

## **Internal Investigations in the Post Sarbanes-Oxley Era**

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### **Introduction**

In the post Sarbanes-Oxley Act (“SOX”) era, in-house counsel, senior management, and especially independent members of the board of directors, are being asked to walk the increasingly narrow line between protecting their company and openness with the government. The ever increasing frequency of internal investigations is an outgrowth of the current business climate, brought about by the public demise of Enron, WorldCom, and others. While depository financial institutions have only played peripheral roles in the various accounting scandals that have occurred, as public companies, the rules of engagement apply equally to them. In that regard, it should be noted that many of the SOX era governance reforms come directly out of banking statutes enacted in the early 1990s, such as the Federal Deposit Insurance Corporation Improvement Act of 1991.

The evolution of the business and legal landscape that has been continued by SOX and focuses on the greater roles for independent directors now mandated by the listing requirements of both the New York Stock Exchange (“NYSE”) and Nasdaq has made it inevitable that conduct that once might have received little scrutiny, may today become subject to an internal investigation under the direction of the independent board members.

Those involved in such an investigation must be mindful of six distinct audiences that will be interested in the outcome of the investigation: (i) regulators, (ii) stockholders, (iii) the Board of Directors, (iv) management, (v) the media, and (vi) employees. The interests and

posture of each of these external interests will influence the choices made in designing and implementing an internal investigation.

### **Pre-Investigation Considerations**

Corporations initiate internal investigations for a variety of reasons, the most common for financial institutions are: (1) governmental investigations or inquiries; (2) external auditor pressures arising out of § 10A of the Securities Exchange Act of 1934 (“Exchange Act”); (3) civil suits; (4) examination findings; (5) whistleblower allegations; (6) internal auditor findings; and (7) general allegations of misconduct. The reasons for initiating an internal investigation will impact issues likely to arise later in the process, such as preservation of privileges, scope of the investigation, retention of outside professionals, and disclosure of information to the media and the government. Initiating an internal investigation carries with it a host of risks, including the possibility that revelations of wrongdoing could encourage governmental, class action, or shareholder litigation, tarnish employee morale, and create negative publicity.

The scope of the investigation must be determined at the outset. Among the factors to consider when determining the scope are: the gravity, subject matter and source of the allegations; the existence of any pending or on-going governmental action; and any deadlines related to resolution of the issues.

With few exceptions, the appropriate investigating body is a committee of outside directors. After the investigating body (herein referred to as the “Committee”) has been selected and apprised of the various factual and legal questions that it is charged to investigate, the full board of directors should adopt a resolution authorizing the Committee and delineating its scope and powers, particularly its authority to retain professionals, including outside counsel, to assist in its investigation.

In order to preserve the integrity and credibility of the investigation, outside counsel should not have performed a broad range of prior services for the institution. Whether from the viewpoint of the government attorneys preparing a prosecution or enforcement action against the institution, or an outside auditor, such appearance of independence will impart a level of credibility.

### **Conducting the Internal Investigation**

Once the Committee has been established, its powers and scope determined, and counsel retained to conduct the internal investigation, it must be mindful of a variety of issues, including: (1) maintaining privileges; (2) document control; and (3) dealing with employees/witnesses.

#### *Maintaining Privileges*

The two most important privileges that must be considered in an internal investigation are attorney-client and work product. In determining the applicability of the attorney-client privilege, courts will frequently look to the purpose for which the legal services were procured. Where outside counsel was retained purely for investigation purposes and the final report is to be used to provide business advice to senior management or the board, or where the report was “prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation,” the courts are likely to find no attorney-client privilege. *Mount Vernon Fire Ins. Co. v. Try 3 Bldg. Servs., Inc.*, 1998 WL 729735, \*5 (S.D.N.Y. Oct. 16, 1998). This privilege, where applicable, will also protect communications between the Committee’s counsel and professionals, for example consultants, accountants, statisticians, and other specialists, retained by such counsel to aid in the investigation.

The “work-product” privilege protects materials prepared in anticipation of litigation. *United States v. Rockwell Int’l*, 897 F.2d 1255, 1266 (3<sup>rd</sup> Cir. 1990); Fed. R. Civ. Pro. 26(b)(3).

