Crisis Management– Preparing for the Possibility of an Internal Investigation

*By William R. McLucas, Christopher Davies, Harvey R. Kelly and Alan S. Fox**

MR. DAVIES: We're looking forward to building on the discussions of the past day and a half concerning transparency and regulatory risk; we'll hopefully expand on the conversation so far by explaining the risks arising from people's coming in and looking skeptically and with hindsight at what you and your colleagues have been doing. The people who are going to be helping do that today are: First, the keynote speaker, Bill McLucas. He is a partner of Bill Wilkins's and mine at WilmerHale, where he is a Co-Chair of our Securities Department. Before joining WilmerHale, Bill was the Director of Enforcement at the SEC for eight years, and since joining WilmerHale, he's led our internal investigations at places like Enron and WorldCom. Second is Alan Fox. Alan is a Principal in the Office of General Counsel at PricewaterhouseCoopers. Before joining PwC, Alan was with a couple of different law firms in New York, where he practiced commercial and securities litigation; at PwC, he heads the legal team advising the firm's tax practice. Third is ... Harvey Kelly. Harvey is a Managing Director in Alix Partners' Financial Advisory Services Practice. He is a forensics accountant by trade and has worked on any number of prominent internal investigations, including those of Adelphia, HealthSouth and WorldCom, where he worked with our WilmerHale team. With that, I think we'll turn it over to Bill and start the panel discussion.

MR. McLUCAS: Thanks, Chris. We're going to talk about some of the more unpleasant things that everybody in the profession faces today and that is what do you do when you actually run into a problem? The caption of the panel is called Crisis Management. In some real sense, the notion of corporate crises and what you do when there's a real problem is becoming far more commonplace in the corporate world today. For at least the four of us on this panel, it is part of our daily routine, as we deal with public companies and their auditors managing through problems. When you think about the world we live in today—after Enron, WorldCom, HealthSouth, Adelphia, Tyco, and the list goes on and on, and against the backdrop of the Sarbanes-Oxley legislation—the climate is dramatically different than it was 10 years ago.

All of us who are lawyers, for instance, learned about privilege in law school (in my case, more years ago than I may care to remember) and of course remains relevant but has become, in a certain practical sense, irrelevant. We now face a climate in which notions of privilege have been dramatically curtailed by government demands, and we're going to talk a little bit about that and about what it means for how we need to keep our eye on the ball when a problem emerges. Sarbanes-Oxley[1] has changed the responsibilities and duties of everybody associated with a public company, certainly senior management, boards of directors and, most significantly, the audit committees and their members. The liabilities have escalated for any perceived misconduct or viola-

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tion of the law, and the burdens and responsibilities Sarbanes-Oxley now imposes on the independent auditors have been extraordinary. These all remain emerging issues, but one of the areas that has had the most significant change in the last few years is the concept of an internal investigation.

For at least the last generation or so—since the Foreign Corrupt Practices Act (FCPA) and the SEC's foreign payments investigations of the 1970s—there have been internal investigations. There was always some notion of an internal inquiry: Counsel would do a review, work with forensic auditors, report to the board, and move on. That notion now has taken on a prominence that I don't think anyone could have anticipated a decade ago.

In Sarbanes-Oxley, whistleblowers, for instance, have now become a protected class. These are individuals who raise the prospect of a problem, like Sharon Watkins at Enron. As a consequence of Sarbanes-Oxley, they immediately get enshrouded with the protections against any retaliation. As a consequence, Sarbanes-Oxley has potentially equated *bona fide* and illegitimate complaints. At this juncture, all of these issues need to be addressed and followed, whereas perhaps a decade ago you could have dismissed those that seemed to be irrational or insignificant.

The settlements that were reached in the private litigation in Enron and WorldCom reflect the new burden on the audit committee. Individual directors reached into their own pockets and wrote checks and had personal financial liability. That prospect has not gone unnoticed among board and audit committee members and is one of the things that has created an enormous level of sensitivity and concern among audit committee members, both in terms of their reputational risk and what their obligations are to the public company and to the shareholders. In some ways, that's resulted in the audit committees being the strongest allies of the auditors, but it also means that when we address problems right now and issues get to the level of the audit committee, which today is far more the presumption than the exception, you can assume that the corporate enterprise is going to behave much differently and take things much more seriously. We consequently have to adjust to this kind of environment of self- investigation, self-help, self-reporting and self-remediation. I think the concept was always something that we believed existed in corporate America and in the accounting profession, but now it's not optional; it's a requirement.

