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Independent internal investigations: a tool of good corporate governance in Europe too?

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Abstract

Following accounting fraud scandals at companies such as Enron and WorldCom, and the subsequent enactment of the US Sarbanes-Oxley Act, independent corporate internal investigations have gained prominence and visibility not only in the US but also in Europe. This article considers how, in an increasingly complex regulatory environment, companies in Europe and beyond can use such investigations to help them maintain a robust compliance culture, and sets out the structural and procedural issues to be considered when conducting such an investigation.
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Fulltext

Independent corporate internal investigations (independent investigations) are not a new phenomenon, particularly in the US where the appointment of special counsel to investigate wrongdoings and report to the US Securities and Exchange Commission (SEC) is not unusual. However, in the last few years, such investigations have made front page news in the US and in Europe, following high profile accounting fraud scandals at companies such as Enron, Tyco and WorldCom in the US, and Royal Dutch/Shell, Royal Ahold and Parmalat in Europe.

The US response to such scandals culminated in the enactment of the Sarbanes-Oxley Act (SOX) in 2002. Since that time, independent investigations have become almost standard for companies facing alleged accounting fraud and accounting irregularities (including companies outside the US that qualify as foreign private issuers of US-registered securities).

The widespread use of independent investigations has raised considerable interest, particularly in Europe. Many have queried why a board would start an investigation into the affairs of its own company and not use the internal control or audit department. In most cases to date, the answer has been to avoid an investigation by the authorities, notably the SEC, and to save the company (but not necessarily its officers) from criminal sanctions and possibly bankruptcy. To achieve this, companies would need to co-operate with the SEC or other relevant authorities. As a result, external lawyers or accountants could become the fact finders of the authorities or the prosecutor. There would also be complex issues regarding lawyer-client privilege, in particular to what extent privileged information of the company could or should be shared with the authorities.

Against this background, this article discusses:

- The relevance and significance of independent investigations for corporate governance and compliance, particularly in relation to European companies.
- The two key prerequisites of an independent investigation.
- The structural issues to be considered when planning such an investigation.
- The main procedural issues that need to be addressed when conducting an independent investigation.

Relevance and significance of independent investigations

In an environment where European companies are subject to increasing corporate governance and other regulatory requirements, which is in turn heightening the focus on compliance, independent investigations can play an important role in creating and maintaining a robust corporate compliance system.

Growing regulatory requirements in Europe

The corporate world post-Enron has been characterised by a new focus on corporate governance. "Internal controls" and "accountability" are the buzzwords of legislative and other initiatives to rebuild the confidence of investors in the capital markets.

The response in Europe to cases of accounting fraud and other corporate wrongdoing has been more fragmented than the quick and far-reaching US SOX reaction. There is no EU-wide corporate governance code. In fact, the EU Commissioner for the Internal Market and Services, Charlie McCreevy, recently commented that trying to enact a European code of corporate governance "would be an inevitable and possibly messy political compromise", with little benefit for investors.

Instead, the European Commission has, since 2003, begun a number of initiatives through its Action Plan on Modernising Company Law and Enhancing Corporate Governance in the EU. These initiatives include:

- Recommendations for the independence of non-executive directors.
- A proposed directive on audit committees (the Eighth Company Law Directive).
- Recommendations for the compensation of directors.

The EU measures are complemented by diverse national legislation and initiatives addressing corporate governance through voluntary regulation or the "comply or explain" principle.

In addition, a host of regulatory measures are being introduced in various EU countries that affect the management of companies and the way they do business:

- France, Germany and The Netherlands have announced plans to introduce "class actions" in certain limited circumstances.
- Money laundering laws have been strengthened and become more expansive, to cover, in many jurisdictions, tax fraud as a predatory crime.
- Additional anti-bribery and competition laws and, depending on the industry sector, industry-specific regulations, have been introduced.

Finally, companies must also take into account employment, health and safety, data privacy and other regulations, which may have compliance and corporate governance implications.

