not preempt any of the other more rigorous ethical rules. The SEC also affirms that its rules prevail over any inconsistent state laws.

Doing the Right Thing

So here is your updated game plan. Let us say you learn of some credible evidence that any agent of your company is involved in a material violation of federal or state securities law. You must:

- Notify the chief legal officer (CLO), or both the CLO and the CEO;
- If CLO/CEO does not respond appropriately, report evidence of the wrongdoing to the audit committee, another committee of independent directors, or the full board; and
- As a supervisory attorney, make sure your subordinate attorneys comply with the rules.

You are off the hook if your CLO/CEO persuades you that:

- There is no past, ongoing, or future violation;
- The problem has been fixed; or
- Further investigation is called for.

Fraud

Fraud is an auditor's bête noire. You should at least be aware of the minimum procedures required to detect such wrongdoing under SAS 99. These are:

- Increased emphasis on professional skepticism;
- Discussion with management;
- Unpredictable audit tests; and
- Responding to management override of controls.

You ought to understand the auditor's own role here, too. Here is what the auditor must do if he suspects an illegal act may have occurred:

- Determine the effect on the financial statements;
- Inform management;
- Make sure that the audit committee or board of directors is adequately informed;
- Report conclusions to the board if senior management has not taken remedial actions; and
- Resign or report to the SEC within one business day—unless the board has reported to the SEC.

Fraud is a serious offense, and needs to be addressed at the highest levels. First, SOX § 303 required the SEC to adopt rules making it unlawful for an officer or directors, or anyone acting for them, to take any action to influence, coerce, manipulate, or mislead an auditor. The SEC did as it was told and issued a rule on May 20, 2003 prohibiting the top brass from causing an auditor to render the financial statements materially misleading. Here, top brass means president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer. You can breathe a bit more easily; the SEC has declined to amend the definition to include general counsel or chief legal officer specifically. (The definition does, however, cover those who set corporate governance and legal policies.)

Other Updates

- SOX § 307—requiring the SEC to adopt "minimum standards of professional conduct" for lawyers practicing before the SEC
- SEC Release 33-8185, "Implementation of Standards of Professional Conduct for Attorneys," January 29, 2003, at *www.sec.gov/rules/final/33-8185.htm*
- Part 205 (17 CFR Part 205), "Standards of Professional Conduct For Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer"

Accounting Treatment for Asserted Claims

Likelihood of Unfavorable Outcome	Ability to Reasonably Estimate the Potential Loss: Reasonable Estimate	Ability to Reasonably Estimate the Potential Loss: No Reasonable Estimate
Probable	Accrue and, if necessary, disclose to avoid misleading financial statements	Disclose contingency and range of possible loss or state that no reasonable estimate is possible
Reasonable	Disclose contingency and estimated amount of possible loss	Disclose contingency and range of possible loss or state that no reasonable estimate is possible
Remote	Neither accrue nor disclose, unless guarantee	Neither accrue nor disclose, unless guarantee

TOOLKIT>>

You need to become familiar with management's increased responsibilities, too, under the fairly recent changes of SOX § 404. Management needs to:

- Establish and maintain an internal control structure;
- Assess the effectiveness of the internal control structure;
- Prepare a management report on the structure and its effectiveness; and
- Secure an attestation from the external auditor on the effectiveness of the internal control structure.

Management's year-end statement must describe whether or not the internal control is effective, and must note any material weakness. In this case, a material weakness means a *significant deficiency* that is likely to cause a material misstatement of annual or interim financial statements.

The ACC Board of Directors has endorsed a proposal to resolve the auditor issue. Authored by David Brodsky of the Corporate Counsel Consortium, the proposal suggests a method by which in-house counsel can offer auditors the information sought while preserving the attorney-client privilege as to third parties. See *www.acca.com/protected/article/attyclient/debate.pdf*.

ACC has developed a Leading Practice Profile on Leading Practices in Providing In-house Legal Support to the CFO and Finance Function, available on ACCA Online℠ at *www.acca.com/protected/article/governance/lead_cfo.pdf*.

Need more advice on this issue? ACC's 2005 Annual Meeting (October 17-19, Washington, DC) has programs about:

- Effective Strategies for Responding to Government Audits, and
- Dealing with Accountants and Auditors.

Plus, confirmed faculty include representatives from J.C. Penney Corporation, KPMG LLP, and Covad Communications Company.

For more information go to *www.acca.com/am/05*.

PROCESS FOR RESPONDING

Now you have some idea of when you need to respond to requests for information, and of how far you should go. So once you get to the nitty-gritty, how should you prepare a response from start to finish? Your first task is to establish the threshold for materiality, working in conjunction with the auditors and the Audit Committee:

- Communicate with the auditors in advance to set the threshold.
- Consider the Audit Committee Charter.
- Consider Audit Committee requirements.
- Consider which reports are given to the Audit Committee.
- Investigate how to find information throughout the business.
- Examine how the business reports information to you.
- Coordinate efforts.
- Scale efforts for the business.

Dangers of the Process

Responses carry certain pitfalls that you should be aware of, particularly in the areas of:

- confidentiality;
- privilege; and
- work product doctrine.

On the confidentiality front, the ABA Section of Litigation has squarely stated that the scope of the attorney-client privilege should be the same for in-house and outside counsel. In a global world, note that communications with employed counsel may not be privileged in jurisdictions outside the United States. The usual exceptions apply—to prevent death, bodily harm, and so forth—and would include the prevention of fraud, or of substantial injury to another's financial interests. Disclosure to the auditor in the year-end audit process is a voluntary, deliberate disclosure, and, as such, is generally sufficient for a waiver of attorney-client privilege.

