When Should the General Counsel Recommend that the Board Conduct an Independent Investigation?

Compliance and Ethics

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CHEAT SHEET

- ***A hallmark of good governance.*** Independent investigations when red flags are raised signals to shareholders, regulators, and business partners that the business takes misconduct seriously.
- ***Cooperation credit is cheap.*** The US Department of Justice has made it clear that it will offer reduced sanctions if an investigated company conducted an independent investigation.
- ***Know when to investigate.*** Not every instance of misconduct requires an investigation, especially for a board with finite resources.
- ***Stay informed.*** The general counsel should request to be informed of the progress of the investigation without compromising its independence.

Global companies face an ever-increasing amount of compliance and regulatory risk. The general counsel plays a critical role in managing risk, and his or her advice can have a significant impact in shaping the company's response to possible violations of law. In some circumstances, and often without a full picture of the misconduct, the general counsel must determine promptly whether to engage, or recommend that the audit committee of the board of directors (or, in some instances, a special committee) engage, independent counsel to conduct an investigation into the possible misconduct.* An incorrect or delayed decision could subject the company and its directors to increased regulatory risks, civil litigation, or reputational damage.

* Independent counsel is counsel that has not previously done work for the company.

This article discusses the importance of independent investigations for global companies and circumstances that might warrant an independent investigation. Practical guidance for general counsel will also be discussed, when evaluating whether to recommend that the audit committee oversee the investigation, and when to make that critical recommendation to the board.

Why should the general counsel consider recommending an independent investigation?

The company's general counsel is obligated to act in the best interests of his or her client. When the general counsel learns of misconduct that could lead to legal liability, the attorney-client relationship requires the general counsel to respond appropriately. Sometimes the general counsel can satisfy this obligation by conducting an investigation overseen by the company's legal department. However, as described further below, in some circumstances an investigation overseen by the general counsel — a member of management — may not be appropriate when the suspected misconduct rises to a certain level, or when management might have participated in the suspected misconduct. In these situations, the lawyer's obligation to represent the best interests of the company may create tension with the general counsel's relationship with management.

With this inherent tension, the general counsel must evaluate whether an investigation led by the audit committee or other special committee of the board is in the company's best interest. In instances where the conduct of management should or will be reviewed, an investigation led by a

committee of independent directors which engages independent counsel to conduct an investigation is considered more credible because the investigation is less likely to be influenced by management. For this reason, independent investigations might be important for positioning the company to not only best uncover and understand the facts but also to best gain credibility when communicating those facts, as appropriate, with government regulators and law enforcement.

There are at least three reasons why an internal investigation may be in the company's best interest.

First, an internal investigation is often a hallmark of good corporate governance and corporate citizenship. It is integral to the board's discharge of its fiduciary duties. For example, an appropriate internal investigation may be necessary to follow up on concerns or so-called "red flags" that arise. And with direct or indirect reporting lines to the board, the general counsel is obligated to bring to the attention of the board possible violations of law. In addition, shareholders, employees, customers, and business partners want to know that the company with which they invest, work, and do business is committed to ethical and lawful business practices. An internal investigation can help demonstrate that a company takes suspected misconduct seriously, desires to learn the magnitude and extent of any misconduct, and is committed to identifying, eradicating, and remediating verified misconduct. While it is better to conduct investigations prior to the issues reaching the public, an investigation is particularly important in instances where there are public allegations of misconduct. In those instances, conducting an independent investigation with a commitment to follow the facts wherever they may lead can be an important first step to retaining — or regaining — trust.

Second, law enforcement agencies and regulators have explicit policies providing that a company's independent investigation is a factor when determining whether a company should receive cooperation credit. The Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have cooperation programs that describe the potential for reduced sanctions if a company cooperates with a government investigation. Whether the company conducted an independent investigation is one of several factors that these agencies consider. In a speech last year, Deputy Attorney General Sally Quillian Yates stated that "[c]ompanies seeking cooperation credit are expected to do investigations that are timely, appropriately thorough, and independent and report to the government all relevant facts about all individuals involved, no matter where they fall in the corporate hierarchy."

