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Do We Really Need To Do An Internal Investigation?

By David M. Stuart

About The Author

David M. Stuart is a senior attorney in Cravath, Swaine & Moore's Litigation Department. His practice focuses on government and internal investigations and matters related to regulatory enforcement and compliance, including financial reporting and disclosure, improper payments, insider trading and corporate governance.

Mr. Stuart joined Cravath in 1996, where he was trained as a litigation associate working on private disputes over violations of the securities and antitrust laws. He left the Firm in 2000 and served for six years in the Division of Enforcement at the U.S. Securities and Exchange Commission in Washington, D.C.

The prospect of a corporate internal investigation can be ominous. The words may evoke the specter of an intrusive, endless process that has the potential to cost a lot of money, detract from the corporate mission and impair employee morale.

While with proper planning and a clear sense of the investigative goals, an investigation need not be marred by these characteristics; management may, nonetheless, resist an investigation entirely or seek to narrow its scope without considering its necessity and ultimate benefits.

This is the first in a series of articles that address the complexities of corporate investigations and the practical challenges frequently encountered. Starting from the basic question, "Why do an investigation?" this article presents five situations that most commonly lead to internal investigations.

1. Whistleblower Allegation

Employee or third-party allegations of corporate misconduct, through an internal reporting channel such as a compliance hotline, are possibly the most common impetus for a corporate internal investigation.

Depending on the nature of the allegations, there is almost no way to avoid an investigation that, at a minimum, involves interviewing the whistleblower (if he/she is not anonymous) and the individual(s) who allegedly participated in or have knowledge of the supposed misconduct.

For almost all corporate organizations, a swift and robust investigative process addressing whistleblower allegations is essential to generating a culture of compliance, maintaining rigorous internal controls and demonstrating to government authorities that the company takes compliance seriously.

2. Government Inquiry

If a prosecutor or regulator initiates an inquiry, this too, provides the company cause to perform its own internal investigation, and one that may be particularly broad and deep. An internal investigation in this context must serve multiple purposes. The company must, of course, respond fully to the government's inquiry, as required by law. Therefore, this type of internal investigation must enable those speaking on behalf of the corporation to respond to governmental requests for information with absolute accuracy and completeness.

But for many reasons, the company often must go beyond whatever is required to respond to the immediate government subpoena or request for information and conduct an investigation that addresses matters beyond the apparent scope of the government inquiry. This investigation must also demonstrate to the government that the corporation appreciates the seriousness of the governmental inquiry and that its interests are aligned with the government's – that is, that the company wants to understand the facts and take whatever steps are warranted to fix any problems that might be discovered.

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Also, the internal investigation should enable the company to evaluate the strength of any assertions of regulatory or criminal violations that may later be alleged by the government and argue for leniency in the government's charging and/or penalty decisions.

3. Section 10A Notice from Independent Auditor

The company's independent auditor may force an investigation as well. Under Section 10A of the Securities Exchange Act, when an independent auditor detects or otherwise becomes aware that an illegal act may have occurred, it must determine the likelihood that such an illegal act has, in fact, occurred and the effect of the illegal act on the company's financial statements.

The auditor may fulfill its obligations under the federal securities laws by relying upon the company to conduct an internal investigation and report its findings to the auditor. The investigation must be sufficient in scope to address the auditor's suspicions and measure the impact, if any, of the suspected illegal act on the financial statements. Failure to conduct a swift and thorough investigation under these circumstances may result in the auditor being unable to issue an audit report on the company's financial statements.

4. Internal Audit Findings

In the context of testing compliance with the company's financial or operational controls, the internal audit function of a corporation may identify possible misconduct requiring an internal investigation.

In this context more so than the previous three, the company has a large degree of discretion in the scope and design of the investigation. This is because internal audit findings are rarely disclosed outside of the company and, accordingly, there is not the pressure to address concerns of an outsider, such as a whistleblower, a regulator or the independent auditor.

Nonetheless, similar to an investigation into internal whistleblower allegations, these investigations provide a form of insurance against future claims, whether by a prosecutor, regulator or demanding shareholder (discussed next), that the company ignored past problems. Accordingly, a credible and well-documented internal investigation must be undertaken with an eye to how it might be judged in hindsight by an outsider who may discover similar misconduct in the future.

5. Shareholder Demand

Finally, an investigation may be warranted when a shareholder demands that the board of directors investigate potential misconduct as the precursor to filing a derivative action. Here, the company again has discretion in whether and how it investigates a shareholder's allegations.

Ultimately, the board of directors must determine whether, consistent with its fiduciary obligations, it should initiate a civil action against management or members of the board themselves. To make that determination, the board may conclude that an investigation is warranted.

The purpose of the investigation should be to determine whether an action should be filed and, in the event the board decides not to file an action, the investigation must be sufficiently robust to convince the shareholder (and ultimately, the reviewing court) that pursuing a derivative action is not in the best interests of the corporation.

In this article, I addressed the five most common situations necessitating a corporate internal investigation and the different goals of each type of investigation. In my next article I will address how to appropriately scope an investigation so as to achieve the investigative goals without disrupting corporate productivity and wasting corporate resources.