I'll discuss Section 10A of the Securities Exchange Act of 1934[2] in a minute, but the basic reason that corporations conduct all these internal investigations is that, if they don't and the government discovers a problem—which it will review with 20/20 hindsight—the consequences can be draconian. It is not unusual for public companies or accounting firms to worry very seriously about the threat of a criminal indictment and, as we all know, for any public company to survive a criminal indictment, much less, for instance, a financial services firm or one that contracts with the government, is rare. Many of these things end up in deferred prosecutions and some sort of agreement.

If you look at the most prominent guidance on corporate cooperation—the SEC's pronouncements in the Seaboard 21A Report and the Department of Justice's pronouncement in the Thompson Memorandum—you'll see the reason behind all of these internal investigations. The Seabord Report deals with the effect of an entity's cooperation in an SEC civil investigation, and the Thompson Memorandum discusses the Department of Justice's factors in the criminal prosecution of entities. Both documents lay out the factors the government will consider when it's deciding both whether to proceed with a case, and if it does proceed, how severe the appropriate penalty should be. The kinds of factors both documents discuss are what the problem was, how pervasive it was, how high up in the organization it went, how long did it take place, what was the harm to the public, to shareholders, when the problem was identified what did the company do, how quickly did the company get its arms around it, fix it, and in the government's eyes, how quickly did the company report the issue to the government?

Those are the kinds of factors, along with Section 10A of the Exchange Act, that have pushed public companies across the board to engage in all these internal investigations. As for 10A, it has been on the books for 15 years or so. We've only heard regular reference to Section 10A, however, in the last five or six years; indeed, it now comes up with such a degree of frequency that it's become a common feature of auditors' language when they're dealing with an audit client. What the statute says essentially is that if an auditor becomes aware of facts or circumstances that indicate that an illegal act has or may have occurred, it must determine whether an illegal act in fact occurred, whether its effect on the company's financial statements could have been material, and

whether the company's remedial measures are adequate to the misconduct in question. Further, an illegal act is not confined to something affecting the financial statements. Did somebody book revenue that they shouldn't have booked? Did somebody take a position that they shouldn't have taken in order to pad the reserves for the next quarter? The notion of illegal act is left far more broadly than just financial statement impact, and the statute says if there's any indication that there's been or may have been an illegal act, the auditors have to take affirmative steps to decide whether in fact there was an illegal act and, if so, they've got to report it to the board. Now, an entire lore has evolved under this section of the statute as to what happens in an audit when the auditors determine that there might have been a problem. What generally follows is that the auditors go to the company, meet with the audit committee and explain their concerns, which may range from a conventional financial statement issue to a bribery issue to an antitrust issue and indeed to a tax issue. The auditors then typically advise the audit committee that it must run the issue to ground or the auditor will not issue its opinion.

The procedure that has developed that's been generally accepted in the profession and in the corporate community is that an independent entity is brought in to run the facts to ground. By independent, I means someone other than the company's law firm, its in-house counsel, and its in-house accounting people, but instead a third party law firm, which conducts the investigation on behalf of the audit committee and then reports its results to the independent auditors so that the auditors can get some satisfaction and some comfort on whether they have a reporting issue with respect to whether there's been an illegal act.

That's the background that I will leave you with, and we're going to move on to an almost alien concept that we all see in corporate America now of lawyers and forensic accountants running around investigating everything and then reporting to the board and to the government compared to what we would have imagined would have been the situation a decade ago if we had decided there might be a problem in a public company. We're in an environment now where these kinds of things are far more routine, because the failure to do them runs the risk that the company and the board will be indicted, will be sued by the SEC for penalties, or will suffer some other consequences far more draconian than we'd have ever imagined. That reality has changed the way the corporate enterprise behaves, and it's changed it in a way to which I think we're all still trying to adjust. It raises all sorts of issues about privilege, about risk to individuals, risk to the auditors, that we may get into as we go on here today, but that's the basic background of sort of crisis management environment in which we collectively find ourselves.

MR. FOX: Thanks, Bill. Picking up on what Bill said, I'm going to start with something that I discuss sometimes in my own firm. I refer to it loosely, probably too loosely, as the criminalization of tax practice; I'm not just talking about what we've all seen in the papers and what we've seen with the Senate subcommittee in the last couple of years. I'm talking about what starts to feel like criminalization of routine tax practice and in a couple of different ways. Bill talked about the standard under Section 10A of the Exchange Act. You know, when an auditor determines that an illegal act may have occurred, this whole 10A process begins to kick off. Well, that's one way in which you get into these criminal investigations, and what in the world does it mean to an auditor and an accounting firm that an illegal act may have occurred? For those of you and those of us in the tax practice, you get some really interesting and difficult questions that we have seen in the Big Four firms recently.