In the context of a potential DOJ prosecution for violations of the Foreign Corrupt Practices Act (FCPA), cooperation credit can be significant and tangible. For example, in June 2015, the DOJ entered into a Non-Prosecution Agreement (NPA) with IAP Worldwide Services, Inc. based, in part, on the company's cooperation, including conducting an extensive internal investigation and voluntarily making individuals and evidence available to the DOJ. In contrast, in the landmark resolution against Alstom S.A., the DOJ cited Alstom's failure to cooperate, which required investigating the alleged FCPA violations itself. Alstom agreed to pay a record US$772 million penalty to resolve the charges, an amount in the middle of the monetary penalty range recommended by the US Sentencing Guidelines. After the case was resolved, Patrick Stokes, the chief of the DOJ's FCPA Unit, explained in public speeches how Alstom's penalty could have been lower if Alstom had disclosed the conduct, cooperated in the investigation, and taken appropriate remedial actions. According to Mr. Stokes, companies who cooperate are typically penalized at the bottom of the guideline range, which would have been between US$296 million to US$592 million for Alstom. Mr. Stokes indicated that additional discounts — up to 30 percent — are available for extraordinary cooperation.

Similar to the DOJ, the SEC has an express policy of crediting a company for conducting an independent investigation. The policy, known as the Seaboard Report, provides that the SEC will consider several factors when determining whether to grant cooperation credit. Among the factors are: 1) whether the company conducted a thorough review of the nature, extent, origins, and consequences of the conduct and related behavior; 2) whether management, the board, or committees consisting of solely outside directors oversaw the review; and 3) whether company employees or outside persons performed the review. Additionally, in 2012, the SEC and DOJ issued a joint resource guide for complying with the FCPA. In the guide, the SEC and DOJ provided anonymized examples of cases that the two agencies had declined to pursue. In Example 3, the agencies stated that they declined to take enforcement action against a company for bribes paid by a foreign subsidiary in part because of the audit committee's thorough independent internal investigation, the results of which were provided to the government.

Despite these policies, some have observed that the "carrot" of cooperating with the SEC has become smaller or less certain in recent years while, on the other hand, the "stick" has gotten larger as the SEC has increasingly sought to punish those who fail to take appropriate action. In fact, the SEC has imposed sanctions on companies that failed to investigate beyond the penalties imposed for the misconduct itself. For example, in 2014, the SEC brought a controversial enforcement action against the audit committee chair of AgFeed Industries Inc. for his alleged failure to appropriately investigate and disclose accounting fraud by executives in the company's China offices.

Third, a well-conducted independent investigation can help to rebuff shareholder claims that inevitably arise for allegedly failing to respond adequately to allegations of internal misconduct, and an independent investigation will provide the steps for remediating the cause of the misconduct. By contrast, failing to independently investigate may present problems in litigation. For example, a judge denied a motion to stay a shareholder derivative lawsuit in order for the special litigation committee (SLC) of the company's board of directors to complete an independent investigation because the SLC was found to be not sufficiently independent, among other related reasons.

Whether to recommend an independent investigation

Not all circumstances require the general counsel to recommend an independent investigation. Investigations into certain forms of suspected misconduct can remain within the purview of management and company counsel. General counsel should consider the following factors when determining whether to recommend that the audit committee conduct an independent investigation:

The persons involved in the conduct. An independent investigation is necessary where senior management (including the CEO, CFO, head of a country, region, subsidiary, or business line) may have allegedly directed, condoned, or knew or should have known about the suspected misconduct. The SEC's division of enforcement remains focused on bringing enforcement actions against managers, so an independent investigation is warranted whenever senior managers could face regulatory scrutiny. On the other hand, suspected misconduct that is confined to lower-level, non-managerial employees likely will not warrant an independent investigation.

The nature of the conduct. Suspected misconduct relating to potential violations such as bribery of foreign officials, violations of laws or regulations applicable to the company or its industry, accounting misconduct, efforts to inflate or smooth earnings, false or misleading statements in disclosures to investors, and defrauding investors often are best investigated through an audit committee using independent counsel. But if the suspected misconduct clearly does not involve possible violations of criminal law or federal securities laws by the company, then a management-led investigation may be

appropriate. For example, investigations into allegations of sexual harassment, embezzlement, and insider trading often may be conducted without involvement of the audit committee, provided that senior management was not involved in the suspected misconduct.