The failure to maintain this privilege could be a windfall for the government or a private litigant, effectively allowing the opposition to have a glimpse into the institution's playbook. In the context of a private lawsuit, the filing of the suit need not be the first trigger for the privilege, however merely a remote prospect of future litigation is insufficient to invoke the privilege, *Sanner v. Board of Trade of City of Chicago*, 181 F.R.D. 374, 378 (N.D. Ill. 1998), and investigations by regulatory agencies present "more than a mere possibility of future litigation, and provide reasonable grounds for anticipating litigation." *Garrett v. Metropolitan Life Insurance Co.*, No. 95 Civ. 2406, 1996 WL 325725 at \*3 (S.D.N.Y. June 12, 1996).

Unlike the attorney-client privilege, however, the attorney work-product privilege may be breached upon a showing that the adverse party has a substantial need for the materials and is unable to obtain the equivalent except upon substantial hardship. Fed. R. Civ. P. 26(b)(3). Outside counsel can reduce the risk of work-product materials being discoverable under this exception by incorporating the attorney's own thoughts, impressions, and opinions into the objective materials prepared.

Prosecutors, regulators, and industry self-regulatory organizations have indicated that institutions should be willing to waive applicable privileges in order to avoid prosecutions, enforcement actions, and high penalties. The U.S. Department of Justice has issued guidance indicating that the waiver of privilege is a factor to be considered in determining whether to launch a formal investigation or seek an indictment. In a January 20, 2003 memorandum from then Deputy Attorney General Larry Thompson, the Justice Department provided the following guidance to its prosecutors: "In determining whether to charge a corporation, the prosecutor may consider 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.” Memorandum from Deputy Attorney General Larry D. Thompson to Heads of Department Components and United States Attorneys, *Re: Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003) (hereinafter “Thompson Memorandum”), reprinted in *United States Attorneys’ Manual, tit. 9, Crim. Resource Manual*, §§ 161-62. The Thompson Memorandum was recently affirmed as the Justice Department’s continuing policy in a memorandum from Acting Deputy Attorney General Robert McCallum in which Mr. McCallum notes that, in furtherance of the Thompson Memorandum’s factors on whether or not to charge a corporation, some United States Attorneys have established a review process for waiver requests that require a federal prosecutor to seek prior approval from the U.S. Attorney or other supervisor before seeking a waiver of attorney-client or work product privilege. Memorandum from Acting Deputy Attorney General Robert D. McCallum, Jr. to Department Components and United States Attorneys, *Re: Waiver of Corporate Attorney-Client and Work Product Protection* (October 21, 2005) (hereinafter “McCallum Memorandum”). The McCallum Memorandum standardizes this practice by directing all U.S. Attorneys to establish a written waiver review process “so that each United States Attorney or component head retains the prosecutorial discretion necessary, consistent with their circumstances, to seek timely, complete, and accurate information from business organizations.” Financial regulators have adopted a similar view, as reflected in the model civil money penalty matrix (“CMP matrix”) utilized by the member agencies of the Federal Financial Institutions Examination Counsel (“FFIEC”), an interagency body consisting of the OCC, FRB, OTS, NCUA, and FDIC. Under the CMP matrix, agencies will consider lack of cooperation and concealment, as among the aggravating factors in determining the appropriate amount of a civil money penalty, and restitution, good faith, and full cooperation as mitigating factors. *Federal*

*Reserve Supervision and Regulation Bulletin* SR 91-13 (FIS), June 3, 1991; *see also*, NYSE Information Memorandum No. 06-65, Sept. 14, 2005 (disclosure and cooperation are viewed as mitigating factors in potential enforcement actions).

In October 2001 the SEC, in a report issued pursuant to Section 21(a) of the Exchange Act, provided a glimpse into the factors that will influence its decision as to whether or not to initiate an enforcement action. The report itself arose out of the SEC's decision not to bring an enforcement action against Seaboard Corp. ("Seaboard") for financial reporting discrepancies, citing Seaboard's response to discovery of the misconduct as a model for public companies in addressing financial reporting problems. In the report, the SEC provided guidance as to the criteria that it will consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation – from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in the documents the Commission uses to announce and resolve enforcement actions. Among the factors that the SEC considers in determining how much credit a registrant will get for its self-policing efforts are:

- Did the company promptly initiated a thorough, independent investigation?
- Were the results of the investigation given to the SEC?
- Did company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law?
- Did the company take steps to identify the extent of damage to investors and other corporate constituencies?
- Did the company appropriately recompense those adversely affected by the conduct?