For example, if you are a tax director of a large retailer, maybe a big box retailer, and you've recently, only in the last couple of years, expanded into some states and so you've got thousands and thousands of outlets, but you've got two or three in Idaho and two or three in Alaska or something like that, and you haven't quite caught up yet in terms of sales tax in every state, you're paying all the tax on your income that you're supposed to pay, but maybe for a couple of years now, you haven't paid in a particular state.

Also at what point does your knowledge of that become possible illegal acts? At what point does your knowledge that years and years ago you undertook a certain transaction, you had a "more likely than not" opinion in connection with that transaction, but it's become clear in the interim that the IRS has listed the transaction or it's become clear, you've seen in the paper, that other companies are getting attacked for the transaction? If you sit by and do nothing, at what point does it become a possible illegal act that the auditors are going to cause to kick off a section 10A investigation, or more likely that a whistleblower is going to cause to kick off a 10A investigation? Maybe somebody that you hired in the tax department only last year and something's been going on for years

and that person gets increasingly uncomfortable and finally goes to the auditor or, worse yet, goes to the government. These are the ways in which we've seen these investigations kicked off. I don't have great answers today. I'm not trying to tell you that, if you haven't paid sales tax in a particular year when you've opened outlets in a certain state, suddenly it's illegal activity, but these are the types of situations that are raising very, very difficult questions.

There are other unpredictable areas in which investigations get kicked off and one of the really hot areas seems to be transfer pricing. We talked about transfer pricing yesterday in one of the panels. We had an example earlier about a transfer pricing situation. I can tell you that we've now seen two criminal investigations kicked off with grand jury subpoenas about what turned out, at the end of the day, to be routine transfer pricing practices. Probably a whistleblower became uncomfortable with the high level of a royalty payment that had been going on for years, possibly somebody new to the company. In one situation, this level of royalty payment had been used for nearly a decade. The company had been through three IRS examinations. The company had received, I can't remember now if it was two or three transfer pricing reports from an independent accounting firm, and nonetheless a grand jury subpoena arrives. It hits the papers. A 10A investigation gets started and a little bit under a year later, millions of dollars in legal fees later, the company winds up with a civil settlement, essentially paying an amount that would have equaled a higher tax relating to a lower royalty payment for the last several years. That situation clearly seemed to be fairly routine transfer pricing practices. So that's an area that seems to be very hot. It's clear that the IRS Criminal Division special agents are working closely with the U.S. Attorney's Offices. For example, I understand there is a task force or other group in the Southern District of New York in which a particular Assistant U.S. Attorney is in charge of tax-related matters, working closely with IRS Criminal Division agents.

MR. McLUCAS: Alan, let me ask you a question because, at least at some point in the past, the practice might have been for the IRS or even the U.S. Attorney's Office to pick the phone up and call you and you'd walk in, you'd have a conversation, they'd ask some questions, and you'd either have a cogent explanation or you'd say we'll look into it and come back to you. That may happen today, but it's equally likely, it seems to me, that the government proceeds by (a) presuming the worst and (b) just firing off a grand jury or civil subpoena; it says something about the climate we're in. There is an extraordinary level of skepticism by the government and by government lawyers and regulators as to the reliability of what they hear from corporate America and its advisors, and it is not uncommon that they just proceed very formally and with subpoenas early on rather than sit down and have a conversation.

MR. FOX: I agree with that, absolutely. I think we in the tax world, at least from my perspective in the general counsel's office, see it kind of going one of two ways without much middle ground. Either you're in a routine examination with IDRs and there is an opportunity to discuss this type of thing and hopefully come to a satisfactory resolution. It may mean additional tax has to be paid in the sense that we all thought of 10 or 15 years ago. Or, at the other extreme, you're going right to IRS summons or grand jury subpoenas, and the middle ground that I would have said was the norm five years ago, in which you get that call and you have discussions, seems to have virtually disappeared.

So, it is a very different world, and that kind of leads into the next point that I wanted to make, which is a real pet peeve of mine, and that's the difference between the way tax professionals see the world in this environment and the way that other financial accounting and financial reporting executives have come to see the world. Far too many tax executives, and I include some of my own tax partners in this, are still operating in what they see as a fairly congenial environment. And we have therefore seen situations in which a couple of special agents who have cards that say IRS Criminal Division show up at the door at a point when they know an IRS audit is going on, ask for the tax director and the accounting firm partner, show them their cards, and they say we'd like to have a conversation with you about a criminal investigation that we're in the middle of. The tax directors and accounting firm partners think these special agents are just like the regular agents that were here three days ago for the IRS audit. "Come on in. Here are the papers. What do you want to know about? We're happy to talk to you." Of course, about six hours later, when the thing's gotten a little bit ugly at 6 p.m., I get a call in the general counsel's office saying, "I just did something that may not have been a great idea." It's a little bit hard to understand why somebody would proceed like that, other than you're so used to working in a world in which the back and forth with the