Materiality. Suspected misconduct that could result in the restatement of a company's financials or otherwise be deemed material under securities laws weighs heavily in favor of an independent investigation. The general counsel must assess the potential impact based on considerations such as the nature, scope, and duration of the misconduct, geographic extent, persons involved, and potential monetary impact. Any misconduct that has remained undetected for extended periods also could signal material weaknesses with internal controls and necessitate remediation within the purview of the audit committee's charter.

Possibility of regulatory sanctions. In light of the DOJ's and SEC's preference for independent investigations, any suspected misconduct for which there is a strong possibility of an enforcement action by the DOJ or SEC likely warrants an independent investigation. As mentioned, Deputy Attorney General Yates recently emphasized the importance of independent investigations. And, if a criminal action is brought, the federal sentencing guidelines make a specific provision for reducing fines for organizations that self-report the offense and cooperate with the investigation. Similarly, the SEC's Seaboard Report described above specifically asks whether independent directors oversaw the internal investigation and whether independent counsel was utilized.

The need for remediation. Both the DOJ and SEC grant leniency to companies that have undertaken to remediate the problems giving rise to any misconduct. For example, in a recent settlement with FLIR Systems, Inc., the SEC noted that, among other things, FLIR terminated certain personnel and vendors, broadened its policies, and enhanced certain controls to prevent FCPA violations. The federal sentencing guidelines similarly stress that sentencing courts "should require that the organization take all appropriate steps to compensate victims and otherwise remedy the harm caused or threatened by the offense." Remediation is best overseen and conducted by the audit committee, which by charter normally has ultimate oversight of the compliance and internal audit functions at the company.

Global independent investigations

The guidance in this article is also applicable for general counsel located out the United States responding to potential misconduct around the world. Because the United States has some of the strictest standards for corporate liability of any country, a general counsel generally will be served by following this guidance no matter where the misconduct may have occurred.

Like their US counterparts, foreign regulators value independent investigations, self-reporting, and cooperation. For instance, in November 2015, Jamie Symington, director in enforcement of the UK's Financial Conduct Authority (FCA), stated that the FCA "is inclined to give credit" to those firms who assist the FCA in "unravelling potential misconduct." Mr. Symington emphasized that the independence of an investigation is an important factor in determining whether the firm's internal investigation has been adequate.

German authorities also have recognized the benefits of independent investigations and cooperation. At the beginning of the landmark prosecution of Siemens for potential corrupt payments, the Siemens general counsel and audit committee engaged an outside law firm to conduct an independent investigation and report directly to specially-designated committees of the board. Siemens then

coordinated its investigation with German authorities. At the time, independent investigations and company cooperation with German law enforcement were considered unusual. However, when the case concluded in 2008, the Munich Prosecutorial Decree regarding Siemens stated that "[a] substantial mitigating factor was that, during the investigations, Siemens AG cooperated extensively with the investigators and assisted them in clarifying the allegations."

Conducting an independent investigation can be complex. Further adding to the complexity for international companies is the variation in local laws that may influence the investigation. One significant consideration in the investigatory process is establishing and preserving privileged lines of communication. But in some countries, communications with in-house counsel are not afforded the same privileged or protected status as communications with outside counsel. Consequently, general counsel of international companies should be mindful of local laws that will affect the investigation.

Practical guidance for general counsel considering whether to recommend an independent investigation

General counsel recognize the importance of their recommendations to the audit committee. Once the audit committee is informed of alleged misconduct and the general counsel recommends action, the members of the audit committee likely will need to investigate to satisfy their fiduciary duties to the company. Not only can such investigations be disruptive to the company's day-to-day business, independent investigations can be extremely costly and potentially catastrophic. At the high end of the spectrum, for example, Siemens reportedly spent over US$1 billion on an investigation into bribes of government officials. Avon reportedly spent US$344 million on its internal investigation into FCPA violations. Of course, not all costs of independent investigations rise to these levels, and the audit committee should carefully scope the investigation to curtail costs and avoid unnecessary disruption to the company. The ultimate cost is tied to the nature and pervasiveness of the misconduct and the requisite scope of the independent investigation.