- What assurances were there following the investigation that the conduct would not reoccur.

Notwithstanding the Seaboard goals of full cooperation and transparency, and a strong preference toward waiver of privilege, senior government attorneys as well as private practitioners have recently noted that a company's right to attorney-client and work product privilege is still viable. Earlier this year, Peter Bresnan, an associate director in the SEC's Division of Enforcement, in a panel discussion, pointed to the SEC's 2004 investigation into Electro Scientific Industries as an example of a case where no charges were levied against the company because of its extensive cooperation. Mr. Bresnan contrasted the Electro Scientific investigation with the \$225 million penalty imposed by the SEC against Computer Associates in 2004 for securities violations and failure to cooperate with the SEC. When asked whether the SEC staff requires a waiver of the attorney-client privilege in order to receive credit for cooperation with an investigation, Mr. Bresnan responded that the SEC does not demand waivers of privilege, and that the SEC staff is open to exploring other avenues to discover the underlying facts, such as attorney proffers, verbal recitations, factual summaries or access to witnesses. This is consistent with the approach articulated by Timothy Coleman, Justice Department senior counsel to the deputy attorney general, who, as part of the same panel discussion, stated that where the information the Justice Department seeks to obtain is protected by the work product doctrine, investigators will accept notes, memos, oral presentations and occasionally will enter into confidentiality agreements. Mr. Coleman noted, however, that where the target of an investigation is relying on advice of counsel as a defense, a waiver may be requested. Similarly, at an American Bar Association conference on enforcement action risks in early 2005, Dixie Johnson, an SEC enforcement partner at Fried, Frank, Harris, Shriver and Jacobson, LLP, in

Washington, DC, was asked about the extent to which companies are waiving their attorney-client privilege in order to cooperate with the SEC. Ms. Johnson said that the privilege is not gone, protection of the privilege is still a goal of corporate counsel, and companies are seeking ways to provide factual information to the SEC that is not privileged and furnished in a more cooperative manner. Although the official position of the SEC is that waiver of attorney-client privilege is not mandatory in order to receive cooperation credit, as a matter of practice it is becoming increasingly common in the internal investigation context that SEC enforcement attorneys will expect a target corporation to waive privilege as a showing of its good faith in seeking out and purging itself of misconduct.

The challenge for institutions is cooperating with government investigators while preserving their privileges. An example of this tension is found in *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 235 (2<sup>nd</sup> Cir. 1993), where private plaintiffs sought production of a memorandum provided by defendants' counsel to the SEC arguing that defendants had waived their privilege by voluntarily providing the materials to the government under a FOIA "confidential treatment" request. The court held that voluntary disclosure to the SEC constituted a waiver of the privilege. Other jurisdictions have viewed such voluntary disclosure to the government as a selective waiver, not a complete one, thereby preserving the privilege with respect to subsequent parties or proceeding. *See In re McKesson HBOC, Inc. Securities Litigation*, Docket No. C-99-20743 (RMW) (N.D. Cal. March 31, 2005). The reasoning behind the "selective waiver" rulings has been that "the benefit to the public of permitting disclosure of work product to the government" by allowing "the government to focus its investigation on the primary wrongdoers, filtering documents produced to the SEC and permitting the government to deploy fewer employees" is sufficient to protect the privilege. *Id.*

These precedents, combined with the posture of the Justice Department and regulatory agencies, present institutions with the difficult choice of either potentially waiving privilege by cooperating with the government in exchange for leniency, or protecting privilege and facing the consequences. Institutions can attempt to avoid or at least mitigate the effects of voluntary disclosure by entering into broad confidentiality agreements with the government at the initiation of the information exchange, by requesting FOIA treatment, or by requiring that the government issue a civil investigative demand for the materials sought.