Impact of US regulation

In addition to the above European regulatory requirements, there are a number of US requirements that may impact directly or indirectly on the governance of a European company. If a European company has US-registered securities it must comply with the accounting and governance requirements of SOX. The requirements of the US Foreign Corrupt Practices Act may also be relevant.

But even if SOX and other US requirements do not apply, a European company may still be subject to indirect effects of the new US corporate governance standards:

- They may become a benchmark for potential investors in European companies or for creditors and rating agencies of European companies.
- There are already examples of international audit companies which, because they are subject to increased scrutiny in the US, are being influenced by the stricter US standards when auditing European companies, even if the latter are not regulated by the US regime.

Focus on corporate compliance

Given the steady increase in corporate governance and other regulatory requirements with which companies must comply in Europe and beyond, compliance has become a key issue on the agenda of large companies and their general counsel. In the new corporate climate, where investor confidence needs to be ensured and reputational and other damage avoided, compliance must not only follow the letter of the law but also the spirit

of the law. A robust compliance system must have as its objective that breaches or violations of law and regulations (and their spirit) remain a one-off difficulty and do not constitute a systemic failure.

Establishing such a compliance culture requires, among other things, that a company:

- Is willing to enforce its controls to create a sense of accountability.
- Regularly reviews its compliance systems.
- Creates a "lessons-learned" culture, that is, analyses wrongdoing and failures or possible weaknesses of its compliance system, to change and improve internal controls and procedures.

Functions of an independent investigation

Independent investigations are a flexible, sophisticated tool which can be used to examine complex fact situations. Provided that an investigation is both independent and preserves legal privilege (*see below Key prerequisites of an investigation*), it also can be used to effectively complement a corporate compliance system. In particular, it can:

- Discover weaknesses in existing compliance procedures.
- Ensure that compliance procedures remain up to date and are modified in response to changing regulatory and other conditions.
- Make sure that wrongdoings and other violations of regulatory conditions or the governance regime remain one-off difficulties and do not become systemic failures.
- Help prepare for litigation or arbitration.
- Give a clear sign that a company's compliance rules are taken seriously when a violation of regulatory or other rules has been discovered or is anticipated.

In addition:

- Independent investigations, particularly when used for enforcement purposes or to "learn" from failures, can create transparency and, as a result, improve the compliance culture in a company, as well as mitigate the dangers of reputational damage which can be caused by corporate scandals.
- Certain European and other financial authorities (such as the Financial Services Authority in the UK) may take into account company conducted internal investigations as part of their programme of oversight and enforcement of financial regulatory compliance.
- Depending on the circumstances and jurisdiction involved, the results and findings of an internal investigation may be used to co-operate with the relevant authorities and, as a result, the company may qualify for leniency (*see box, Royal Ahold*).

For reasons such as these, more and more European companies are considering the option of conducting an independent investigation or a review of their controls and compliance systems. The number of such companies looking at independent investigations as a tool to improve and strengthen their compliance systems is likely to increase in the future.

Key prerequisites of an investigation

For an internal investigation to fulfil the above functions (*see above Functions of an independent investigation*), it must be:

- Carried out independently.
- Covered by legal privilege.

Independence

A company contemplating an investigation might initially be drawn to conducting it using an internal audit team composed of, for example, in-house counsel or the internal audit department. After all, an internal investigation can be very disruptive for a company, particularly because:

- Investigating lawyers and accountants might be viewed in a prosecutorial role.
- Retrieving e-mails and other data from employees (*see below Conducting an investigation*) can be perceived as threatening.
- Extending the investigation to home computers and private laptops can easily have an alarming effect.

However, in addition to the fact that, depending on the jurisdiction, the findings of in-house counsel may not be protected by legal privilege (*see below Legal privilege*), it is worth remembering that any internal audit team:

- May be involved in the problem requiring an investigation in the first place.
- Remains subject to instructions of the board or management.
- Is always affected by a company's internal politics.