agents has been not a big deal. In that old world, an IDR comes in with 14 paragraphs and 28 subparagraphs and you think to yourself as the tax director, as the accounting firm working on this, we'll give them these five things, but they don't really need the other things. So, we're just not going to give it to them and they'll probably forget about asking for it, so don't worry about it. You can't do that with a grand jury subpoena. You can't do that with an IRS summons. You technically can't do it with an IDR either, but it happens. I would really say that I think that the tax executives need to catch up. I'm not advocating, of course, bad governmental or regulatory relationships. I guess I'm advocating what I would call good common sense. I think it's improved over the years, but we continue to see a certain amount of that, and it can be very disturbing in a position like mine.

Another thing I wanted to mention briefly are some surprising aspects of auditor independence that come into play in these investigations. I think a lot of tax executives, tax directors, CFOs, audit committees, and others understand the principal changes that have occurred in the last several years, the changes that have occurred with the PCAOB, and Sarbanes-Oxley. They understand that your audit firm cannot provide you with tax-advantaged transactions. Of course, that may not be a big deal because nobody can provide you with tax-advantaged transactions realistically in this environment, and understand that audit committee approval needs to occur, either pre-approval or specific approval for certain types of services by your audit firm. But when you're in the context of one of these internal investigations, things come up that really touch on the very basis of independence that sometimes aren't thought of. This in particular can be a problem in either nonpublic or small or mid-sized public companies in which issues like who is actually preparing the calculations that go into financial statements make a big difference. There are probably CFOs and others signing representation letters for their outside auditors in which they are legally representing to the auditor that we take responsibility for all these calculations, we understand all these things. When you're in the middle of one of these investigations and the company and the independent investigating lawyers essentially need to report to the government, when it turns out that, in fact, your own audit firm did certain calculations and your audit firm had the understanding that you were going to re-review the calculations, maybe redo the calculations and clearly take responsibility for them, and you just sort of forgot about that, you may have a serious problem with auditor independence. That ties into internal controls, as well as Sections 302 and 404 of Sarbanes-Oxley. These matters need to be taken very seriously in what I think is in many ways a new way of looking at things. On that note, I think I will turn it over to Harvey.

MR. KELLY: Thanks, Alan. I'd like to add a little more context from a tax point of view on the kinds of issues that Bill and Alan have spoken about and why and how in a real world the tax folks tend to get swept up into less than pleasant exercises. Standing behind it all are some broader trends. One is certainly Sarbanes-Oxley. Beyond Sarbanes-Oxley, another trend involves changes to what is perceived to be best practice these days versus in times past. By and large, I think what those best practices and Sarbanes-Oxley have had the effect of doing is lifting the veil of secrecy as it relates to both tax practices and the tax accounting as it flows into the financial statements. That lifting of the veil of secrecy and the requirement to document exactly what the tax reserves are comprised of is giving rise to some real-world challenges and questions.

We have seen, as I'm sure many of you have seen in the press reports, a proliferation in the number of restatements that involve tax-related issues. Tax issues are bearing upon the financial statements, and the fact of those increased restatements is symbolic of an increased attention to the tax matters and how they flow into the financial statements. For example, we're seeing an increased focus of regulators and auditors on overseas practices generally. That's not just for tax reasons, but at least in my experience, that increased attention on overseas practices has had some ramifications to the tax area. Another reason why tax professionals should be aware of the trends in 10A investigations of the type that Bill and Alan were talking about, is that what auditors do in those situations, very understandably but very frustratingly from a company point of view, is they'll hold up their audit opinion until all the questions are resolved. Once a question of whether there has been a potential illegal act has been raised, no more financial statements will likely be issued until those questions get resolved. As we are all aware, tax issues are often very complex and require extensive analysis. So, those tax questions, once raised, are not the kinds of issues typically that can get resolved in one, two, or three days. Therefore all of a sudden, if tax happens to be the centerpiece of the investigation, you are not only getting the focus

and attention of the tax folks in your organization but others too, all of a sudden, financial statements are being delayed, 10-K deadlines are missed, the company is making press releases disclosing some issue and maybe they're even being so specific as to say it happens to be the tax area is the proximate cause of why the company can't tell the public what its financial results have been. Moreover, it doesn't have to be a big financial issue that has large dollars attached to it. It could be in some remote part of the world that may not even be material by any stretch of the imagination, but until those questions of ethical behavior and illegal acts are fully resolved, the whole show stops. It's an uncomfortable position to be in and that's one of the unfortunate side effects.