National banks are in a unique position compared to other corporations by virtue of the broad examination authority accorded the OCC under 12 U.S.C. § 481, which provides national bank examiners with the authority to “make a thorough examination of all the affairs of the bank and in doing so . . . to administer oaths and to examine any of the officers and agents thereof under oath and . . . make a full and detailed report of the condition of said bank to the Comptroller of the Currency.” The OCC has taken the position that this provision empowers national bank examiners to demand any materials under a bank’s control. During the examination process this power is sometimes resisted by banks however it may also be a means for banks to earn favor by cooperating while maintaining privilege by asserting that § 481 denies national banks the ability to refuse to produce documents to the government, therefore, unlike the *Steinhardt* decision, the furnishing of information to the government might not be treated as a voluntary waiver.

Various courts have held that materials covered by the attorney-client privilege are not subject to discovery through the government’s examination authority. In *Clarke v. American Commerce National Bank*, 974 F.2d 127, *rehearing denied*, 977 F.2d 1533 (9<sup>th</sup> Cir. 1992), the OCC issued an administrative subpoena to American Commerce National Bank requesting,

among other things, the production of all billing statements from outside legal counsel. The court noted that “correspondence, bills, ledgers, statements, and time records which also reveal the motive of the client in seeking representation, litigation strategy, or the specific nature of the services provided, such as researching particular areas of law, fall within the privilege.” *Clark*, 974 F.2d at 129. Upon review, the court determined that some of the materials were not privileged because they contained merely information on the identity of the client, the case name for which payment was made, the amount of the fee, the general nature of the services performed, did not reveal “specific research or litigation strategy which would be entitled to protection from disclosure,” and were therefore not privileged. *Id.* Other documents, however, did contain litigation strategy and were ruled protected. *Clark*, 977 F.2d at 1533.

Since *Clarke*, the OCC has adopted a more thoughtful approach to sharing privileged materials during the course of an examination or investigation, acknowledging that “bank management or counsel, while desirous of being fully cooperative, may be concerned that disclosure of certain materials to an examiner could result in a waiver of an applicable privilege (i.e., attorney-client privilege or attorney work-product privilege).” *Comptroller’s Handbook: Litigation and Other Legal Matters*, February 2000. Under its current policy, the OCC provides the following safeguards for bank examiners to observe when seeking information that might be privileged: request privileged documents only when the risk exposure to the bank’s earnings or capital is material; limit the form and scope of a request for privileged documents; and exchange written communications with the bank setting forth the precise identity of the materials being provided, confirming the OCC’s and the bank’s expectations that the privileged materials are being provided pursuant to the agency’s examination authority (i.e., 12 U.S.C. § 481), and

confirming that the confidentiality of the materials will be maintained to the extent required or permitted by law.” *Id.*

### Document Control

In conducting an investigation, counsel must be mindful of the myriad of SOX provisions that relate to document retention. SOX amended the federal criminal statutes to significantly increase the penalties for the destruction, falsification, or alteration of records or documents with intent to impede, obstruct or influence the investigation or administration of any matter within the jurisdiction of a federal department or agency or any bankruptcy case. *See* 18 U.S.C. § 1519. SOX also provides for fines and up to 20 years imprisonment for anyone who corruptly "alters, destroys, mutilates, or conceals" a record or document with intent to impair its integrity or availability for use in an official proceeding. 18 U.S.C. § 1512(c). Notably, the official proceeding need not be pending or forthcoming at the time of the offense. 18 U.S.C. § 1512(f)(1).

In light of these considerations, document control and retention policies in conducting an internal investigation in the post Sarbanes-Oxley era are particularly important when the investigation is performed in response to a governmental investigation. In *U.S. v. Trauger*, Case No. CR 03-308 (N.D. Cal. 2003), a former partner with the outside auditing firm conducting an audit of NextCard, Inc., was arrested for altering or destroying documents with the intent of impeding a federal investigation, and charged with obstruction of the SEC and OCC. In an agreement reached with the government, the defendant plead guilty and agreed to twelve months imprisonment, a \$5,000 fine, and two years of supervised release.

As *Trauger* illustrates, the consequences for document destruction in anticipation of a regulatory action can be severe. In order to avoid this result, immediately upon learning that the

government has initiated an investigation, all employees in areas relevant to the pending investigation must be informed that the normal document destruction processes should be discontinued, and relevant information should be assembled.

