Conducting Internal Investigations: When Providing a Good Offense Is the Best Defense
By Yvette Ostolaza and Liani Ketcher

Defending corporations against charges of wrongful conduct has always been challenging. In the wake of the Enron and Tyco scandals and corporate wrongdoing, however, it has risen to dramatic new heights. Enron and Tyco were not isolated incidents. The list of corporations touched by financial scandal soon included Global Crossing, Quest, Worldcom, Xerox, Adelphia, MicroStrategy, IntClone and home maker Martha Stewart, AOL-Time Warner, K-Mart, J.P. Morgan Chase, and Halliburton Oil.1 As a result, state and federal governments passed legislation and regulations, including the Sarbanes-Oxley Act of 2002 and the new Securities and Exchange Commission (SEC) regulations.2 New laws require corporations to establish appropriate compliance programs and conduct prompt and effective internal investigations when misconduct is suspected.3 The result has been the proliferation of internal investigations in recent years,4 with some studies reporting that nearly two-thirds of American corporations have hired outside counsel to launch internal investigations.5 Though the industries most commonly subject to internal investigations seem to be energy and health care, all corporations can benefit from this preventive or remedial action.6 Lately, the options backdating controversy has placed internal investigations in the spotlight. Former executives of Brocade Communications Systems were the first to be indicted for crimes.

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The Attorney-Client Privilege and Public Relations Consultants
By Donald M. Lewis

Many corporate litigators assert the attorney-client privilege and work product doctrine to prevent discovery by adverse parties of its communications with public relations consultants retained in anticipation of litigation? The short answer: Don’t count on it. In a case of high media visibility, a federal court can be persuaded that a public relations consultant plays an important role in the formulation of legal strategy. But the decisions are not consistent, and a strictly narrow application of the privilege will not protect the routine tasks performed by public relations firms even when they collaborate with lawyers in executing “damage control” arising from litigation. The work product doctrine, however, may protect some documents exchanged between counsel and the consulting firm.

Since the Second Circuit’s decision in United States v. Kovel,7 extending the attorney-client privilege to communications in the presence of a party’s accountant, courts have struggled in applying waiver principles to the presence of other third parties, most notably with respect to public relations consultants.

In Calvin Klein Trademark Trust v. Wachner,8 the plaintiff retained a public relations firm, in anticipation of litigation, to assess the potential reaction of its “constituencies,” to provide legal advice, and to otherwise manage the plaintiff’s response to media inquiries. The defendant sought written and deposition discovery of the work of the public relations firm.

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inal charges relating to the stock options backdating scandal. Nearly 200 corpora-
tions have disclosed internal or federal investigations into how they issued back-
dated options—a practice that is not fraudu-
sent if it is properly accounted for and disclosed. More recently, in November 2007, Sycamore Networks Inc., a tele-
communications equipment maker, disclosed that the SEC decided to bring a civil action against it for possible violations of

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securities laws for alleged illegal backdat-
ing of stock options it awarded to its execu-
tives. Currently, at least four other executives and directors from corporations involved in improper backdating of stock options face criminal charges. Further, shareholder lawsuits have been filed against many corporations as a result of these actions.

Some corporations will wait until a lawsuit has been filed before approaching their attorneys with problems. However, early internal investigations have a signifi-
cant and often underused role in helping a corporation avoid liability and correcting significant problems. Internal investiga-
tions often take place when the stakes for a corporation are at their highest—to pre-
vent government actions, business reperc-
ussions (such as plummeting stock prices), and private litigation. In addition, government regulations place special responsibilities on audit committees regarding the investigation of accounting and audit-related compliance issues, and boards and board committees are initiating with greater frequency their own indepen-
dent investigations of a wider range of concerns, including in response to "whistleblowers." This article suggests a decision-making process for in-house counsel and corporations to use to decide whether an internal investigation is appro-
priate for their clients and offers examples of procedures to be used in conducting such an investigation.

Developing a Game Plan

Timing is key for initiating an internal investigation. As soon as a corporation has reason to believe a widespread problem may exist, it should decide whether an internal investigation should be initiated. Conducting an internal investigation offers a number of risks and rewards, each of which a corporation, its legal department, and its board should weigh in determining whether to proceed with an internal inves-
tigation.