Work product doctrine is broader than attorney-client privilege. It can protect those materials you or your agents have prepared, whether or not you have disclosed them to the client. This doctrine is addressed under Rule 26 of the Federal Rules of Civil Procedure. That rule states that disclosure of "work product" to a third party does not waive protection of the doctrine, unless it significantly increases the opportunity for adversaries to obtain the information.

As a final caution, the current trend in case law appears to be one of making more things discoverable. In giving access to case management databases or spreadsheets, you may therefore risk letting these materials become discoverable. This can leave you in a very tough position if the auditors still refuse to sign the audit letter without your materials.

A New World

Attitudes to professional responsibilities and behavior are in a constant state of evolution. The ABA has revised its rules to be more aligned with all "up-the-ladder" reporting, as SOX has expanded reporting duties to the CLO, CEO, the Audit Committee, or in extreme circumstances, even to the outside Board of Directors.

The ramifications of the 2002 accounting scandals profoundly shocked the investment community and the general public alike. In order for the U.S. securities markets to function efficiently and transparently, a huge overhaul was required. Each member of the business community is expected to play some part in the chain of creating a fair, visible, and level playing field for all participants.

You may chafe at some of the added burdens, responsibilities, and liabilities. But at the end of the day, you must come to terms with the new realities, and prepare to walk this tightrope with a full understanding of your professional obligations.

This Toolkit is drawn from Course #605 at the ACC 2004 Annual Meeting, presented by Jeff Kelsey, managing director–litigation, Federal Express Corporation; Stephen R. Martin II, vice president–law (litigation), Adelphia Communications Corporation; and Mark N. Rogers, corporate counsel and assistant secretary of Insight Enterprises, Inc. The course materials are available on ACCA Online℠ at www.acca.com/am/04/cm/605.pdf.

by: deborah l. edwards, mark t. colloway, and brian d. edwards

what to do when the whistle blows

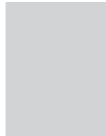
Do's and Don'ts of Internal Investigations

The reality of our times is that companies face increasing scrutiny of all facets of their conduct, and that scrutiny comes both from without and within. Further, as the numerous recent and well-publicized corporate scandals demonstrate, the consequences to a company that cannot withstand such scrutiny can be catastrophic. As a result, it is more important than ever that companies re-double their efforts not only to prevent misconduct in the first instance, but also to police themselves vigilantly to detect and correct misconduct that does occur. Accordingly, the ability to conduct a credible internal investigation of alleged wrongdoing is essential to corporate survival.

Deborah J. Edwards, Mark T. Calloway, and Brian D. Edwards, "What To Do When the Whistle Blows," *ACC Docket* 22, no. 5 (May 2004); xx–xx. Copyright © 2004, Deborah J. Edwards, Mark T. Calloway and Brian D. Edwards, and the Association of Corporate Counsel. All rights reserved.

Deborah J. Edwards is assistant general counsel for Duke EnergyCorporation in Charlotte, North Carolina where she specializes in complex litigation, investigations and compliance matters. Previously, she was a senior commercial lawyer for Continental Tire North America. She is available at dedwards@duke-energy.com.

Mark T. Calloway is a partner in the Governmental Investigations and Compliance Group at Alston & Bird LLP in Charlotte, North Carolina and, prior to joining Alston & Bird, served as U.S. Attorney for the Western District of North Carolina. He is available at mcalloway@alston.com



Brian D. Edwards is a partner in the Labor and Employment Group in the Atlanta, Georgia office of Alston & Bird LLP. He is available at bedward@alston.com

Conducting and/or supervising an internal investigation of potential misconduct can be the most challenging and important function that an in-house counsel performs. If done properly, an investigation can precisely identify the conduct in question and the identity and role of the persons responsible for that conduct, permit the company to make an informed assessment of the legality and propriety of that conduct, and provide the company with the opportunity to make an informed and proactive decision regarding whether and how to take corrective action. If done properly, all of these goals can be accomplished in a privileged and confidential way and in a manner that limits or eliminates the potential for legal liability.

On the other hand, an investigation that is incomplete or conducted improperly can actually place the company in a worse position than it would have been in if no investigation had been conducted at all. Examples of the problems that can be caused by an improper investigation include inadvertent waiver of privileges, destruction of or failure to retain relevant evidence, and creation of an inaccurate or misleading record of events that portrays the company in an unnecessarily negative light or that calls into question the company's motive in undertaking the investigation.

KNOWING WHETHER—AND HOW—TO INVESTIGATE

Deciding To Investigate

At the outset, it is important to recall the theory behind corporate criminal liability. Organizations act through their agents and, under the doctrine of *respondeat superior*, the government may prosecute the organization for an agent's wrongdoing.[1] Significantly, an organization need not profit from an agent's wrongdoing to be criminally responsible.[2] Consistent with these principles, the Department of Justice (DOJ) has stated that a company may be charged when its agent's actions "(i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation."[3] Further, DOJ has directed that "[i]n all cases involving wrongdoing by corporate agents, prosecutors should consider the corporation, as well as the responsible individuals, as potential criminal targets."[4] Against this background, an internal investigation is warranted whenever counsel believes that the alleged misconduct of its employees or agents may be imputed to the company.