Below are some practical considerations to guide general counsel before, during, and after circumstances arise that may require an independent investigation.

Maintain an open dialogue with the audit committee. The general counsel should have a reporting line and regular access to the audit committee and maintain an open dialogue with the committee on legal, regulatory, and compliance matters. This reporting line and access can promote the timely escalation and disclosure of potential problems. Moreover, regular access to the board of directors and the audit committee can set the appropriate tone that the general counsel's duty is to represent the interests of the company.

Act promptly. The general counsel's response to potential misconduct will be assessed by the promptness of the actions taken after being notified of potential issues. Regulators expect prompt cooperation, and an organization's eligibility for reduced sanctions depends, in part, on reporting an offense promptly after learning about it. For example, when calculating a company's culpability score, the sentencing guidelines take into consideration whether the company reported the conduct to the appropriate governmental authorities "prior to an imminent threat of disclosure or government

investigation . . . and . . . within a reasonably prompt time after becoming aware of the offense . . . .” In this regard, it is important that the company be the first to report the misconduct to its regulators. Prompt action by the general counsel will reduce the chance that regulators learn of the misconduct from the press or a whistleblower.

Respond appropriately to red flags. The general counsel’s response to potential misconduct will be judged with the benefit of hindsight, so careful evaluation of the conduct and its potential consequences to the organization are critical to determining whether an independent investigation is warranted. On this point, the general counsel rarely will face criticism for doing too much to evaluate alleged misconduct. If the general counsel does not respond appropriately, up-the-ladder reporting requirements and the SEC’s whistleblower program make it less likely that misconduct will just “go away” without being discovered. As SEC Director of Enforcement Andrew Ceresney has said, “companies are gambling if they fail to self-report . . . . After all, given the success of the SEC’s whistleblower program, we may well hear about that conduct from another source.”

Make an appropriate recommendation to the audit committee. If the general counsel determines that an independent investigation is warranted, the recommendation should be made promptly and clearly. Given the time sensitivity and the potential for scheduling conflicts, the general counsel can make the recommendation in an oral presentation to the committee. In doing so, the general counsel should set out the potential misconduct, the relevant considerations, and the reasons why an independent investigation is warranted.

Determine whether to notify management about the recommendation to investigate. In some situations, particularly where management is involved in the potential misconduct, it may be necessary to refrain from informing certain members of management about the investigation. For example, to preserve materials that may be necessary for an investigation, the general counsel may need to initiate an information preservation hold without notifying the relevant custodians.

Request to be kept appropriately informed. In order to maintain independence, the audit committee and independent counsel likely will avoid sharing all of the details of the investigation with management. However, some interaction with management is appropriate and warranted. Without participating in the investigation or compromising its independence, the general counsel should request to be informed of necessary information so that appropriate disclosures, periodic filings, and adjustments can be made. Similarly, independent counsel usually needs to interface with management, including the general counsel, concerning disciplinary actions of employees, restatement of financials, adjustments to accounting, certain descriptions in disclosures, and issues relating to implementing remediation recommendations approved by the board.

Conclusion

The role of the general counsel in appropriately responding to misconduct is increasingly more critical as global companies face a more difficult regulatory and litigation environment. Against this backdrop, independent investigations can provide significant reputational, business, and legal benefits. While not all misconduct will require an independent investigation, the general counsel should carefully evaluate the relevant facts and circumstances, and not hesitate to recommend an independent investigation where necessary.

Further Reading

ABA Model Rule 1.13 (Organization as Client).

See also Plea Agreement, *United States v. Alstom S.A.*, No. 3:14-cr-0246-JBA, at 13 (D. Conn. Dec. 22, 2014).

Biondi v. Scrushy, No. Civ. A. 19896-NC, 2003 WL 203069 (Del. Ch. Jan. 16, 2003).

2015 Federal Sentencing Guidelines Manual, § 8.

See Stone v. Ritter, 911 A.2d 362, 371 (Del. 2006).

