

The Role of Special Committees in Overseeing Internal Investigations

By William Schuman and James Sanders

The last few years have seen unprecedented efforts by governmental agencies (most prominently the SEC and federal and state prosecutors) to aggressively investigate, and often prosecute, claims of wrongdoing by major corporations and their management and directors. Time and again, corporations under scrutiny have been treated more favorably, and have received acceptable resolutions, by appointing special committees to conduct internal investigations of their own activities, and if wrongdoing is found, to initiate corrective action to prevent wrongful conduct in the future. Indeed, enforcement agencies urge target corporations to actively cooperate and often are willing to await the results of the investigation before deciding whether, and how vigorously, to proceed.

The stakes are particularly high for corporations. Catching and punishing wrongdoers and creating a foundation for good corporate citizenship in the future are major drivers of governmental investigations. Criminal sanctions are available to agencies, and they wield them like a bludgeon. At its extreme, failure to cooperate can result in the corporate death penalty (witness Arthur Andersen).

The special committee is required to deal with numerous difficult legal and practical issues. Failing to address them properly can subject its members to severe criticism, and even potential personal exposure. And the cost in dollars and human resources that need to be

committed to a meaningful investigation often is substantial. However, experience shows that the benefits outweigh the costs.

Responsibilities of the Special Committee

The special committee is charged with overseeing the independent investigation. Its members should be independent of company management so that the investigation retains credibility. The special committee ordinarily retains independent counsel to conduct the investigation. Importantly, independent counsel's client is the special committee, not the company, members of management, or board members. At the special committee's direction, independent counsel often will retain additional specialists, such as forensic accountants, to assist in the investigation.

The members of the special committee must be fully engaged in the investigatory process. They must roll up their sleeves and review the materials provided by their counsel. They should conduct regular meetings, remain fully apprised of developments, and be active participants in the decisions concerning the scope of the investigation and the actions to be taken in light of what is uncovered. If its members are largely absent from the process, the investigatory agencies will doubt their sincerity and be skeptical of their conclusions.

Selection Of Independent Counsel

Experience

An internal investigation by the special committee and its independent counsel is a complex endeavor, loaded with competing considerations, and laced with the need to make nuanced, difficult decisions. As a result, selection of counsel who have "been there and done that" is critical.

Securities litigation experience is invaluable, as so many investigations are centered around allegations of securities fraud. In addition, class action experience will allow investigating counsel to more ably render informed advice where an option under consideration may clash with

Director Summary: The authors discuss the process involved in establishing a "special committee" to oversee an internal investigation when a regulatory or prosecutorial agency finds evidence of wrongdoing. Select a totally independent counsel, and ensure all parties are familiar with privilege issues.



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the interests of the company in defending against class or other collateral litigation. In addition, it can be a meaningful benefit for the company and the special committee if the independent counsel is known to and respected by the SEC or other investigative agency.

White collar experience is often another important credential for independent counsel. Many, perhaps most, regulatory investigations come with criminal exposure. Investigating counsel must be sensitive to this risk and capable of providing guidance to their client in light of this exposure.

The Need for Independence

The special committee and its counsel need to be open and candid with, and responsive to, the investigating agency so that the agency will have confidence in them. The SEC sometimes holds back on its own investigation in the hope that the special committee will do much of the SEC's work and allow it to be more targeted or selective in its investigation. Indeed, the SEC may decide not to pursue the matter if an independent review reliably demonstrates that no meaningful wrongdoing of interest occurred.

Counsel to the special committee, especially where management's conduct is under review, must be truly independent. A law firm, which prior to the investigation has been working for the company on major matters on a regular basis, earning large fees, and forming relationships with management, may not be viewed as having the independence necessary to make objective, credible findings.

Human Resources

Investigating counsel must have the human resources readily available for assignment to the investigation, on short notice, and for extended and/or intense periods of time. In addition, depth in a variety of substantive areas, which ordinarily only comes with law firms of meaningful size, is important in making sure that the special committee's, and the company's, timetable and objectives can be fully met.