Talking about Sarbanes-Oxley and one of the areas I think that folks have found a bit disconcerting is the whole tax reserve area. I'm sure many of you have experienced an increase in the documentation standards, either in your own 404 internal control policies as to what degree one documents the basis for the tax reserves, but also auditors are demanding it even if there haven't been changes in the company's policies or practices. The significance is a couple of things when it gets to investigations. The more one has documented the basis for the tax reserves, the more it gives another an ability to fully dissect and challenge the judgments that have been made in those areas. We're talking about an area of accounting reserves, as we all know. We've all heard in nontax-related concepts about cookie jar reserves and about people managing earnings in some way through use of reserves. The same kinds of questions are raising themselves in investigations that we're doing these days, as they relate to the tax area. The more that those tax reserves are fully documented and fully spelled out as to exactly what the judgments and bases are, the easier it is for somebody to Monday morning quarterback it later and challenge it and question whether it was appropriate.

MR. FOX: Harvey, are you effectively advocating that less is more in terms of documentation? The scale has kind of moved on that. That may have been the theory some years ago. What's your view?

MR. KELLY: No. I think the right result is not that less is more, although it may be the more comfortable result. As a practical matter, I think it's just not a path one can go down anymore. I think that horse left the barn a while ago and you've got to document the bases for tax reserves. I think what it does call for is an appropriate sensitivity to how those judgments may be viewed by others. In my experience, if things are done with appropriate business judgment, very rarely will they later be considered fraudulent. Estimates and judgments are not an exact science. The accounting rules certainly allow for that. I think the regulators and auditors by and large are understanding of the fact that not everybody guesses right, but I do think that one should do it not with haste and one should do it with an appreciation for the fact that others may be looking at it at some future date.

MR. McLUCAS: Harvey, let me ask you a question on your reference to 10A and holding up the filing of financial statements. Let's assume we had a multinational company with well into the double-digit billions in revenue and we had an operation in a third world country, maybe $30 million in revenue, and there's a question that comes up about franchise tax, sales tax, perhaps the relationship between the local manager and some tax authorities, and the auditor suddenly focuses on that. Explain to me why or how the idea of filing and certifying the financial statements for a multibillion dollar revenue company gets held up over an issue of whether we have a problem of either calculating or paying or maybe we got a questionable relationship between our country manager and the local tax authority. How does one come to that judgment as the independent auditor when, by any standard of materiality, one would think we can fix this problem or not fix it, but it certainly doesn't have anything to do with our consolidated financial statements?

MR. KELLY: Well, it's a fair question, and it's one that companies regularly get frustrated with. I had almost that identical issue come up just the other day where a lawyer called me and said, "Our Big Four firm is holding up financial statements because of some third tier subsidiary in a strange place. There's just no way the number could be material. Isn't that wrong?" The answer to that is while it may be true that that particular issue might be not quantitatively material, there come into play a number of other questions, at least in the auditors' minds, until you've ruled those other questions out. Questions like: "Who knew about it in the organization? Is this something that flowed all the way up the chain, that was condoned at some higher level of management than that remote location? Could it be that those kinds of practices are occurring somewhere else in the organization?" So, what happens is when questions like these arise, people start speculating, if you will, on how far can it reach, what other things might be im-

plicated, who might have known about it. It becomes a fundamental ethical question. It may prove at the end of the day, after lots of investigation and lots of attorney hours and lots of forensic accounting hours, that it was a very narrow discrete issue. However, the auditors take the viewpoint that it is better to be sure and take the time to get it right than risk misgauging that this was isolated and independent only to find out later that it was more widespread.

