

*Internal Investigations in 2007 —
Current Strategies, Optimal Procedures*



INTERNAL INVESTIGATIONS IN 2007: CURRENT STRATEGIES, OPTIMAL PROCEDURES

Internal investigations continue to play an important role in good corporate governance. Three areas are of particular interest this year, including the impact of technology on internal investigations; surviving regulatory inquiries; and ensuring an internal investigation does not go too far.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Internal Investigations in 2007: Current Strategies, Optimal Performances," was a featured session dedicated to these issues. John Landis, partner, Foley & Lardner LLP, moderated the discussion which featured the following panelists: Jerry Okarma, vice president, secretary and general counsel, Johnson Controls, Inc.; Jerry Barbanel, executive vice president and co-global leader, Aon Financial Advisory and Litigation Consulting Services; Corey Martens, partner, Deloitte Financial Advisory Services LLP; Amy Jones, internal audit director, McDonald's Corporation; David Skidmore, director, corporate security, NCR Corporation; and Bryan House, partner, Foley & Lardner LLP.

The Impact of Technology on Internal Investigations

Continued advancement of technology — widespread acceptance, expanded usage, and new forms — has been a blessing for a corporation's business efficiency and operations, but an occasional curse for those charged with conducting an internal inquiry concerning potential wrongdoing. In particular, internal and external investigators must stand ready to answer the increasingly difficult question: have we looked in the right places for the right information, and in sufficient detail, to determine "what happened"?

Rapid advances in technology have impacted internal investigations. John Landis asked what challenges the panelists faced on the technology front as well as what strategies they have developed for processing information and moving forward. David Skidmore began by noting that one challenge in internal investigations today is ensuring the corporation has the right tools to adequately conduct and determine the scope of investigations. Amy Jones echoed Mr. Skidmore's comments and noted that the trend in 2007 is to move corporations from a reactionary stance, where they simply are trying to respond to issues that arise, to a preventative stance where they actually can stop fraud and misconduct from happening. Mr. Skidmore commented that it is a constant struggle to stay ahead of the power curve: as corporations acquire faster systems, those conducting the investigations need to process larger amounts of data to determine where wrongdoing may be taking place.

In order to do this, corporations frequently need to utilize forensic tools or trending software internally, or hire outside experts to conduct investigations. In order to conduct internal investigations effectively, it is essential that a corporation understand its own strengths and limitations. By way of example, Corey Martens cautioned that members of the information technology (IT) department frequently do not have forensic capabilities. In an effort to understand and investigate an issue, they inadvertently may end up damaging or destroying evidence. Mr. Skidmore explained the need for a company with a global footprint to leverage resources internally and take a practical approach. It is extremely



rare that the necessary language skills or legal expertise needed for an investigation abroad are available in-house. On the other hand, Mr. Skidmore noted that no one knows a particular corporation's business better than its own officers and employees. Consequently, it can be very effective for a corporation to use internal resources in conjunction with external forensic experts in the course of the investigation.

Whether to use forensic tools internally or to engage outside experts is a question for each individual corporation. NCR Corporation has found it worthwhile to invest in internal forensic tools like EnCase to conduct its own internal investigations. Mr. Skidmore explained that EnCase is recognized and accepted by law enforcement agencies as a program that provides forensic images of the computer systems at issue, and that it has internal safeguards to prevent the manipulation of data and any resultant spoliation of evidence. Ms. Jones agreed that it is a decision each corporation needs to make and added that McDonald's decided not to use dedicated forensic software. Instead, they find it more effective to rely on trending software that allows them to identify suspicious patterns of activity and flag potential issues for further investigation, either by internal sources or hired experts.

When a corporation begins an internal investigation, it is important to understand the importance of effectively marshalling the scope of the investigation. Jerry Okarma cautioned that any addition to the scope of the search exponentially can expand the data retrieved, adding expense to the investigation, particularly when a corporation is dealing with electronic search terms to retrieve documents and other potentially relevant information. In order to control the cost and time of an electronic investigation, Jerry Barbanel believes it is worthwhile to spend time at the beginning of the process to work with both outside counsel and any relevant regulators to gain consensus on the scope and manner in which the investigation will move forward. Ultimately, clearing the investigation with applicable regulators instead of just reacting will save money by preventing duplicative work and reactionary tactics that unnecessarily expand the scope — and inherent cost — of the investigation.

Mr. Landis questioned the panel on the appropriate level of involvement in technology for both the audit committee and the board of directors. Ms. Jones stressed that once an issue is identified, the audit committee no longer can turn a blind eye. Rather, the audit committee has an obligation to act quickly to resolve any issues that are brought to its attention. While board members are allowed to rely on outside experts for information, Ms. Jones noted that they need to judge how much information they need on the technological tools used in investigations to meet their standard of care. Effective corporations require that investigators provide detailed reports to the audit committee and discuss these reports in regular private sessions with the audit committee. Mr. Skidmore added that these private sessions allow the audit committee the opportunity to ask whether investigators have applied technology in the appropriate way and whether the investigations are scoped properly.