While it is obvious that an investigation of any allegations of material wrongdoing should be conducted, in reality this can be a difficult decision. Initial complaints often are incomplete or too general to permit a meaningful inquiry. Where this is the case, it is valuable to have a mechanism for communicating with the source of the complaint to attempt to define the issue. For this reason, corporate compliance reporting mechanisms should provide for two-way communication with anonymous sources where possible.

Even when a specific complaint is made, the amount of practical discretion that the company has regarding an investigation can vary widely. On one end of the company's discretion are insignificant matters such as a complaint that someone has "stolen" office supplies for personal use. On the other end of the spectrum are matters of great importance or sensitivity about which the company has little choice but to investigate, such as a detailed complaint alleging securities fraud or a government subpoena indicating the company is under investigation. Obviously, the most difficult decisions arise in between these two extremes.

> **BUILDING AN INVESTIGATIVE STRUCTURE**
>
> For more information regarding ways to establish an effective corporate compliance program, see:
> - Thomas R. Lavelle, *Developments In Corporate Compliance Programs*, American Law Institute CLE (available on Westlaw, SJ014 ALI-ABA 817) (2003);
> - Gregory J. Wallance, *Corporate Compliance Programs Under The Organizational Sentencing Guidelines*, Practising Law Institute, Corporate Law and Practice Course Handbook Series (available on Westlaw, 1248 PLI/Corp 105) (2001); and
> - John F. Fatino, *Corporate Compliance Programs: An Approach To Avoid Or Minimize Criminal And Civil Liability*, 51 DRAKE L. REV. 81 (2002).

In making the decision to investigate, the following factors should be considered in analyzing the credibility and materiality of a complaint:

- *The source of the complaint.* While no complaint should be disregarded simply because of the source, it is beyond dispute that some sources are inherently more credible than others due to the nature of the source (*i.e.*, regulatory agency or prosecutor vs. anonymous source) or factors such as bias or self-interest on the part of the complainant.
- *The form of the complaint.* Information can come to the company's attention in a variety of forms, including a public news story, a compliance helpline call, a letter from an attorney representing a third party (*i.e.,* a customer, competitor, or employee), or an anonymous communication.
- *The substance of the complaint.* What is material will vary widely from case to case and may require consultation with outside counsel to determine whether the substance of the complaint sets up a legal duty to investigate.
- *Whether there are other indicia of credibility or lack thereof.* Has the company previously received similar complaints? Has the company received multiple complaints from this source? Does the complaint reference confidential factual information that relatively few know? Were documents or files that support the allegations provided with the complaint?

A useful rule to follow is that an investigation should be conducted of any apparently material and credible complaint that describes a potential violation of law or company policy. If for no other reason, such complaints should be investigated because the risks of foregoing an investigation are, quite simply, not worth it. Indeed, one need look no further than the well-documented examples of Enron, Arthur Andersen, MCI/WorldCom, and HealthSouth to find evidence of the extreme consequences that can result from unchecked corporate wrongdoing.

In addition, a decision to investigate may have a beneficial effect on any subsequent government investigation. Corporations historically have been limited to "back-end" credit under the U.S. Sentencing Guidelines (Guidelines) for effective compliance programs aimed at preventing and detecting wrongdoing.[5] Current DOJ policy, however, gives credit for effective compliance programs and internal investigations at the front end, when the critical decision of whether to file charges against the company in the first place is being made.[6]

Where to Aim and How Wide to Cast the Net

The scope and purpose of an investigation need to be defined early in the process. Important steps at this initial stage include:

- *Identifying the reason(s) for the investigation*. Counsel should identify the allegations levied against the company and describe the purpose(s) of investigating those allegations. For example, if an allegation implicates only an internal policy, then the reasons for investigating may be solely to determine the relevant facts, analyze those facts in light of the company's policy, and recommend appropriate remedial action. On the other hand, if the allegations involve conduct for which the company or its employees may be criminally or civilly liable, then the reasons for the investigation may also include an assessment of the potential criminal and civil exposure. Because the attorney-client and work product privileges typically apply only in situations involving antici-

pated litigation and the provision of legal advice, where appropriate, it is essential that counsel make it explicit at the commencement of the investigation that the provision of legal advice is at least one of the purposes of the investigation.

- *Specifying the scope and goal of the investigation.* In-house counsel responsible for an investigation should specify the scope and the goal of the investigation. For example, will the investigation focus on a single transaction or business unit? Will it focus solely on the specific conduct and/or subject matter described in the complaint? Will it be limited to internal sources of information? Are the investigators supposed to simply report the facts and provide legal analysis or are they expected to recommend remedial action? Defining the scope of an investigation provides focus and boundaries to the investigators and identifies the purpose and logical endpoint of the investigation. Care must be taken to recognize, however, that the initial scope of the investigation may change along the way as the facts develop. Further, it is important to understand that an investigation's credibility may be compromised if it is limited in ways that prevent a reasonable and thorough analysis of the allegations raised.
- *Identifying the client.* To whom should the investigative team report? The obvious goal is to identify an individual or group who (1) has appropriate authority to act upon the results of the investigation; (2) is independent of the alleged wrongdoing and wrongdoers; and (3) will be perceived by those outside of the company as independent. In this context, the client can be in-house counsel, the corporate compliance officer, the board of directors, the audit committee, or a special committee comprised of the independent members of the board of directors.

Drafting the Investigative Team

There are four primary factors to consider when structuring an investigative team: independence, competence, resources, and privilege.