2015 Federal Sentencing Guidelines Manual, § 8C2.5(g)(1).

See Statement of Siemens Aktiengesellschaft: Investigation and Summary of Findings with respect to the Proceedings in Munich and the United States, (Dec. 15, 2008), available at (citing Munich Prosecutorial Decree at 12).

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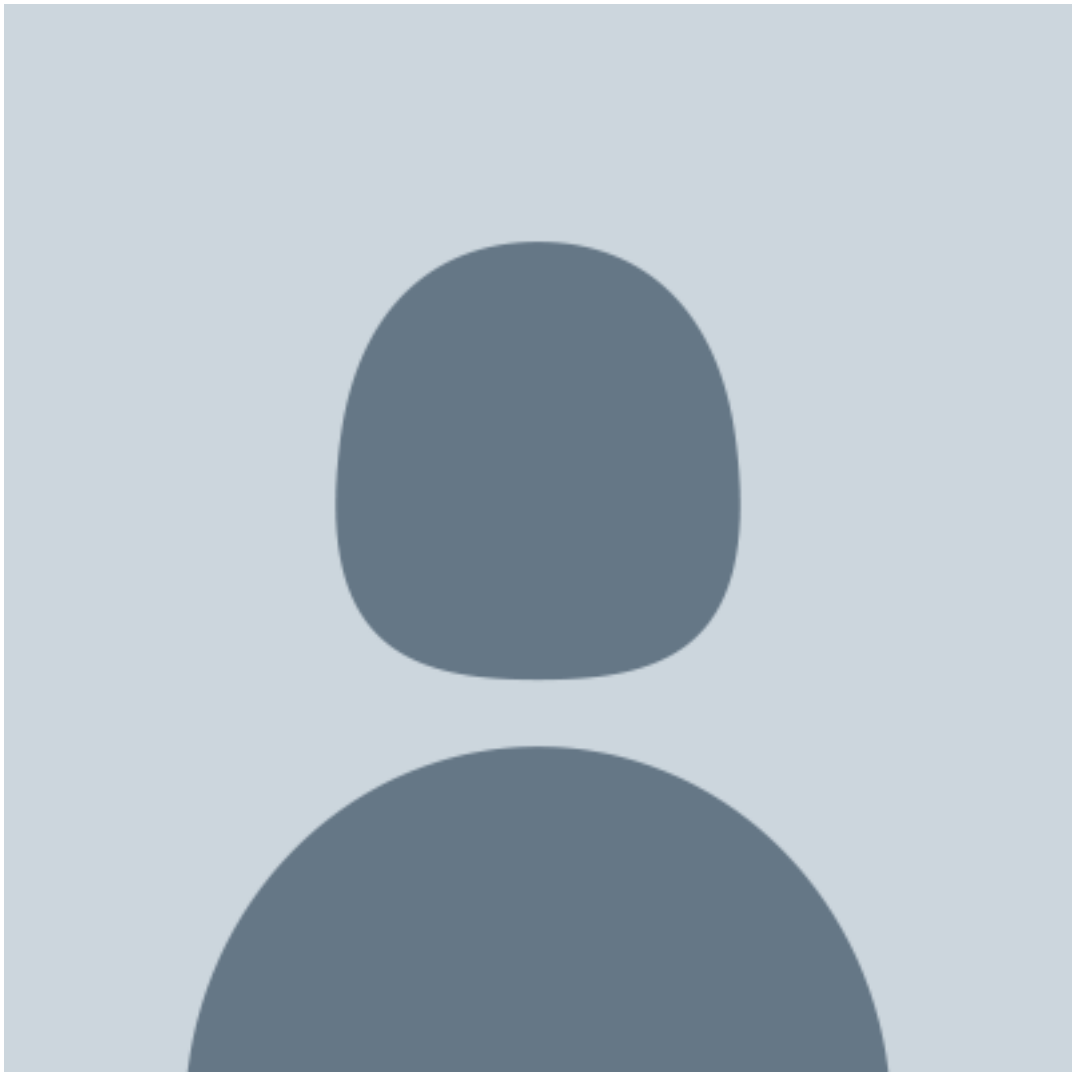

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