How a skilled board should manage an internal investigation

As the fates of these contrasting boards illustrate, there is much to be lost in shying away from a robust, independent investigation when warranted by the circumstances.

By Paula Anderson and Claudius Sokenu

With the recent uptick in global enforcement efforts, boards of directors are increasingly adept at managing internal investigations and navigating potential land mines that could increase the litigation exposure of both the company and the board. An internal investigation, whether triggered by a whistleblower, shareholder complaint, or government investigation, need not be a harbinger of doom for a company or its board. However, mishandling an internal investigation, particularly in the early stages, increases the probability of legal exposure, regulatory and/or criminal penalties, and reputational damage to the company and its board members. Because most damage occurs early and can quickly spiral out of control, it is crucial that boards swiftly take the reins and proactively manage any material internal investigation.

A tale of two boardrooms

A comparison of recent enforcement actions against Wal-Mart and Ralph Lauren illustrates how a board's response to allegations of misconduct critically influences the scope and severity of potential consequences. Ralph Lauren, in a case involving bribes allegedly paid by an Argentine subsidiary in violation of the Foreign Corrupt Practices Act (FCPA), secured the first non-prosecution agreement (NPA) from the SEC

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in an FCPA matter. Almost immediately upon learning of the alleged misconduct, Ralph Lauren initiated an internal investigation and voluntarily reported its findings to the SEC and DOJ within two weeks of uncovering the potential violations. While Ralph Lauren ultimately paid approximately $1.6 million in fines and disgorgement to the SEC and the DOJ, it was able to quickly wrap up the entire ordeal, avoiding significant media scrutiny and preventing further litigation. The company was praised by the government for its "extensive, thorough, real-time cooperation" and for fortifying its compliance program.

The experience of Ralph Lauren and its board stands in stark contrast to the plight of Wal-Mart, which expended in excess of $439 million over a two-year period in costs related to possible FCPA violations. According to public reports, Wal-Mart was alerted to allegedly illicit payments to government officials in Mexico, but did not undertake a credible investigation until after learning of a scathing (and Pulitzer Prize-winning) *New York Times* article asserting that the company buried the results of an internal investigation and ignored advice from outside counsel to expand the scope of its investigation.

In addition to shareholder lawsuits, an ever-expanding and costly internal investigation, and negative media coverage, the directors have also come under attack. The country's largest proxy advisory firm has on two occasions urged shareholders to vote against the company's directors "to send a clear message that such poor oversight does not come without repercussions." Specific board members are targeted in these reports, and while no board member has yet been ousted, a battle cry against a director is a near worst-case scenario.

What were the differentiating factors that led to such disparate responses by these two boards and ultimately disparate consequences for the company? What practical steps can boards take prior to and at the onset of a potential crisis to minimize the damage to the company, the board and ultimately to shareholders? How can boards manage potential conflicts of interest and maintain the independence of an internal investigation into the alleged wrongdoing? We address these questions below.

Prevention is the best medicine

Boards should implement rigorous oversight processes and increase their engagement in monitoring risk management, compliance and internal controls. Prompt action, flexibility and a willingness to fix lapses in internal controls were crucial to Ralph Lauren's securing NPAs. Of course, ideally, prevention is the best cure. If not already in place, develop investigation and crisis management protocols in advance of a crisis event. Establish direct channels of reporting to the board or an appropriate committee thereof on key compliance issues, and implement regular compliance training for board members.

• ***Why Conduct an Internal Investigation?*** Why initiate an internal investigation when confronted with alleged wrongdoing? Simply, it's good practice to ensure compliance with the law. Both the DOJ and SEC cite independent investigations as an important part of cooperation, which in turn is a key element in reducing corporate and individual liability. In most cases, it is also a legal obligation. For example, under Delaware law, directors have a duty to monitor risk management, internal controls, and legal compliance. Failure to properly discharge this duty could result in claims of breach of fiduciary duty, corporate waste, and in cases of acquiescence in wrongdoing, fraud or knowing violation of the law. A putative shareholder class action in Arkansas federal court asserting claims against Wal-Mart and its executives for alleged fraud, personal profit, and knowing violations of the law survived the crucial motion to dismiss phase.

Voluntary disclosure is not without risks.

Directors are also expected to be informed, to be free of conflicts of interest, and to act in a deliberative manner. Investors and regulators will expect a robust, independent investigation. To this end, developing a record of thoughtful and independent deliberation is essential to discharging a director's fiduciary duties. Part of this process should also include seeking advice of counsel as to best practices for handling investigations, whistleblowers, and shareholder complaints, particularly if the company is already under government investigation.