Surviving Regulatory Inquiries

In addition to advancements in technology, recent developments in the law have altered the manner in which internal investigations are conducted. In particular, it is difficult to



weigh the pros and cons of cooperating with a regulatory body — be it the U.S. Securities and Exchange Commission (SEC) or the U.S. Department of Justice (DOJ) — during the course of an investigation. An audience member questioned the panel on how to navigate a regulator’s inquiry and how to evaluate the risks and benefits of cooperation.

Mr. Skidmore pointed out that, on one hand, voluntary disclosure likely will create goodwill within the regulatory agency. If a corporation works with the government and discloses all steps taken to investigate a particular problem as well as the results of that investigation, this may give the regulators confidence that a troubling issue is being addressed adequately, which in turn may allow regulators to leave the corporation alone and move on to more pressing concerns. Bryan House countered by noting that, on the other hand, voluntary disclosure often provides a roadmap for private litigants and most likely results in a waiver of the attorney-client privilege as to communications with counsel.

The government initially adopted strict standards for dealing with corporations that refused to cooperate. Mr. House explained that in its 2003 Thompson memo, the DOJ stated that the corporation's “timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection”¹ is one of the factors that can be considered during the sentencing process. This encouraged a corporation to waive its attorney-client privilege in the hopes of attaining leniency. However, in 2006 the DOJ issued the McNulty memo,² effectively revising the calculus on this issue and refusing to consider some instances in which a corporation declined to waive its attorney-client privilege. While it is not clear how the recent McNulty memo will be applied in practice, Mr. House pointed out that there appears to be in 2007 a general shift toward corporations pushing back to preserve the attorney-client privilege as much as possible.

There is no right or wrong answer as to whether a particular corporation should disclose voluntarily the results of its internal investigation to the applicable government agency. While the DOJ and others try to make sure that disclosing corporations feel the benefits of their cooperation, the risk/benefit analysis varies for each individual situation.

Ensuring a Regulatory Inquiry Does Not Go Too Far

A final challenge for corporations in 2007 is how to conduct an internal investigation in an appropriate way. Excesses in internal investigations can land a corporation on the front page of the financial press. In light of recent scandals, Mr. Landis asked the panelists to explain best practices in conducting an internal investigation so that a corporation does not face the additional burden of explaining and defending the conduct of its investigators. Formal internal investigations have become a fact of corporate life over the past five years, and corporations understandably have explored a wide range of practices to ensure they have collected relevant information.

¹ http://www.usdoj.gov/dag/cftf/corporate_guidelines.html

² http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf



Mr. Skidmore explained that transparency is one of the most effective means to ensuring an internal investigation does not go too far, as is a rigorous system of checks and balances for investigators. In particular, there need to be mechanisms in place to monitor when and how forensic tools are used. Successful corporations have safeguards in place that force the investigators to state upfront the purpose of using a particular forensic tool as well as its intended use in a particular instance. It is helpful for a corporation to audit investigators periodically, both with planned inspections and surprise audits, to ensure the forensic tools are being utilized in an appropriate manner. Corporations need to be certain that there is constant oversight in the decisions that investigators make so that the powerful tools at their disposal are not misused.

It is not appropriate for investigators to proceed based on speculation or guesswork. While there may be warnings on the computer networks that communications are monitored, it is unavoidable that some employees still will use their systems for personal use. To the greatest extent possible, a corporation has to protect the privacy of these individuals. A corporation should operate under the assumption that employees and officers are innocent until proven guilty. Given this assumption, auditors, investigators, and officers should not share information about the allegations, or reveal the identity of those being investigated or other private information unless absolutely necessary.

Again, it pays to know the corporation's strengths and limitations. Mr. Barbanel advised that before embarking on an investigation, it is essential to use your own resources. Mr. Okarma agreed and added that a corporation needs to determine the best person or group to investigate the particular issue. If the suspected problem area entails accounting, it may make sense to involve internal financial officers. In contrast, if the concern is misappropriation of data, it may make sense to involve the internal IT department to determine the source of the problem.

Regardless of the specific issue at hand, Mr. Martens stressed the importance of vetted resources. He noted that it is essential for a corporation to have resources — either internal or external — who are familiar with the applicable state, federal, or international laws and who can ensure the investigation is conducted appropriately. Mr. Skidmore stated that companies should not risk running afoul of local rules governing investigations: "if you can see the line, you are probably too close." Corporations simply cannot afford the reputational damage that comes with mishandling an internal investigation.

An effective way to ensure an investigation is conducted properly is to note whether investigators are willing to exert independence. Mr. Skidmore acknowledged that this can be difficult, particularly when senior management wants answers quickly. However, a corporation needs to find investigators, either internally or externally, who are willing to push back on senior management and take the time to fully address the issue at hand. Mr. House emphasized how important it is for investigators to communicate directly with the audit committee. Ideally, investigators should have a direct pipeline to the chair of the audit committee to keep him or her well-informed.



For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.