INDEPENDENCE. It is essential that the team be free from actual or apparent bias or conflicts of interest. The key variables here are the scope and seriousness of the alleged wrongdoing. When the investigation concerns a matter that is less significant, an entirely internal investigative team may be appropriate. As the scope and significance of the alleged wrongdoing increases, however, it becomes increasingly difficult to assemble a truly independent internal team.

More Than a Slap on the Wrist

The DOJ continues to be very active in pursuing white collar crime and corporate fraud. For 2002 alone, DOJ reports the following results in the white collar arena:

- 5,799 convictions and/or pre-trial diversions,
- $9.8 billion in recoveries and restitution, and
- $500 million in fines.

See Department of Justice, *Fiscal Year 2002 Performance Report*, available at http://www.usdoj.gov.

In each case, counsel must assess whether it is possible to assemble a competent internal team that has no overlapping reporting or personal relationships with the alleged wrongdoers. Counsel must also determine whether the nature of the allegations and/or the identity of the alleged wrongdoers are such that any member of the team may feel pressure to reach a certain result or to hold back from inquiring about sensitive issues based on considerations such as career growth, job security, personal relationships, or financial self-interest.

Independence also is a factor when assembling an external team. It is common for law firms, accounting firms, and consultants to have significant ongoing relationships with their client companies. These relationships can undermine the independence of the outside professionals where the professionals reviewed or participated in some way in the alleged wrongdoing, where the alleged wrongdoers are significant to the relationship between the professional and the company, or where the financial relationship between the company and the professional is so significant that the professional could be said to have a financial interest in reaching a certain result.

COMPETENCE. Counsel must be able to assemble a team with the experience and expertise to conduct a credible investigation. Competence encompasses both process and substance. Specifically, counsel must consider the team's background in procedural matters such as:

- interviewing witnesses in a sensitive and privileged environment;
- managing the collection, review, and retention of paper and electronic records; and
- documenting an investigation in a privileged manner.

Counsel also must determine whether the nature of the allegations under investigation requires team members with particular subject matter expertise (*for example,* accounting, finance, or insurance).

RESOURCES. Often a company has sufficient internal experience and expertise such that, if concerns regarding independence are not determinative, the investigation could be conducted in-house. The problem in most instances, however, is that a company's in-house experts are fully engaged in other aspects of the company's business. In all but the smallest internal investigations, using in-house personnel extensively may be impossible or, at a minimum, may require formal reassignments to enable those personnel to focus on the investigation.

PRIVILEGE. If the company wants the option of treating the investigation as protected by the attorney-client and work product privileges, it is critical that the investigative team be run by an attorney and that the information-gathering and analysis be performed as much as possible by or under the direction of an attorney. Further, if outside subject matter consultants are to be involved, in-house counsel should consider who should select and/or retain such consultants. If in-house counsel hires a consultant, it may be hard for investigators to know if the consultant was retained to provide her *[instead of "its"]* ordinary services or whether she was retained to assist with the provision of legal advice. This is particularly true when the consultant is already on retainer with or provides services to the company.

MAINTAINING APPLICABLE PRIVILEGES

If the allegations underlying an internal investigation are disclosed outside the company, there is a very real chance that the allegations will become the subject of further scrutiny by prosecutors, regulators and/or private litigants. If and when this happens, the company will almost certainly face a request for the results of any internal investigation in the form of a grand jury or regulatory subpoena or a discovery request. In some instances, particularly where it is attempting to cooperate with government investigators, a company may elect to waive the attorney-client and work product privileges by disclosing the results of its investigation. In most cases, however, a company will not choose to waive privilege because the results of an investigation can provide a valuable road map to any adversary. As a result, an important job for both the investigative team and in-house counsel is to ensure that waiver occurs only as a matter of choice rather than as a matter of coercion.

The first step in protecting against coerced or negotiated waiver of privilege is to define and structure the investigation to maximize the likelihood that the privileges will apply. The attorney-client privilege only applies to communications made for the purpose of obtaining legal advice,[7] and thus will not protect communications with an attorney where the attorney has been retained for some other purpose. As a result, where appropriate, in-house counsel must be explicit at the outset of the investigation that one of the purposes of the investigation is to provide advice to the company about its legal rights and obligations regarding the subject matter of the investigation. Similarly, the work product doctrine applies only to materials prepared by or at the direction of counsel in anticipation of litigation.[8] Consequently, the investigative team should be assembled with an eye towards ensuring that the materials generated by the investigation will be prepared by or under the direction of an attorney.[9]

Next, counsel must recognize that no decision should be made to waive privileges applicable to an internal investigation until after the conclusion of the investigation. Remember, attorney-client privilege attaches only to communications that are intended to be confidential. If a company decides before or during an investigation to waive the privilege, it can be argued that subsequent communications are not privileged because they were not intended to be confidential. This could be particularly harmful if such a decision is made before potentially damaging facts are discovered in the investigation.

Finally, counsel should be mindful that any disclosure of the results of an internal investigation can operate as a broad waiver of the attorney-client

and work product privileges. Increasingly, federal prosecutors are requesting that companies waive the attorney-client privilege and work product protection. Indeed, waiver is a significant factor considered by the DOJ in assessing a company's level of cooperation.[10]

Waiving privileges to ward off potential criminal prosecution or regulatory action, however, has potential adverse consequences. Specifically, courts have held that a party may not refuse to disclose privileged information and documents when the party previously has provided the same information and documents to a governmental agency in an effort to gain favorable treatment in another proceeding. In other words, selective disclosure in the context of a government investigation constitutes a subject-matter waiver of the attorney-client and work product privileges.[11] This is true even when the company attempts to limit the scope of the waiver via a contractual arrangement with the government.[12]

CONDUCTING THE INVESTIGATION

Whether an internal investigation should commence with a document review or employee interviews will depend on the facts. In general, however, it is best to start with a review of the principal documents surrounding the transactions or decisions at issue. Such a review allows the investigation team to understand the nature of the matters at issue, to identify the key players, and to plan for informative interviews. In addition, the use of documents may be necessary to refresh the recollection of some employees during the interview process.