On the other hand, the use of external investigators detaches an investigation from internal company pressures and politics, which is important in the context of information gathering and evaluating findings. Such independence has the best chance of the findings:

- Satisfying a regulator.
- Convincing shareholders.
- Being an authoritative basis for management to implement corrective measures and enforce change.

Using external parties also provides more flexibility in determining who is ultimately responsible for commissioning and supervising or co-ordinating the investigation. For instance, if there is reason to believe management is implicated in the matter being investigated, the non-executive directors or the independent audit committee can instruct external investigators instead of the company.

To establish a lessons-learned culture, the findings and advice of external parties often carry more authority and can be more direct, because external parties do not have to fear any internal consequences for their career in the company.

Legal privilege

The availability and existence of legal privilege is probably the single most important reason for conducting an independent investigation. Legal privilege provides considerable assurance that the findings of an investigation are not immediately available to, or accessible by, the relevant authorities. In addition, it can also help a company in the preparation of possible or threatened litigation.

Under the protective umbrella of the legal privilege, a company can also engage in a thorough investigation to get to the bottom of an issue. Only with protection from compulsory disclosure can a company freely analyse the reasons for the alleged wrongdoing, criminal conduct and so on. Of course, if for other reasons, such as co-operation with the authorities (as was the case in Royal Ahold (*see box, Royal Ahold*)), a company wants to waive the privilege, it can do so. However, at least in principle the company retains control over whether or not it wants to do so.

Structuring an investigation

A properly structured independent investigation will almost always:

- Investigate alleged wrongdoing or perceived weaknesses of a company's control systems.
- Form the basis for the company to take remedial action and corrective measures.

When undertaking an independent investigation, consideration must be given to the particular legal and other requirements in the jurisdiction concerned, as they will impact on the structure of the investigation and how it is carried out. In addition, thought should be given to:

- The reasons for the investigation.
- Securing legal privilege.
- Securing independence.
- Other structural issues.

Reasons for the investigation

In many highly publicised cases such as Enron, WorldCom and Royal Ahold, allegations of accounting fraud were the reason for conducting an independent investigation. While accounting issues continue to be an important reason for such an investigation, there are, of course, many other reasons why a company may consider one. These include:

- Allegations of wrongdoing or criminal conduct by employees.
- Government inquiries or threatened private litigation.
- Failures of large projects.
- Perceived weaknesses of a company's internal control and compliance system.

The subject matter as well as the triggering event for an investigation have an important effect on its structure. For example in the case of Royal Ahold (*see box, Royal Ahold*), the purpose of its independent investigation was to pre-empt investigations and enforcement action by the SEC against the company. In a case like this, the investigation must be structured and carried out so that the regulator can rely on its findings. In most cases this means the regulator's standards must be applied, that is, the investigation must be expansive and its results must be detailed, true, credible and conclusive in all aspects.

However, if impending regulatory action is not the main motive, an investigation with a narrower focus and with a less intrusive impact may be more appropriate. For example, a company may just want to analyse its internal compliance structures and organisation, in which case the investigation would take on the form more of a general review. This may mean, for instance, fewer witness interviews and a more limited, or perhaps even no, e-mail review (*see below Conducting an investigation*).

Who the findings are addressed to can also vary, depending on the purpose of the investigation and the desired result. For instance, the recent accountancy fraud investigations were commissioned by, and the concluding reports were addressed to, a special committee or the audit committee of the board. In other cases, where the main purpose of an investigation is to analyse past mistakes, it may be more appropriate for the executive management to commission the investigation. Management is then responsible for taking remedial action, such as changing or improving internal procedures.

Securing legal privilege

Legal privilege is one of the most important considerations in structuring an investigation. This concerns lawyer-client privilege as well as attorney work product and similar doctrines to protect documents prepared by lawyers in anticipation of litigation.