MR. McLUCAS: Yes. Harvey, I understand that the analysis goes on even within the public company. There's enormous frustration with the auditors, saying, "What do you mean we can't file the statements? This is ridiculous." What happens more frequently today is the audit committee members who get put on notice of this promptly sit down with their lawyers and say, "This doesn't make any sense." The lawyers will say to them, "You may be right, but let's assume we have an FCPA problem there, we have bribery, we have bad books and records, we got a corrupt country manager, an individual. Let's assume we've got that in three other jurisdictions. Let's assume somebody on a passthrough from corporate got some inkling and notice of this and just kind of winked and went on about his or her business and that all comes out six months down the road." Well, what you now have is the individual members of the audit committee, the tax director, maybe the controller, maybe the inhouse counsel, are all sitting in a plastic chair across from a 29-year-old SEC lawyer, who is asking them questions about what they know and when they knew it and how they reacted and then turning to the audit committee and the independent auditors and saying, "Explain to me how you came to the conclusion that you could sign off on the financial statements in the audit in the face of this statutory provision that says there was an illegal act; you had the responsibility to run it to ground and to either fix it or disclose it." That's the real world in which auditors and in-house counsel find themselves; it's what's happening with audit committee members after Sarbanes-Oxley, and when you look at the responsibility and the reputational risk, you're finding that the audit committee members and the board members are saying, "Get it done, find out, fix it. I don't care. Get it done and get the answers because I'm not going to have my reputation and my personal wealth put at risk because we said we'll just file the financial statements and sort it out later." The flip side of that is you obviously have a marketplace where if you put out a release saying we're going to be delayed or we don't get it done, is of enormous consequence and so the crisis that you find yourselves in is very real and this does happen and is happening, I think, with more frequency perhaps than most of us are seeing, but it's something that is not unusual in this climate.

MR. KELLY: I'll run through a list of other tax issues that I have seen in recent investigations and give you a little flavor for how they come up. We talked a little bit about the tax reserves and the issues of illegal acts. To some degree, the elements of the tax reserve involve calculating and recording exposure for potentially aggressive tax positions or for positions that perhaps some taxing authority may not agree with at some later date. It begs the question, once it's under the microscope in these kinds of investigations. Is that, in effect, an admission on somebody's part that they knew that this was a violation of the law? Why do you have to accrue for this? If you properly reported it in accordance with the tax laws, why do you have an exposure? Because one objective of tax professionals is to minimize the cost of taxes to an organization, such questions may appear to flip the whole tax function upside down to some degree. But those are the ways that it kind of gets twisted on tax professionals when these types of scrutiny take place.

An area where I'm seeing a lot of tax-related issues come up is in FCPA investigations. Examples include the tax settlement process in foreign jurisdictions. For those with locations in all parts of the world which have different customs and different cultures, relying on those different customs and the manner by which taxes may get settled may be a mistake if it involves improper payments to government officials or the failure to pay certain taxes. The fact that "others do it" doesn't make it okay and those kinds of things are getting more scrutinized. Oftentimes I'm finding that perhaps the tax director at headquarters really didn't know how those things were taking place. But frankly the Sgt. Schultz defense is not one that plays real well in these kinds of situations, in a Sarbanes-Oxley world where you're responsible for controls in your area. You cannot assume that the absence of documentation somehow solves the problem. It doesn't work. When these investigations happen, folks like Bill and myself and auditors are tenacious about getting to the bottom of things. So, the mere fact there isn't some red hot document out there that says we bribed so and so or we did this wrong or we did that wrong, doesn't cease the inquiry.

MR. FOX: I'll make one comment on that, going back to those of you who were at dinner and heard

Alan Murray talk about e-mails. You know, the documentation winds up in e-mails, and the idea that you should, before you write an e-mail, picture it on the front page of the WALL STREET JOURNAL is absolutely right, because I can tell you that Harvey's become an expert at searching e-mails from the center, and the authors of the e-mails don't even know they're being searched. So, there rarely is a true absence of documentation. It seems to be in the e-mails.

MR. McLUCAS: E-mails really represent the end of Western civilization. I think we have become accustomed to the notion that we would craft a position, and the government would craft its position, and we would argue it out and would have the benefit of saying, look, you can't prove that the provision wasn't adequate and appropriate and the judgment was what this individual's now testified to. The reality of the world we're in now is the burden has shifted because, given the climate, unless we can in effect nail it on the evidence, we [are] on the defensive because of the press focus on corporate America and sort of the level of scandal-mongering and, frankly, the degree to which there's enormous public skepticism about the representations of corporate America. Further, these things, if not resolved, get played out in the court of public opinion; the courts and their adversary process are of no use. By the time you measure the damage to the corporate franchise and the loss of market capitalization over the years preceding the litigation, winning may be something that feels good, but the cost of it and the cost of the battle, given the leverage that the government has (not to mention the balance of the risks that go with those kinds of fights), it becomes extraordinarily damaging to fight. It's why trying to fix it up front, even when you believe that maybe the positions that you're arguing against are simply not well founded, puts you in an extraordinary box in trying to manage these problems.