HITTING DELETE ISN'T THE ANSWER

The following is a list of informative articles describing some of the practical and legal considerations associated with electronic discovery:

- Cassandra G. Sasso and Mary Price Birk, "Discovery and Spoliation Issues in the High-Tech Age," *Colorado Lawyer*, September 2003;
- Lesley Friedman Rosenthal, "Electronic Discovery Can Unearth Treasure Trove of Information or Potential Land Mines," *New York State Bar Journal (*September 2003);
- Andrew T. Wampler, "Digital Discovery: Electronic options make the search for evidence a new adventure," *Tennessee Bar Journal*, at 14 (Feb. 2004).

Preserving the Past

Document retention is the stage of an investigation where negligence or inexperience can cause the most damage to the credibility of the process and can have the most dramatic impact on a company's ability to defend itself on the merits in any subsequent litigation or government investigation. The doctrine of spoliation dictates that a company has an obligation to preserve potentially relevant documents in the face of actual or even potential litigation.[13] As a result, any time that a company is faced with the prospect of litigation, it is critical that counsel take steps promptly to identify and preserve all documents that are potentially relevant to the claims likely to be presented in such litigation. This obligation is of paramount importance because the sanctions for spoliation include fines, attorney fees, adverse instructions to the jury, default judgment, or outright dismissal of a case.[14]

More importantly, however, document destruction with knowledge of wrongdoing or in anticipation of government investigations can result in obstruction of justice charges by prosecutors.[15] Indeed, under the catch-all obstruction statute, 18 U.S.C. § 1503, the government need only prove intent to obstruct rather than actual obstruction.[16] Moreover, the Sarbanes-Oxley Act of 2002 created a far-reaching document destruction offense that does not require an active government investigation. The risk of violating these prohibitions is heightened in today's electronic world because of the burden and complexity associated with electronic discovery. [17]

Given these concerns, preserving and gathering relevant documents is one of the most important aspects of any internal investigation. Consequently, the following steps should be taken as early as possible:

- Identify and describe the categories of potentially relevant documents. Typically, this will require the involvement of someone knowledgeable about the business unit(s) under investigation. It is best to be reasonably over-inclusive in preparing this list because the credibility of an investigation can be undermined if the document-gathering process is too narrow;
- Identify the universe of potential locations and custodians of such documents (individual offices, centralized files, off-site storage, shared servers or databases, individual hard drives or disks, backup tapes, etc.). This almost always will require a detailed understanding of the company's information systems and document retention policy and practices. Thus, consultation with IT personnel and document custodians is particularly important;
- Notify, in writing and as early as possible, all potential custodians of potentially relevant documents of the need to locate, gather, preserve, and produce the documents that already exist and to preserve and produce any responsive documents created thereafter. This will require taking steps to segregate and preserve electronic records and, typically, will require a suspension of the company's document destruction practices and the practice of recycling backup tapes;
- Identify a person or persons to be responsible for managing the collection of responsive documents. In some circumstances, it may be advisable for this person to be a non-lawyer who can provide testimony in the future**,** if necessary**,** regarding the steps taken by the company for document collection and retention; and
- Create a detailed record of this process, including identification of the persons who receive the document retention notice, dates and contents of all responses to the notice, and an index of all documents produced that indicates the person who produced the documents, the date of production, and the location from which the documents were obtained. Under certain circumstances, it may be appropriate to require a written response from each potential custodian of responsive documents describing their efforts to locate responsive documents.

Once the company has taken appropriate steps to identify, gather, and preserve potentially relevant documents, the investigative team must establish a plan to review and analyze the documents and information relevant to the investigation. The details of this plan will vary widely depending on the volume of documents and information and the nature of the allegations under investigation. For privilege reasons, it is important that this effort be under the supervision of counsel.

Employee Interviews

An Employee's Legal Rights and Obligations Regarding an Interview

At the outset, counsel must be prepared to respond to concerns from employees, usually the whistleblower and/or the alleged wrongdoers, who are reluctant to voluntarily participate in an interview. Although this issue has not been widely litigated or discussed, there appears to be general consensus that employees are required to cooperate with an internal investigation as a result of an employee's general duty of loyalty to his or her employer.[18] Because this duty to cooperate arises out of the individual's status as an employee, however, it is reasonable to assume that it applies only to the extent that the cooperation requested bears some relationship to the employee's duties or to the company's business generally.