### Dealing with Witnesses

The key to most successful internal investigations is witness interviews, the most important considerations of which are: (1) maintaining applicable privileges; (2) handling the interview so as to ensure the candor of the witness and the credibility of the testimony; and (3) avoiding the impression that company counsel is representing the employee-witness. In *Upjohn v. United States*, 449 U.S. 383 (1981), the Supreme Court provided the following guidelines for assessing whether communications between a company's counsel and an employee may be covered by the company's attorney-client privilege: (1) whether the communications were made for the corporation to obtain legal advice; (2) whether senior management directed the employees to cooperate with the investigation; (3) whether the communications concerned matters within the employee's scope of employment; and (4) whether the information was available from senior management.

In order to obtain information that is as candid and credible as possible, while preserving the attorney-client privilege and apprising the employee of the nature of the relationship, the employee should be informed at the outset of certain realities: (1) the investigating counsel represents the company and not the individual; (2) the investigation is being conducted to provide the company with legal advice relating to specified matters; (3) the interview is protected by the attorney-client privilege, the employee should keep confidential the subject matter of the interview, and that the company reserves the discretion to disseminate the information, and (4) when applicable, that the interview is being conducted in conjunction with an independent

investigation of the institution, that providing false or misleading testimony to an internal investigator acting in response to legal obligations may constitute a felony, and where an internal investigation is undertaken pursuant to a regulatory order, knowingly providing false or misleading information may result in obstruction of justice. Interviewing counsel should also inform the witness of the consequences of refusing to answer questions or fully cooperate. *See, e.g., In re The Cooper Companies*, 1994 CCH Fed. Sec. L. Rptr. ¶ 85,472 (1994) (criticism of the board by the SEC for not taking action when a senior officer invoked his Fifth Amendment rights before the government and refused to cooperate with an internal investigation).

This challenge for investigating counsel to maintain the distinction of representing the company and not the interviewed witnesses was addressed by the 4<sup>th</sup> Circuit recently in *In re Grand Jury Subpoena*, 415 F.3d 333 (4<sup>th</sup> Cir. July 18, 2005) where the court held that all of the “essential touchstones for the formation of an attorney-client relationship between the investigating attorneys and the appellants were missing at the time of the interviews,” because: there was “no evidence of an objectively reasonable, mutual understanding that the appellants were seeking legal advice from the investigating attorneys or that the investigating attorneys were rendering personal legal advice”; the investigating attorneys clearly disclosed that they represented the company, that the attorney-client privilege was solely the company’s, and that the right to waive that privilege belonged solely to the company; that there was no evidence that the individual employees were told that the investigating attorneys represented them; and that there was no evidence that any of the individuals asked for personal legal advice from the investigating attorneys, or that the investigating attorneys gave such advice to the individuals. *Id.*

## **Post Investigation**

Following the internal investigation, the Committee, its counsel, and, if appropriate, in-house counsel must determine how the findings and conclusions will be reported and to whom. There are many benefits to memorializing the results of an internal investigation in writing, such as the promotion of new corporate policies, communication of those policies to employees and investors, convincing regulators that enforcement action is unnecessary (even if improper conduct occurred), and providing evidence that indicates a lack of misconduct so as to assure regulators, investors, and the general public of the status and future of the company.

### **Conclusion**

The passage of SOX and the related corporate governance reforms for NYSE and Nasdaq listed companies have dramatically shifted the corporate governance landscape. Now more than ever, in-house counsel, accountants, and independent consultants are viewed as deputized private sector government agents with a responsibility to police the corporations they serve for misconduct. In order to reduce its risk of government prosecutorial or enforcement action resulting from Sarbanes-Oxley liability, an institution should maintain an active internal audit department and an informed audit committee of its board of directors, and maintain direct reporting lines to its board of directors by its chief risk/compliance officer, chief financial officer, and general counsel. Given the magnitude of the Enron and WorldCom scandals that led to Sarbanes-Oxley, the everyday investors and employees that were affected, and the substantial bi-partisan outcry for reform, we are not likely to see any scaling back of the Sarbanes-Oxley Act, especially as its tools become staples in the prosecutorial and regulatory arsenals.

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