MR. KELLY: I want to make one other point. It's not just income tax reporting issues that may be questioned from a tax point of view. Alan mentioned transfer pricing. Certainly that's an area that's getting a lot of scrutiny. Payroll tax, particularly in foreign jurisdictions, is something that we're seeing a lot of investigations revolve around. Customs and duties as well. Are the practices in the customs and the duties area appropriate, both from a bribery point of view but also from just a reporting point of view? Are you properly valuing things and reporting the values of things as they go through customs and duties? All those sorts of issues are getting analyzed in these kinds of investigations. We've also done investigations recently on the issues of how people are compensated and whether, for those who work in multiple jurisdictions, there is anything improper about the manner by which the compensation structure is set up. It may well be to benefit the individual's tax position rather than the corporation in any way, but if it is something that is viewed as an inappropriate or illegal practice, it doesn't help that the corporation didn't somehow benefit by that. It's still something that we've been charged with audit committees to take a look at it. So, it really can run the whole gamut, of your various responsibilities in the tax area.

MR. DAVIES: There are a number of questions here that actually go back to an issue you have touched on but that seems to demand more elaboration. When someone, tax director or someone reporting to the tax director, knows of noncompliance with some tax provision, whether it's in the non–U.S. or domestic context, but are told "no one pays this tax, so we're just not going to do it either," or it's a sales or use tax issue and people know of noncompliance, at what point does the knowing of noncompliance, whether domestically or internationally, become a potentially illegal act? When is there materiality threshold? You said there is none, but is there some judgment call before you call in the troops?

MR. FOX: Well, my reaction to that, from the perspective of advising the accounting firm, is that I think we're sort of in the second phase of practice under Section 10A. Not everything necessarily means a two-year $10 million investigation, and in those types of examples, what I think we are really looking for is how long has it gone on, how big has it gotten, and now that it's been brought to management's attention, what are you going to do about it? It's not as though every single minor sales and use tax infraction is a knowing illegal act and an investigation has to ensue and people are fired, again depending on how long it's gone on. But from the accounting firm perspective, I think if we're seeing an immediate willingness to correct the problem as opposed to an attitude like, "You gotta be kidding, nobody pays tax in Idaho," though that may be an important factor in the audit firm's views.

MR. DAVIES: What if it's nobody pays tax in Gabon? What if it's nobody pays tax in a jurisdiction where the tax authority is ill-developed?

MR. FOX: What I think we would say, and I haven't really been directly faced with that, is if that's what

the law is and there's no clear exception that you're falling under, you had better start paying now, at the very least. There just doesn't seem to be a lot of flexibility in that example.

MR. KELLY: Well, I'll tell you what I've seen in those kind of circumstances. Step one in the process is to immediately pull that certification that that tax director signed if I'm doing an investigation, and I'm going to read the phrase that says that they're not aware of any illegal acts or however it's phrased in a particular representation. Then, we're going to have a long conversation about if you knew about this, why wasn't it down in the exceptions section of this certification to at least give others in the organization the appropriate opportunity to explore whether that's a problem and to deal with it in whatever way is most appropriate?

MR. McLUCAS: If you're inhouse, though, and the advice I'd give is don't manage this thing yourself. You've got to get your best tax advisor, your inhouse counsel, and work through these problems together. Section 10A refers to illegal acts; if there's water on the men's room floor, that could be an OSHA violation. There's a loss of sort of common sense that's emerging here to be applied to the statute. There has to be some gloss on it, but don't try to fix it sort of in a core group of the three people who would be liable or exposed if the issue were to blow up. Get the lawyers, get your tax advisor involved; figure out a proactive plan to fix it, and then make sure your auditors are comfortable. That's the solution to these things. The solution isn't to say, "It's Gabon and nobody obeys the law there. Next issue." Get some advice and fix the problem with the collective.

MR. DAVIES: One question here that has kind of a contrarian voice apparently refers to the panel that preceded us, during which an audit committee member apparently said that it remains business as usual and that audit committees should be hands-off with regard to corporate tax affairs. Do you have the same view? It strikes me that so far, it seems you have said that it's not the same world, that the level of scrutiny, at least procedurally, if not substantively, needs to be greater than it was five-six years ago.

MR. McLUCAS: It depends on what the audit committee member was saying. If you're talking about sort of assuming that all audit committee members have to be tax experts or, in the case of a chemical company, environmental law experts, the answer is he or she is right. If you're talking about sort of assessing risk, compliance, attention to legal obligations and implications for the public company, the answer is no, it is not business as usual, and the risk to board and audit committee members is quite high in this environment were that to be the view that they would take and an issue came up.

MR. FOX: Bill, I would say, to use an auditor's term, management integrity is the audit committee's business and that doesn't mean that you're supposed to somehow as an audit committee member be deeply involved in a review of tax practices in all 165 countries. But it does mean, I think, that you need to be plugged in enough so that as these issues come up, you've set things up so that you have developed and probably documented an expectation that management is going to bring things to the attention of the audit committee, because I think that if you have not set things up in that way and then compound it by problematic activity going on year after year, that's a real problem.