An employee's resistance to participating in an internal investigation also may come in the form of a refusal to be interviewed outside of the presence of counsel or an attempt to assert the Fifth Amendment privilege against self-incrimination. With respect to the first issue, it is well-established that an employee does not have a right to counsel in an internal investigation.[19] Counsel should be aware, however, that employees who are represented by a duly authorized collective bargaining agent have a right to request the presence of a union representative in interviews which the employee reasonably believes may result in disciplinary action.[20] As for the second concern, the Fifth Amendment right against self incrimination typically does not apply in a private employment setting.[21]

Paving the Way for Individual Employee Interviews

There are two forms of disclosure, one optional and one mandatory, that should be considered prior to or at the commencement of any employee interview. The first form of disclosure is optional and will vary considerably depending on the circumstances. Typically, this disclosure should come from a representative of the company and should include some or all of the following information: (1) an introduction of the member(s) of the investigative team who will be contacting the employee for an interview; (2) a general description of the subject matter of the investigation; (3) an expression of the company's expectation of the employee's full coop-

eration; (4) a statement regarding confidentiality; (5) the identity of a person within the company or the investigative team who is available to answer employee questions or concerns about the investigation; and (6) a statement that the employee has been selected for an interview because it is believed that he or she may have possession of knowledge or information relevant to the inquiry and not necessarily because there has been any allegation that he or she has engaged in wrongdoing. Obviously, the contents of this communication will vary significantly depending on the sensitivity and scope of the investigation and the identity and potential role of the employee in any alleged wrongdoing.

The second form of disclosure should occur at the beginning of every witness interview that is conducted by an attorney and is for the purpose of clearly establishing the relationship of the attorney to both the company and the employee being interviewed. In the absence of such a disclosure, an employee could later contend that he or she believed that the company's counsel was acting as his or her individual lawyer and that the employee's communications with counsel are protected by a privilege that the employee controls. Courts have split on whether such claims are proper.[22] To ensure that there is no misunderstanding and to be fair to the company's employees, the best practice is to make a disclosure of this nature at the beginning of every witness interview.

Conducting the Interview

There are at least two schools of thought regarding the conduct of an employee interview in an internal investigation. Under the first, the employee is interviewed "cold" without any advance notice of the subject matter of the investigation and without any opportunity to review relevant documents to refresh his or her memory. Under the second, employees are provided with relevant documents or information in advance and given the opportunity to prepare for the interview. In practice, both approaches are useful if handled appropriately, and counsel should consider the advantages and disadvantages of each in deciding how to conduct each interview.

The first approach has the benefit of avoiding the appearance that witnesses have been improperly coached and/or given an opportunity to get their story straight through advance notice from or discussions with the investigative team. This benefit can become a disadvantage, however, in instances where the focus of the investigation is on complicated or detailed transactions or on events occurring months or even years ago. Under such circumstances, an employee may provide inaccurate or incomplete information simply because he or she was not given the opportunity to refresh his or her memory prior to the interview, and likely will have to be interviewed again. This can result in an investigative file that contains inconsistent or even contradictory statements from a witness about the same subject matter. While inconsistencies and contradictions often arise in internal investigations, counsel must take care to ensure that this does not happen unnecessarily simply because of the manner in which the investigation is conducted.

The second approach minimizes the pitfalls that can arise when witnesses are not provided with a fair opportunity to refresh their memories regarding detailed or long-ago events or transactions. However, counsel must be careful to avoid any conduct that could be described as trying to influence an employee to remember facts in a particular way or that could be characterized as an effort to suggest that witnesses consult with one another prior to being interviewed to ensure that they are all telling the same "story."[23] To minimize these concerns, employees who are given advance notice of the substance of an interview should only be provided with data or documents to review and should be instructed that they are not to discuss the matter with anyone other than the investigative team.

At the conclusion of the interview, the employee should be directed not to discuss the interview with anyone else (except his or her own attorney) including other employees. Such discussions could affect the company's attorney-client privilege and could be viewed as an attempt by employees to coordinate their recall of the facts. If a government investigation ensues and the employee is interviewed, prosecutors almost certainly will ask the employee to identify anyone, other than his own attorney or the company's attorney, with whom he discussed the matter. In addition, the employee should be reminded of his continuing duty to cooperate and preserve documents.

Documenting the Interview

Finally, whether and how interviews should be memorialized is a determination that should be made in advance. The most common method is to have the attorney who conducted the interview prepare a memorandum. This document usually is protected both by the attorney-client and work product privileges and typically receives the heightened protection provided to opinion work product because it contains the mental impressions of counsel. If a memorandum is prepared, however, and the privileges are waived, the full contents of the document may become discoverable in subsequent lawsuits and the company's counsel may become a witness. Thus, if future waiver is a real possibility, counsel should take care not to include opinion work product (*e.g.*, "this witness is not credible") in the memorandum.

Other methods of documenting witness interviews include the creation of a verbatim record by a stenographer, or an audio or video recording, or having the witness sign a written statement. While these methods may be advisable in certain circumstances, they generally are not preferred because verbatim accounts and written statements signed by a witness may not be protected by either the attorney-client or work product privileges.

From this point on . . .
Explore information related to this topic.

ONLINE:

- ACC's committees, such as the Corporate and Securities Law Committee, are excellent knowledge networks and have email lists to join and other benefits. Contact information for ACC committee chairs appears in each issue of the *ACC Docket*, or you can contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or windley@acca.com or visit ACCA Online[SM] at www.acca.com/networks/ecommerce.php.
- Bryce D. Lindsenmayer, *An Overview of Sarbanes-Oxley*, available on ACCA Online[SM] at http://www.acca.com/chapters/program/sanant/sox.pdf.
- William Joseph Linklater and Patrick J. Ahern, "Corporate Internal Investigations and Employee Privacy Rights," 15 *ACCA Docket*, no. 6 (November/December 1997), available on ACCA Online[SM] at http://www.acca.com/protected/pubs/docket/nd97/investigate.html.
- *Model Internal Compliance Policy*, available on ACCA Online[SM] at http://www.acca.com/protected/policy/conduct/wilmer_inhousepolicy.pdf.