Credibility

The SEC and other regulatory entities are looking for comfort that an internal investigation is being conducted

independently by counsel who are committed to finding the truth, be it good or bad. The special committee, and the company, will receive the benefit of the doubt from investigatory agencies which know that the attorneys undertaking the investigation are credible, knowledgeable, thorough, and honest.

Some Difficult Issues Along the Way

Privilege Issues

Some of the most vexing problems in an independent investigation involve the determination of what is and is not privileged, and whether disclosure in one form or another waives a privilege that otherwise might be preserved. Information developed in the independent investigation may harm the company in ongoing class action litigation and governmental investigations, so a waiver by the special committee of the attorney-client privilege should only occur after careful consideration.

Communication between the special committee and its counsel. The attorney-client relationship runs between the special committee and its counsel. Thus, the special committee and its counsel ordinarily may share information with one another without losing the protection of the privilege. The tough part of the privilege analysis arises in determining whether the privilege will be lost based on disclosure to others.

Communication with company management. Independent counsel and company management are not in an attorney-client relationship. Thus, what company management tells independent counsel will not be a conversation for which management unilaterally can claim privilege. Ordinarily, the special committee owns the privilege and can decide to disclose to third parties information obtained from management.

Communication with company defense counsel. On the one hand, the special committee's counsel must maintain their distance from defense counsel to avoid calling into question their independence. On the other hand, synergies often can be realized by a dialogue between special committee counsel and defense counsel. Defense counsel's own investigation may be on a parallel track with independent counsel's work as each attempts to learn the underlying facts, albeit for somewhat different purposes. Does a sharing of information between these two counsel cause the information to lose its privilege protections? After all, the two law firms do not represent the same client and are not co-counsel. The special committee will need to be guided by its counsel with these issues in mind.

Communication with board of directors. One of the goals of the independent investigation is to apprise the members of the board of the problems that exist and



recommended means for improvement. However, the special committee's independent counsel ordinarily do not represent the full board. Does independent counsel's (or the special committee's) report become discoverable if it is disclosed to members of the board? There is no sure answer to this question. Accordingly, the risk that such information will lose its privilege plays a role in determining the form of the report and of the disclosure to be made to the board.

Communication with the company's auditors.

Auditors frequently require from the special committee some level of disclosure concerning the status of the investigation before they are willing to issue an opinion on the company's financial statements. However, auditors are not the independent counsel's clients. Thus, information provided to them that previously was protected by privilege may lose that protection. Accordingly, the "negotiation" with the auditors to accommodate their needs without damaging the privilege is an important task.

Communication with Investigative Agencies

Investigative agencies often ask to see the report of the special committee. Indeed, it will be difficult for the special committee to demonstrate its cooperation without providing the information uncovered in the investigation. However, if the special committee's full report is provided to the SEC, may a copy be obtained by attorneys for a plaintiff class, on the theory that the information is no longer privileged? The answer is uncertain. The special committee, guided by its counsel, should seek an agreement from the investigating agency that it will maintain the confidentiality of the information and will not view the disclosure as a waiver of the privilege. This will not prevent another party from arguing that a waiver has occurred, but it will better arm the special committee and the company for the battle. Investigative agencies are aware that the company has a legitimate interest in defending itself in civil litigation. Accordingly, they are often willing to address privilege and confidentiality concerns in an effort to obtain the maximum information from the special committee without burying the company by virtue of that cooperation.

"Miranda" Warnings to Interviewees

Before the substance of the matters is discussed, independent counsel must advise the interviewee that they represent the special committee, not the interviewee or the company, and that the special committee controls whether or not the privilege will be asserted with respect to the information disclosed by the interviewee. Upon learning that the information may be disclosed to third parties, the interviewee may decide not to talk to inde-

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pendent counsel without first retaining his or her own counsel. This may frustrate the ability to fully investigate the matters. However, it is a non-negotiable price that must be paid to ensure that no one is misled or deprived of their rights.