MR. KELLY: I frankly think it's a benefit to the tax directors and the controller and the CFO to have a very active audit committee. So, I'm not sure if I were a tax director that such a position on the part of an audit committee would make me feel comfortable. I think that almost makes it sound like the buck stops entirely at the tax director. If I were a tax director, I would encourage active audit committee involvement to the extent that there's something that warrants that level of attention.

MR. DAVIES: Something all of you have hit on and one of the questions asks about and I think the prior panel on attorney-client privilege touched on as well: conflicts of interest. The board directs an investigation be conducted. The investigators go in and tell the people they interview, "There's a privilege that applies to these conversations, but it's not your privilege, it's the company's, and we might waive it in order to satisfy these Seaboard criteria or the Department of Justice requirements." There are other conflicts if the whole board has approved a tax transaction. Who is it who directs the internal investigation? How do these conflicts get played out? How do you deal with the different constituencies as you're conducting an investigation?

MR. McLUCAS: Very carefully. With respect to the former situation, the client's always the public company, and that's why you bring in somebody independent, not counsel that has a relationship, not regular outside counsel. There is a disclosure to the employees. The reality is if you're in one of these things and you're an employee, an officer of a public company, you're in a

very difficult position. You certainly can have your own counsel, but your option to refuse to cooperate with the inquiry or answer the questions is nonexistent because you'll be fired, and the reality is once the information's communicated to the lawyers and the board, you have to assume it's going to go to the government. In fact, at least according to one case in the Southern District of New York, lying to outside counsel that's conducting an internal investigation may be a crime, at least when you understand that the contents of your interview are or may be turned over to the government It's an extraordinarily strange environment, unlike what one would have presumed 10 years ago, where we would defend the company and there was an issue, the company would absorb the blow or take the damage and save the individuals. Today, you have to assume that you can be thrown out of the back of the plane and yet there's no real solution for that. The privilege belongs to the company. The lawyer's obligation is to the company, and the issue for individuals who are interviewed or contacted in one of these inquiries is if you're going to cooperate, which you probably are because you want to keep your job, don't get yourself in the bind of fudging or not being candid or not laying it all out because that can get you in a lot more trouble than any underlying problem.

MR. DAVIES: On the theme of being thrown out of the back of the plane, I think you said earlier that long before there is ever an internal investigation, you can't rely anymore on the kind of confidentiality of the attorney-client communication back when you're making the initial decision, can you? The waiver does belong to the company.

MR. McLUCAS: What decision? To do what?

MR. DAVIES: You're talking to your lawyer about a tax decision today. Two years from now, there's an investigation.

MR. McLUCAS: The corporate lawyer, yes. The point Chris is making, is the waivers in government investigations now don't go only to the internal investigation. The Seaboard Memo and the Thompson Memo essentially provide that the government will either get cooperation or there will be no deal on whether you're going to be indicted or charged. Cooperation will often include waiver of the attorney-client privilege and work product doctrine. And when they say waiver of the privilege, they don't mean waiver of the results of an after-the-fact investigation. They want to go back a year or two or three and get waivers as to all of the legal advice on all of the underlying issues throughout the period at issue. So, all of these things that we had all, both as lawyers and as clients, had presumed were confidential, now may well get laid out for the government to review and to second guess or at least to question with the benefit of hindsight. In fact, the government may well ask whether the lawyers, in fact, understood the transaction or were complicit in the supposed misconduct.

MR. FOX: And I think we've seen both outside corporate counsel and inside counsel need to be a lot more careful about the conflict warnings that you give your clients. So, if I'm conducting an internal investigation, I need to be more careful than ever when it reaches a certain point about telling our people I represent the company or I represent the firm and while this conversation is privileged, because you are an employee or partner, whatever it may be, of the company or the firm, you need to understand that the company owns that privilege and it's going to be the company's decision to waive that. So, I would love to have this conversation with you, but you need to have that in mind and I think that type of warning has become a lot more prevalent and lawyers are a lot more careful about it.

MR. DAVIES: On that happy note, I think our time's run out. Thanks a lot.

Endnotes

* This panel discussion took place at the Seventh Annual Tax Policy and Practice Symposium, *The Corporate Tax Practice in the Age of Transparency: A Path Forward,* held on February 9–10, 2006. The panelists' comments were edited, annotated and augmented prior to publication.

[1] Sarbanes-Oxley Act of 2002 (P.L. 107-204).

[2] Securities Exchange Act of 1934, 48 Stat. 881 (June 6, 1934), codified at 15 USC §78a *et seq.*