Privilege issues are complex, particularly if an investigation spans several countries and the definition and conditions of legal privilege vary in the jurisdictions concerned. Depending on the jurisdiction involved, the availability of privilege may be the decisive factor in choosing external as opposed to in-house counsel, since

external lawyers are more likely to be able to provide privilege.

However, despite the importance of confidentiality and privilege, the investigation and its findings may still be disclosed externally. In fact, as the Royal Ahold case shows (*see box, Royal Ahold*), it can often be important for the company to make the results of the investigation available to the regulatory authorities. This can raise interesting questions, such as whether privilege can be maintained despite disclosure to a regulator, even if the disclosure is subject to a confidentiality agreement between the regulator and the company.

It is not contradictory to structure the investigation so that privilege can be maintained, even if one of the primary reasons for the investigation is possible later co-operation with the relevant authorities. The key is to retain for the company the possibility of deciding whether and under what circumstances it wants to disclose the investigation's findings. In particular the company may consider:

- Making disclosure subject to certain conditions.
- Who it is going to make disclosure to.
- The timing of disclosure.

These issues require a careful decision, which can only be made when the full results of the investigation are known. Privilege must be maintained until this point is reached.

Securing independence

If a company decides that an independent investigation should be carried out, one of the key issues to determine is who should conduct it. Again, this will be affected by the reason for the investigation. While external lawyers are often engaged to conduct such investigations, if accountancy irregularities are an issue, an external accounting firm will almost always be involved. Depending on the jurisdiction, the company's outside lawyers may be required to retain the accounting firm, to maximise the chance of the latter's work being covered by privilege.

Other structural issues

Before beginning the investigation, it is also important to define the relationship between the investigators and other company participants. In particular this concerns the:

- Co-ordinator within the company; this may be the in-house counsel or the internal auditor or controller.
- Compliance officer.
- Company's data protection officer, given the need to process electronic data as part of the information gathering and review process.

The reporting lines and relationship between the client (the audit committee, management, or others) and external counsel need to be structured accordingly. This determines the scope and, therefore, the mandate of the investigation.

Thought also needs to be given to the form of the product that will be the result of the investigation. Privilege and confidentiality issues and possible co-operation with the relevant regulator are some of the main things to consider here. For instance, the company may decide that the results of the investigation should only be presented in oral form.

Distinctions also may need to be made in relation to the disclosure of the findings. For instance, the audit committee of the board would normally receive a full written report, while senior management may only be presented with the main findings of the investigation.

Conducting an investigation

In independent investigations such as those at WorldCom, Enron and Royal Ahold, core components of the

process involved:

- The collection, organisation and analysis of company documents including electronic documents, notably e-mail correspondence of company personnel.

- Extensive witness interviews.

However, before taking these actions, investigators must work with the company to determine the scope and type of information required. This in turn will depend on the subject matter and purpose of the investigation.

The company must consider both:

- What information is or can be made available.

- Who inside the company can and must be approached to obtain and disclose the required information.

If accounting fraud issues or other wrongdoing or non-compliance are the subject of the investigation, the company must consider whether any executives or employees may be implicated. This influences the way information is obtained about the subject matter of the investigation and these particular individuals. Above all, the conditions for creating and maintaining legal privilege must be observed throughout the investigation and for any investigative measure.

How an independent investigation is conducted is in itself a good test of a company's compliance culture. It is obviously critical for the value and credibility of the investigation that it is conducted in strict compliance with any applicable laws and regulations. Findings must not be based on any material obtained improperly. At the same time, both the company and the investigating external agents have an interest to secure as broad a basis as possible for the investigation.

Company documents

The factual basis for the internal investigation must be as broad as possible. This requires an exhaustive and systematic collection of all relevant documents, including documents in electronic form such as e-mails. As a first step, the company's usual document retention procedures must be reviewed, to make sure that potentially important documents remain available during the investigation.