• ***Who Will Manage It?*** At the outset, it must be determined, based on the nature of the allegations, whether it is appropriate for management to lead the investigation. Typically, the legal department can oversee smaller, less serious investigations, unless the allegations implicate the department. More serious investigations should be overseen by the board or a committee thereof. The degree of independence necessary tracks the seriousness of the misconduct and the players involved. For example, if there is suspicion that a member of the board or senior management is implicated in the allegedly unlawful conduct, it may be necessary to establish a special committee of independent directors. Alternatively, the audit committee may suffice. This decision should be revisited as the investigation progresses, as new facts may change the nature of the investigation.

Optics plays a role. With the risk of media expo-

sure, the perception of independence is critical. An independent investigation is perceived as more trustworthy and reliable than one conducted by management. Indeed, one of the major criticisms of Wal-Mart in the *New York Times* investigation stemmed from the assertion that the Mexico subsidiary's general counsel who was alleged to have authorized the illegal bribes was given primary responsibility for managing the internal investigation. Such potential conflicts of interest need to be addressed by the board at the outset.

• ***Who Conducts the Investigation?*** Generally, to be considered truly independent, the investigation should be conducted by outside counsel that has not previously represented the company. Preferred company counsel may be seen as biased towards management because of the preexisting relationship, even if that assumption is without merit. While existing outside counsel will already be familiar with the company and its board, bringing new counsel up to speed on the company is a small price to pay for certifiable independence that will hold up to even intense scrutiny.

Where a special committee is convened to oversee the investigation, senior management with potential conflicts may need to be walled off from outside counsel's reporting on the results of its investigation. The committee, comprising outside directors with no involvement in the alleged misconduct, will have attorney-client privilege separate from the company's. As results come in, while it may seem uncomfortable, board members not on the special committee should leave the boardroom, and minutes on the investigation should be kept separately from regular board minutes.

• ***If and When to Disclose Results?*** Having concluded the investigation, what should be done with the results? First, it is important that any unlawful conduct be terminated at the earliest opportunity. Determine the scope of the wrongdoing and whether it implicates other actors. Consider disciplinary action. Implement changes to the company's compliance program and enhance internal controls. Second, in consultation with counsel, determine the necessity of disclosure to regulatory agencies, auditors, or the general public. Delays in required disclosures can form the basis for follow-on litigation.

Even if disclosure is not required as a matter of law, a board will need to decide whether to voluntarily disclose results, both to regulators and the public. There will inevitably be tension among board members. Some may want a complete and immediate disclosure of all the facts to demonstrate the company's best intentions as a good corporate citizen. Others may worry about reputational harm, effects on ongoing equity or debt transactions, follow-on litigation, or a significant drop in the stock price. These are all valid concerns, which will have to be weighed with the help of counsel.

• ***Voluntary Disclosure to Regulators?*** By disclosing misconduct to regulators, a board is placing the company at the mercy of the government. On the one hand, disclosure should be forthcoming and credible, such that the government does not doubt the legitimacy of the investigation. Conversely, a company will want to avoid broadly waiving attorney-client privilege and seek to minimize penalties associated with the wrongdoing.

Cooperation credit from the SEC or DOJ can facilitate a favorable outcome. Both agencies explicitly consider a company's degree of cooperation, and have in recent times shown an increased willingness to exercise prosecutorial discretion. However, voluntary disclosure is not without risks. Foreign prosecutors may not enter into or respect NPAs, and cooperation in one jurisdiction may risk successive prosecutions elsewhere. There is also the risk of parallel investigations by different agencies, which could result in inconsistent charging decisions or a race to charge first. There is also the increasing prevalence of shareholder suits following public disclosure of wrongdoing and settlement with authorities.

• ***Other Disclosures?*** A company will also need to decide whether to disclose pending investigations in SEC filings. Many companies announce the initiation of internal investigations in parallel with voluntary disclosure to the DOJ and SEC. The trickiest question will be timing. Disclosing too early risks over- or underreporting. Disclosing too late invites potential shareholder suits and may prompt potential whistleblowers to beat the company to the SEC.

The best course of action

While an independent investigation is not always necessary, when there are serious allegations of misconduct that potentially implicate senior management with conflicting interests, it is the best course of action.

As the contrasting boardrooms of Wal-Mart and Ralph Lauren illustrate, there is much to be lost in shying away from a robust, independent investigation when warranted by the circumstances. A skilled board will take the necessary steps to prepare for such eventualities and will act swiftly and judiciously to minimize the potential damage to the company, its shareholders, and its employees. ■

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