The Upfront

Early investigations may give a corporation more time to develop responses or defenses, reduce the likelihood of law-
suits, or stay a lawsuit in some instances, and they make a corporation look more responsible to governmental entities, shareholders, and auditors. First, an internal investigation can help identify potential liability and can be useful in developing a plan to limit such liability. "An internal investigation assists the cor-
poration in determining the extent of potential criminal or civil liability to enable the corporation to make fully informed decisions for mitigating poten-
tial exposure." Internal investigations also allow corporations an opportunity to control investigations before the government intervenes. As Ronald L. Mazer quoted in his article Conducting Internal Investigations After Sarbanes-Oxley: Best Practices, "If a corporation effectively investigates its own misconduct, the cor-
poration may persuade the government to forgo conducting a separate investigation, reduce the scope of its investigation, or allow the corporation to guide the govern-
ment’s investigation." The government may also agree that if the results of its investigation conform to the results identi-
fied by the corporation, the penalty will be no more than a specified sanction. Thus, a credible internal investigation can prevent government intrusion into the corpora-
tion’s affairs. Furthermore, an internal investigation may allow a corporation to minimize criminal and civil exposure.

The best means to avoid indictment is to have full knowledge of all of the relevant facts so that an appropriate pre-indictment defense may be presented to the govern-
ment. A thorough investigation, combined with voluntary disclosure, may be the de-
terminative factor in convincing the gov-
ernment not to bring criminal charges. An internal investigation may also help to minimize adverse regulatory action. During disclosure, the attorneys conduct-
ing the internal investigation may per-
suade the government not to act—or at least to act in a more restrained manner.

In addition, "a corporation can use an internal investigation to minimize the effect of any negative publicity that has arisen from allegations of wrongdoing." The corporation can develop a plan to address any negative publicity before such publicity hits the press. The investigation may also "distance the corporation from any wrongful acts by its employees." It also demonstrates "the corporation’s good faith and may help restore or maintain investors’ confidence." In some circumstances, an internal investigation must be initiated based on a preexisting legal duty. Under Sarbanes-
Oxley, for example, audit committees have become the overseer for investiga-
tions into financial reporting and account-
ing issues. The audit committee in these investigations is charged with oversight and responsibility for all aspects of the investigation, including its initiation, its conduct, and ultimately, the decision of whether, when, and how to report to the government and/or shareholders. Failure to investigate may sometimes result in lia-
bility. In addition, management’s fidu-
ciary duties to the corporation may require management to initiate an investigation when there are indications of misconduct, and failure to investigate could subject management to civil liability. In-house
and outside counsel may also have obligations to investigate and report misconduct of a corporation. Finally, outside auditors are sometimes required to investigate before “signing off” on an audit.

The Disclosure
The disclosure of investigative findings can subject a corporation and its employees to criminal or civil liability and both criminal and civil liability. Facts discovered and reported through the investigation, even where there is no wrongdoing, also may serve as fodder for litigation against the corporation and its officers. In some instances, information derived from investigations that go public may satisfy Federal Rule of Civil Procedure 12(b)(6) and 9(b) requirements.

Internal investigations also may raise privilege and confidentiality concerns. The results of an investigation may be disclosed to the government, potential plaintiffs, or the public through reporting to the government or self-reporting. Finally, internal investigations can be very costly. In addition to the cost of the investigation itself, extended public and private investigations may have other negative financial consequences for a corporation, such as delaying its submission of financial releases, causing the corporation's stock to be delisted from a stock exchange or constitute an event of default under loan agreements, bonds, or significant contracts, depressing the price of the corporation’s stock value, generating low employee morale, hampering employee recruitment or the corporation’s ability to obtain new contracts, and protracting regulatory investigations.

The Playbook
Once a corporation weighs the pros and cons and decides to investigate, it must next determine the scope and goals of the investigation. Establishing guidelines and the scope of the investigation in advance will enable the corporation to avoid allegations that the corporation proceeded in an inconsistent or a capricious manner and will minimize the time and effort spent addressing procedural issues. The guidelines may cover when an investigation will be conducted, how it will proceed, who will determine the need for it, and who will oversee the investigation. It may be advisable for counsel to prepare a set of guidelines for a specific investigation to ensure the integrity and confidentiality of the investigation. The guiding principle in determining scope should be the need to uncover wrongdoing suggested by the specific allegations. As the investigation proceeds, counsel should continuously reassess the breadth of the engagement and recommend expanding or contracting, the scope of the investigation as the circumstances warrant.