If you like the resources listed here, visit ACC's Virtual Library[SM] on ACCA Online[SM] at www.acca.com/resources/vl.php. Our library is stocked with information provided by ACC members and others. If you have questions or need assistance in accessing this information, please contact Senior Attorney and Legal Resources Manager Karen Palmer at 202.293.4103, ext. 342, or palmer@acca.com. If you have resources, including redacted documents, that you are willing to share, email electronic documents to Managing Attorney Jim Merklinger at merklinger@acca.com.

Follow a Script

The following is a sample disclosure to be used by attorneys conducting witness interviews:

> We are attorneys representing the company in connection with an internal investigation relating to [the general matters at issue]. As an employee of the company, your statements to us are covered by the company's attorney-client privilege. This privilege protects from disclosure confidential communications, exchanged between an attorney and client that are made for the purpose of seeking or rendering legal advice. In this case, our client is the company, not its employees, such as yourself. Thus, the privilege belongs to the company and the company may choose to waive it. That means that should the company choose to waive the privilege, our conversation may be disclosed to other parties. Again, we represent the company, and we are *not* your lawyers. It is important, however, that in order to maintain the company's privilege you keep our conversation confidential. Do you have any questions or concerns about this?

MEMORIALIZING FINDINGS AND PRESENTING RESULTS

There are competing considerations that should be taken into account when deciding whether to prepare a written report summarizing the contents and results of an internal investigation. On the one hand, a written report can be a valuable tool for management in planning the company's response to the allegations of misconduct, and a written report creates a documented record of the scope and findings of the investigation that may prove to be valuable to the company in future litigation or investigations. On the other hand, counsel should consider the fact that a written report may discuss potentially illegal or unethical conduct by company employees. In this regard, counsel should be mindful of the fact that, if the existence of such a report becomes known, prosecutors or government investigators may be very tempted to pressure the company to waive any applicable privilege and to disclose the report, and future litigation adversaries almost certainly will seek disclosure of the report in discovery.

CONCLUSION

In today's business and regulatory environment, a properly conducted internal investigation is essential. Numerous issues and pitfalls can arise even with the most well thoughtout investigative plan. Failure to properly plan an internal investigation, as well as failure to deal with critical issues that arise along the way, will result in numerous problems that may be more difficult to address than the underlying conduct at issue.

Furthermore, failure to properly undertake a complete and thorough investigation, including taking appropriate corrective action warranted by the investigative findings, may leave the company in a worse position than when the investigation started. The guiding principle of any internal investigation is to find the truth. Likewise, the company should be prepared to handle the truth once it's found. ■