As soon as a company learns of possible irregularities and breaches of the law, it must in any case look at its document retention procedures. If there are policies providing for the routine destruction of documents after a certain time, these must be reviewed critically. Depending on the requirements in a given jurisdiction, any routine destruction of documents will probably have to be suspended until further notice.

E-mail correspondence

With the current popularity of e-mail as a tool of corporate communication, an important source of information for any investigation is e-mail correspondence. This creates a number of issues relating to:

- **Retrieval of e-mails.** Before e-mails (and other electronic documents) can be reviewed, they must first be retrieved. Usually, this is done by copying data from a company's and key individuals' servers, hard-drives and computers (including home computers) onto external storage devices for counsel to review. Ideally, the company and relevant employees should not have a chance to select or deselect any e-mails or other electronic records before the retrieval process starts.

  The most efficient way to ensure data integrity is to retrieve e-mails and other electronic documents through a so-called imaging of servers, back-up tapes, hard-drives and computers. This means that a mirror image of these storage devices, representing a true copy at the time of retrieval, is produced and made available to the investigators. If circumstances require, individuals' home computers may have to be included in this process.

- **Review of e-mails: data protection and employment law.** The following issues arise:

  - retrieval and review of electronic data and e-mails may in many European countries constitute

data processing and, as a result, must comply with applicable data protection laws;

- reviewing employees' e-mails can also intrude into individuals' privacy, so compliance with applicable privacy laws and regulations must be ensured; and

- retrieval and review of electronic data in the workplace may also fall within the scope of labour and employment laws and regulations.

These issues impact on the extent to which electronic documents can be used in the investigation. Involving a company's data protection officer and, if appropriate or required, employee representatives (particularly in jurisdictions with statutory employee co-determination) can help to ensure compliance with all applicable laws, particularly when data are processed by electronic means rather than manually.

Witness interviews

The most important source of information in any investigation is likely to be that which can be provided by relevant employees and officers. Although documents may be the starting point of an investigation and the basis for preparing interviews, it is often the interviews that show how a company's rules have been followed in practice.

Investigating counsel must be given the chance to meet face-to-face with the relevant managers and employees individually. The investigators must be free to decide whom they want to interview, to preserve the independence of the investigation.

As a practical matter, interviews should only be conducted after the investigators have acquired a basic understanding of the subject matter of the investigation. Depending on the course of the investigation and information obtained from other sources, certain key individuals may have to be interviewed a number of times.

It is important to make clear to the witness right from the start that the investigating counsel does not represent the employee-witness and that the interests of the company and of the witness may conflict. As a result, a witness may want to consult his own lawyer and request his presence during the interview.

A related and equally important issue is clarity about privilege. The witness does not have any rights to privilege and confidentiality over the contents of the interview. This remains with the client of the investigation, for example the audit committee or the company. This could mean, for instance, that the contents of the interview may later be disclosed to a regulatory authority as part of the company's decision to co-operate, and this must be understood by the witness. These and possibly other local jurisdictional issues must be taken into account when structuring and preparing for interviews.

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Royal Ahold

In 2003, the US Securities and Exchange Commission (SEC) charged the Dutch global food retail company Royal Ahold (Ahold) with fraudulent conduct, resulting in overstatements of sales for 1999 to 2000 of about US$26 billion (about EUR21.5 billion) and operating income of about US$1.1 billion (about EUR909 million). In a precedent-setting settlement with the SEC, Ahold was charged no monetary penalty. The SEC did not seek such a penalty because of the company's "extensive co-operation with the Commission's investigation" (*see SEC Litigation Release* (*No 189292, 13 October 2004*)).

Ahold self-reported the misconduct and carried out an extensive independent internal investigation. The company's audit committee began the investigation by retaining external accountants and lawyers. During the investigation, which lasted 20 months, Ahold took remedial action by correcting and adjusting its internal control and compliance systems. Significantly, the company also made available to the SEC staff its investigation reports and supporting information, and waived lawyer-client privilege.