The Players
Once the decision is made to conduct an internal investigation, a corporation must decide who should conduct it. For example, where the allegation of misconduct is not substantial and where the in-house legal department is not implicated, the investigation may be conducted by in-house counsel who are familiar with the corporation and its programs. In situations where senior officers or the legal department is implicated or where laws require an independent investigation, the investigation should be conducted or overseen by outside counsel. Under these circumstances, independent outside counsel should bring greater objectivity and credibility because of their arm's-length relationship with the corporation and should reflect a greater level of self-interest in validating the conduct. In addition, outside counsel may have a greater ability to achieve confidentiality because there is a reduced risk that communications will be perceived as involving business rather than legal advice.

In turning to outside counsel, in certain circumstances, the corporation will want to select independent outside counsel and not hire a law firm that has handled the corporation's business in the past or that has a working relationship with the corporation. This is especially the case where the scope of the investigation covers transactions or other work handled by the law firm.

Next, counsel must identify who the client is. Typically, either the audit committee or a group of disinterested directors will act as a special committee for the corporation regarding the internal investigation. This committee should be free from conflicts. For example, the audit committee of a corporation's board of directors plays an enhanced role in investigating corporate wrongdoing and should be immediately informed by in-house counsel of a significant impropriety involving financial reporting or other compliance issues.

During the investigation, counsel's client may be the corporation, the board of directors, the audit committee, a special committee, or even employees of the corporation. A decision must be made as to whether separate counsel should be retained for each of these parties. This is because conflicts may easily arise, although they may not be discernible at the start of the internal investigation. In addition, the corporation's outside auditors may play a role in an internal investigation and, depending on the circumstances, or may consultants, including forensic accountants and other experts.

The Document Gathering Hurdle
At the start of an internal investigation, it is important to “trap” and preserve the documents at issue. In this regard, electronic documents pose unique issues and concerns. It is important to secure employee computers and meet with the corporation's information technology (IT) personnel to determine how the corporation organizes relevant electronic files and identify what information is stored and how frequently that information is saved in backup cycles. A corporation’s normal recycling of electronic information and documents may need to be suspended so that relevant electronic information and documents are not inadvertently destroyed. In addition, if there is an outstanding subpoena or pending case that involves the issues raised by the investigation, there will be certain duties to preserve documents. Another important consideration is whether to allow the IT personnel to gather all the electronic documents or whether to hire an independent forensics consultant to gather and organize the documents. An independent consultant adds a
With heightened standards of conduct imposed, internal investigations have become a potent instrument in the defense of corporations and in the identification and management of risk. Also, the timing of the witness interviews should be considered to ensure the integrity of the investigative process. During interviews, attorneys should encourage truthfulness from employees. Counsel should be conscious of intra-corporate "political landmines" and understand that employees may be nervous about making honest statements that might embarrass them or their superiors.48 It is important to impress upon employees that full disclosure is best for the corporation and that the corporation does not want to learn of a fact later in a lawsuit or government investigation. To maintain the integrity of the investigation, the investigation and interviews should be structured so that witnesses do not talk to one another during the investigation. Counsel may want to conduct interviews away from the corporate offices where witnesses may feel more comfortable discussing sensitive issues. Also, attorneys typically should not attend interviews alone and should be sure to take accurate notes of meetings for later use in a report or, if necessary, in a proceeding.

Protecting privilege while fact-gathering should also be a key concern. Attorneys must do more than simply gather and report facts; they should also include their mental impressions and opinions in their work product to take full advantage of protections afforded by the attorney-client privilege and the work-product doctrine.45 In addition, at the beginning of the interview, attorneys should define their role on behalf of the corporation and participating employee and non-employee witnesses.46