NOTES

1. *E.g.,* United States v. Automated Medical Laboratories, Inc., 770 F.2d 399, 406 (4th Cir. 1985) ("A corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation even if ... such acts were against corporate policy or express instructions.").
2. *Id.* at 407 ("Whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation.").
3. Department of Justice, *Federal Prosecution of Business Organizations*, Section I (Revised January 20, 2003) (hereinafter "Thompson Memo").
4. *Id.*
5. Under the Guidelines, a corporation is entitled to a downward departure if it maintains an "effective program to prevent and detect violations of law." U.S.S.G. § 8C2.5 (f).
6. Thompson Memo, Section II, factors 4, 5 and 6.
7. Upjohn Co. v. United States, 449 U.S. 383, 394 (1981).
8. *Id. at* 397-98. Courts also distinguish between fact and opinion work product. For example, an employee's summary of facts, prepared at the direction of counsel, is fact work product. The attorney's notes of a meeting with the employee, on the other hand, reflect the attorney's opinions of the case, or the attorney's opinion of the employee's probable performance as a witness at trial, and are opinion work product. While all materials covered by the work product doctrine receive some measure of protection, materials containing opinion work product are given nearly absolute protection. *E.g.,* In re Allen, 106 F.3d 582, 607 (4th Cir. 1997) (opinion work product "enjoys nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances.") (citations omitted).
9. Some courts have held that documents prepared in an independent investigation are not covered by the work product privilege because they were not prepared "in anticipation of litigation." *See* In re Kidder Peabody Securities Lit., 168 F.R.D. 459, 461 (S.D.N.Y. 1996); Diversified Industries v. Meredith, 572 F.2d 596, 611 (8th Cir. 1978). Most cases, however, devote little or no analysis to this issue and, instead, assume without discussion that the work product privilege applies. *See, e.g.*, Neal v. Honeywell, Inc., 1995 WL 591461 (N.D. Ill.); Republic of Philippines v. Westinghouse Electric Corp., 132 F.R.D. 384 (D.N.J. 1990). Moreover, numerous courts have found that attorney memoranda and notes reflecting interviews and communications with employees of a corporate client constitute opinion work product. *See, e.g.,* Baker v. General Motors Corp., 209 F.3d 1051, 1054 (8th Cir. 2000); In re Allen, 106 F.3d 582, 608 (4th Cir. 1997).
10. *See, e.g.,* Thompson Memo (discussing importance of waiver of the attorney-client privilege and work product protection in assessing a company's cooperation with prosecutors).
11. *See* In re Columbia/HCA Healthcare Corp. Billing Practices Litigation, 293 F.3d 289, 302-307 (6th Cir. 2002) (waiver based on disclosure to DOJ); Westinghouse Elec. Corp. v. Republic of the Philippines, 951 F.2d 1414 (3rd Cir.1991); Martin Marietta, 856 F.2d 619 (4th Cir. 1988). *But see* Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 606 (8th Cir.1977) (en banc) (no waiver of attorney-client privilege where documents disclosed to the SEC).
12. Such agreements do not apply to third parties. *See* Columbia/HCA Healthcare Corp., 293 F.3d at 306 n.28 (reviewing case law). Once waived, the privilege is waived in its entirety as to everyone. For example, Columbia/HCA attempted to preserve privileges applicable to its internal investigation when it disclosed certain documents to the DOJ through an agreement that provided, in part: "[t]he disclosure of any . . . information by one party to the other does not constitute a waiver of any applicable privilege . . . ." The Sixth Circuit ultimately held that this agreement would not protect against waiver as to other entities. *Id.*
13. *E.g.,* Zubalake v. UBS Warburg LLC, No. 02 Civ. 1243 (SAS) (S.D.N.Y. Oct. 22, 2003) (duty to preserve documents arose before filing of charge of discrimination with administrative agency); Scott v. IBM Corporation, 2000 WL 1425151 (D.N.J. Sept. 27, 2000) (destruction of document prior to filing of EEOC charge was spoliation because employer should have known that litigation was possible); Smith v. Borg Warner Automotive Diversified Transmission Products Corporation, No, IP 98-1609-C-T/G, 2000 WL 1006619 (S.D. Ind. July 19, 2000).
14. *E.g.,* Mathias v. Jacobs, 2000 WL 1041668 (S.D.N.Y. July 28, 2000); Smith v. Borg Warner Auto. Diversified Transmission Prod. Corp., No, IP 98-1609-C-T/G, 2000 WL 1006619 (S.D. Ind. July 19, 2000).
15. Federal obstruction of justice statutes include 18 U.S.C. §§ 1503, 1505, 1510, 1512-1514, 1517, 1518 and 1519.
16. *See* United States v. Aguilar, 515 U.S. 593, 599 (1995) ("It makes conduct punishable where the defendant acts with an intent to obstruct justice, and in a manner that is likely to obstruct justice, but is foiled in some way.")
17. 18 U.S.C. § 1519 ("Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.")
18. *See* In re Grand Jury Subpoena, 274 F.3d 563, 571 (1st Cir. 2001) ("an employee has a duty to assist his employer's counsel in the investigation and defense of matters pertaining to the employer's business."); United States v. Sawyer, 878 F. Supp. 295, 296 (D.Mass. 1995) ("as an employee of Hancock, Sawyer had an obligation to aid Hancock's in-house counsel with their internal investigation . . . ."); Williams v. Pima County, 791 P.2d 1053 (Ariz. Ct. App. 1989); *see also* Sarah Helene Duggin, *Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview*, 2003 Col. Bus. L.Rev 859, 907; Joseph F. Coyne, Jr. et al., *Employees' Rights and Duties During an Internal Investigation*, *in* Internal Corporate Investigations (Brad D. Brian and Barry F. McNeil eds., 1992).
19. Pollard v. Univ. of Mass. Medical School, No. 000138A, 2002 WL 31188443 (Mass. July 8, 2002) (no right to counsel during internal interview); TRW, Inc. v. Superior Court of Los Angeles County, 31 Cal.Rptr.2d 460 (Cal.App.2d 1994); Williams v. Pima County, 791 P.2d 1053, 1057 (Ariz. Ct. App. 1989); TCC v. Handley, 275 NLRB 604 (1985) (no right under NLRA to have attorney present during interview).
20. NLRB v. J. Weingarten, Inc., 420 U.S. 251 (1975). Although the NLRB has vacillated as to whether the National Labor Relations Act grants a similar right to unrepresented employees, its most recent position is that *Weingarten* also applies to such employees. Epilepsy Foundation of Northeast Ohio, 331 NLRB No. 92 (2000).
21. A private entity that is regulated by the government can be found to be a government actor for these purposes. *Compare* Skinner v. Railway Labor Executives Association, 489 U.S. 602 (1989) (applying Fourth Amendment to railroad company that administers drugs tests pursuant to Federal Railroad Administration requirements) *with* United States v. Solomon, 509 F.2d 863 (2d Cir. 1975) (holding that where New York Stock Exchange is investigating pursuant to its own interests, and not the SEC, it is not acting as an agent of the government).
22. *Compare* United States v. Hart, 1992 U.S. Dist. Lexis 17796 (E.D. La. Nov. 16, 1992) (where employees testified that lawyer never identified herself as solely representing the company and court viewed their belief that conversations were confidential and privileged as reasonable, all communications between investigating corporate counsel and the employees held to be protected); Rosman v. Shapiro, 653 F. Supp. 1441, 1445 (S.D.N.Y. 1987) (finding an attorney-client relationship where shareholder in close corporation reasonably believed that corporate counsel was representing him individually*); with* United States v. International Bhd. of Teamsters, 119 F.3d 210, 215 (2d Cir. 1997) (individual's "reasonable belief" that he was being individually represented is not sufficient for him to assert privilege); Securities and Exchange Commission v. Credit Bancorp Ltd., 96 F. Supp. 2d 357 (S.D.N.Y. 2000) (corporate employee must demonstrate that he made clear he was seeking personal advice and that attorney "saw fit to communicate" with him in his individual capacity).
23. To avoid the appearance that witnesses have been encouraged to collaborate so as to avoid giving inconsistent statements, counsel also should not conduct group interviews.