Forensic Accountants

The special committee and its counsel must be realistic about their needs and limitations to ensure that technical matters are fully understood. Especially in securities and financial investigations, the special committee's counsel likely will need to obtain assistance from experienced forensic accountants. Their mission is to assist independent counsel and the special committee in understanding the data and applying complex accounting concepts to the information uncovered. They, too, need to have a balanced perspective. They are not hired to find excuses for wrongful conduct. Neither, however, are they to act as prosecutors or to presume guilt.

In addition, the special committee must be ready to draw on consultants in other fields. Specialists in a highly regulated industry may prove invaluable. It is viewed positively by investigatory authorities when the special committee can show that when support in a particular field was needed, it was obtained.

The Whistleblower Issue

Corporations need to take appropriate disciplinary action against culpable employees. However, the Sarbanes-Oxley Act and other "whistleblower" statutes prohibit companies from retaliating against an employee for providing to investigators information that the employee reasonably believed constituted a violation of law. The special committee must make careful judgments here to ensure that wrongdoing is adequately addressed without unfairly punishing the whistleblowers who brought it to light.

The Report

Form of the Report

Ordinarily, some written report is appropriate. The entire process can lose its credibility if the special committee and



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its counsel cannot demonstrate that they have gathered, synthesized, and analyzed the pertinent facts, arrived at meaningful conclusions, and presented them to company personnel so that appropriate action can be taken. An oral report can be employed if privilege considerations are deemed so strong that putting findings in writing is too dangerous. However, the downside of that choice is that investigating authorities are likely to view such reports with skepticism.

Content of the Report

The report can be tailored to the circumstances, but some basic topics are regularly included. The special committee's and its counsel's assignment should be spelled out. Sometimes the investigation does not extend to all claims of wrongdoing that have been raised. It is important to lay out the boundaries of the assignment.

The scope of the work performed should be detailed. The report should identify the locations investigated, persons interviewed, documents reviewed, and any other work that was performed.

Ordinarily, findings and conclusions are included in the report. Often the special committee sets forth recommendations, ranging from what to do with the wrongdoers to proposed new procedures to improve corporate governance and oversight so as to eliminate the problems for the future.

A difficult issue is whether to share a draft with management or company counsel before it is completed. On the one hand, the appearance, and the fact, of independence will be jeopardized if the company is permitted to have substantive impact on the findings and conclusions of the special committee and its counsel. This kind of input must be rejected by the special committee.

On the other hand, accuracy is essential to the integrity of the report, and there may be instances when review by company personnel is needed to catch and correct descriptions about the business or operations that are not stated

properly. The special committee and its counsel must obtain the input necessary to insure accuracy, without ceding control over the report's content to any company constituency. And, of course, privilege concerns come into play when a draft is discussed with company personnel.

Who Receives the Report?

Obviously, the special committee will receive a copy of any written report prepared by independent counsel. As dissemination of the report goes beyond the special committee, competing considerations arise.

For example, the board of directors and management need to see the report to understand what went wrong and to assist in fixing the problems. However, sharing this information carries the risk that privilege protections may be lost.

Auditors may demand access to the report before they will sign off on the company's financial statements. However, the cost of providing this information may be loss of the privilege. Sometimes, an accommodation can be made so that sufficient information can be communicated to permit the auditors to do their job, without destroying the privilege protections that may attach to the report.

One of the most important decisions will be whether to provide the report, or a portion of it, to investigative agencies. Slavish adherence to privilege concerns in the face of a request by an investigative agency to review the special committee's report may help win the privilege battle with third parties down the road, but may result in loss of the war with the regulators. The best course for the special committee is to obtain as many protections from the investigative agency as possible in exchange for providing the information it insists on receiving.

Post-Report Activities

The special committee's role may not be over when its report is completed. The environment being investigated often results in moving targets as the facts evolve and new issues emerge. For this reason, it is not uncommon for the special committee and its independent counsel to remain in place and empowered to respond at a moment's notice. Accordingly, the special committee's job may not be complete until the matter has reached a full and final resolution.

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