The Score

Once the investigation has been completed, the attorney needs to determine in what form to deliver the results. Sometimes a written report is appropriate and required by a board committee or outside auditors. At other times, an oral report may suffice. In either case, reports will summarize the circumstances that led to the investigation; the scope of the investigation and whether it was limited in any way; the investigative steps that were taken; the relevant facts uncovered; the applicable law; arguments for and against liability, prosecution, or sanctions; internal policies, procedures, or practices that led to the event; and appropriate remedial actions.47 Reporting to the government entails special considerations. It is clear, under Upjohn Co. v. United States and its progeny, that the protections of the attorney-client and work-product privileges are available to corporations conducting internal investigations.48 Though waiving attorney-client privilege when reporting to the government is not an absolute requirement, regulators often cite waiver of privilege as a factor in determining cooperation. The Department of Justice, for example, often expects organizations that are the subject of investigations to waive attorney-client privilege.49 Similarly, the Commodity Futures Trading Commission assesses whether the corporation willingly waives attorney-client privilege and work-product protection for internal investigation reports, corporate documents, and employee testimony.50 The Department of Justice has released two memoranda meant to aid federal prosecutors in determining whether to charge a corporation—distinct from the individuals—with criminal wrongdoing. The first memorandum, issued in January 2003 and informally titled "the Thompson Memorandum," indicated that prosecutorial decisions would be partly based on the level of a corporation's cooperation; however, claiming cooperation often required "the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection."51

The guidelines were heavily criticized for their potential to seriously erode well-established norms respecting attorney-client privilege.52 In response, Deputy Attorney General Paul J. McNulty issued a revised version of the memorandum in December 2006, mandating that, to obtain confidential and privileged information, prosecutors must establish a legitimate need for the information and then must seek approval before they can request it, and the U.S. Attorney must obtain written approval from the Deputy Attorney General.53 Thus, "waiver of attorney-client and work product protections is not a prerequisite to a finding that a company has cooperated in the government's investigation."54 Finally, and again in contrast to the dictates of the Thompson Memorandum, the McNulty Memorandum instructs prosecutors that they may not consider a corporation's advancement of attorney fees to employees as the basis for charging a corporation.55 One difficulty for clients is that waiver of the privilege may render otherwise privileged documents, information, and advice readily discoverable by future civil litigants. A general waiver of privilege while cooperating with a governmental investiga-
as “more liberal” between client and outside counsel.

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33. Marmer et al., supra note 1, at 39.
34. Id.
35. Id.
36. See John A. Mack, The Ethics of Workplace Investigations, 61 BUS. & BAR. OR. (May 2004) (“When first notified of the allegations of financial misconduct, Enron chose the law firm of Vinson & Elkins to conduct a preliminary investigation.”) Vinson & Elkins was probably not the best choice to conduct the investigation, as the law firm had a 30-year working relationship with Enron. Enron’s general counsel was a former partner at Vinson & Elkins, and the law firm was apparently involved in the transactions under scrutiny.”) Sarbanes-Oxley Myth at 11, available at mediatux.wiley.com/product data/issn05504715697/ 6471569755.pdf (“The law firm investigating Sherron Watkins’s memo (the Enron whistleblower) was ripe with conflicts of interest. The firm of Vinson & Elkins was a long-term advisor to the company and, predictably, its investigation was ineffective.”)
38. Handtryk & Connolly, supra note 36.
39. See Kentra, supra note 1.
40. Marmer et al., supra note 1, at 42.
41. Id.
43. Marmer et al., supra note 1, at 21.
44. Duggan, supra note 1, at 908.
45. Kentra, supra note 1.
46. Id.
47. Marmer et al., supra note 1, at 23.
49. Bar of the City of New York, supra note 29, at 173.
50. Id.
51. See Memorandum from Larry D. Thompson, supra note 2.
53. See Memorandum from Paul J. McNulty, supra note 2.
54. Id.
56. Kentra, supra note 1.
58. Bar of the City of New York, supra note 29, at 173.
59. Marmer et al., supra note 1, at 39.
60. Advist., Inc. 2001 WL 605227, at *2 n.1.
63. In re Stewart, 2004 WL 3193793, at *16- 17 (collecting cases rejecting “market rate” approach to measuring fees).
64. Id.
65. Id.
66. Id.
68. Id. at 117.
70. Central Carriage, 76 F.3d at 115; see also PCLM Group, 997 F.2d 519 (affirming fees awarded for in-house counsel’s time based on “prevailing market” rates because, among other reasons, this approach was simpler to administer.
71. Central Carriage, 78 F.3d at 116.

Guide your in-house clients down the best path. In-house lawyers are uniquely positioned to understand both the underlying legal issues and the myriad of business objectives that our clients face. If our clients merely wanted an interpretation of the law or a list of the legal constraints they face, they could obtain that from outside counsel. Instead, they have hired us to be experts at putting the legal issues into context and advising them on which path they should take. Select the opportunity to add the value that only in-house lawyers can provide and help your clients make decisions.

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