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Managing an Internal Corporate FRAUD Investigation and Prosecution

Routine reports of corporate malfeasance, jury verdicts against formerly untouchable senior officers, the emergence of a new cottage industry in corporate compliance—all spawned by the collapse of Enron and fueled by the enactment of Sarbanes-Oxley. The business of corporate fraud and white collar crime has risen to new heights.

Now more than ever, in-house counsel should know how to properly investigate and pursue internal allegations of fraud, theft, and corporate malfeasance. Otherwise, counsel may find themselves on the wrong end of the next audit committee inquiry, an inquiry focused not on the underlying problem, but on how in-house counsel responded to it. In this atmosphere of intense scrutiny, no one is safe from criticism.

The bad news is that lying, cheating, and stealing are as old as mankind, and fraudulent schemes come in many shapes and sizes. They are as creative as the sinister minds that dream them up. The good news is that, from an in-house counsel's perspective, the proper approach to investigating and handling such schemes is consistent and almost formulaic. This is true despite the fact that a surprisingly wide array of legal expertise comes into play when addressing corporate fraud: civil and criminal litigation; corporate governance and compliance; employment law; insurance coverage and recovery; corporate finance and regulation; and tax law, among other areas.

Aided by a hypothetical example,[1] this article spells out the steps in handling a case of theft or corporate malfeasance -- from initial detection and internal investigation, to criminal and civil prosecution, through post-prosecution review of better controls and remedial safeguards. A few simple suggestions can help you avoid the common problems that arise in such cases and manage the matter in your position of responsibility.

Typical Fraud Scheme

Mark was doing well in his career. He was a valued and trusted senior officer of the company, having worked his way up the corporate ladder over two decades. He now enjoyed the title of senior vice president of finance of one of the company's most profitable divisions. Sure it was a lot of responsibility, but Mark liked his job.

The problem started when Mark caught up with a college buddy who was the CFO at a similarly sized company in the mid-west. His friend was making triple what Mark was making and with far less responsibility. It was just wrong! Mark made the added mistake of mentioning the discussion to his wife, Ashley. Admittedly, the timing was bad since Mark and Ashley had just agreed to forgo buying that great beach-front property from Ashley's parents, and college tuitions would start soon for his twin daughters. Just an extra $100,000 per year in income could make the difference between a comfortable existence and a stressful life.

It was with this thought that Mark went to work the next day. He started his daily business of overseeing the financial operations of the company. This included such complex projects as reviewing the finances of major merger targets, along with such mundane tasks as approving invoices for endless outside vendors used by the company. Boy, was the company spending a lot of money on outside accounting and law firms! And those rates for the top partners—yet another group of professionals making more money than Mark. That's when he got an idea.

How hard would it be to dummy up a few invoices from an approved, but infrequently used vendor, submit them for approval, intercept the processed check, and deposit it in an account opened using a fictitious corporate name? Who would notice, considering all the money the company spent last year? He would only do it once or twice, more as an experiment than anything else. Who would get hurt?

Ten years and $1.5 million later, Mark was now a highly paid senior officer, even without considering the tax-free nature of his "side" income. Colleges were paid for, he and Ashley owned a great condo in the Bahamas, and they had a nice stock portfolio for retirement. Yes, life was good until an accounts-payable clerk called the outside vendor about one of its recent invoices. It was an innocent inquiry, but the response from the vendor—that it had not performed services for the company in years—was unexpected.

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Initial Detection

Detecting Mark's scheme is the first step. The accounts-payable clerk had a few choices when she stumbled upon the suspicious information. She could have ignored it because rules enforcement was not a focus at the company. She could have shared the information with Mark, sensing that he was involved but not wanting to "get him in trouble." She could have been afraid to disclose the information based on the company's historical ambivalence toward corporate ethics or lip service to confidentiality protections surrounding the company's "anonymous" fraud hotline.

This is where written policies and procedures, and an effectively communicated compliance program, are necessary. Gone are the days that a company can rely on the auditors to detect wrongdoing. Companies must now establish a formal Code of Ethics/Conduct which is routinely updated and communicated to employees. The code should be formulated with the aid of outside employment counsel and emphasize the real protections afforded anyone who comes forward with information. An anonymous tip or hot line must be established and routinely published to employees, along with rules governing the confidentiality of the communication.

Also important are employment policies clearly stating that the company owns the communication systems used by the employee, including email and voicemail received and generated by employees. The policy should state that the company has the right in its sole discretion and without prior notice to monitor and review data composed, sent, or received through its computer systems, and that the monitoring activity may limit the level of privacy employees can expect.

A working and effective compliance program is also critical. Adopting systems for routine auditing, establishing mechanisms for reporting suspicious information, and creating a top-down atmosphere of strict ethical behavior so it becomes part of the company's core culture are all at the heart of a good compliance program. Such a program will help detect Mark's theft against the company at an early stage, or deter it all together based on an atmosphere of zero tolerance.

A good compliance program can be particularly important where the wrongdoing is not just a crime against the company, but one against the public at large. Change our

hypothetical from Mark embezzling funds to a small group of employees, led by Mark, illegally removing and disposing of large amounts of asbestos from a portfolio of commercial properties owned by the company. Or perhaps a key financial officer of a public company discovers he or she has been responsible for misstating the company's earnings and then decides to cover the mistake to keep their job.

In either case, laws have been broken and government prosecutors will be interested in whether the crime is an isolated incident of a few, or part of the core culture of the company. The answer may impact the level of criminal liability facing the company, and even whether senior management is drawn into the investigation and criminal charges.

The *United States Sentencing Commission Guidelines Manual*,[2] in conjunction with the *Federal Sentencing Guidelines*,[3] set forth the elements of an effective corporate compliance program. Summarily stated they include:

- prevention and detection procedures;
- high level of oversight;
- due care in delegating substantial discretionary authority;
- company-wide training and communications with periodic updates;
- auditing, monitoring, and reporting including allowing for anonymity and confidentiality mechanisms;
- consistent enforcement; and
- response and prevention.[4]

The 2004 amendments to the *Guidelines* now include a list of modifications synchronizing them with *Sarbanes Oxley* and the emerging number of public and private regulatory requirements.

An effective program under the *Guidelines* will help the company mitigate any potential fine range, in some cases up to 95 percent, if there is also prompt reporting to the authorities and non-involvement of high level personnel in the actual offense.[5] It can also help investigators conclude that the conduct was isolated, and not caused by the company's senior management. At a minimum, suspicious information, such as the call about Mark, will be reported to the appropriate compliance officer and the wrongdoing detected early.

In our hypothetical story, suspicions about Mark have been reported using the anonymous "hotline." Proper controls are in place for in-house counsel to monitor credible reports from the hotline. The information has been reviewed by in-house counsel, a few calls made, and internal financial records reviewed. It appears clear, at least initially and before talking with others within the company, that a stream of payments approved by Mark were never received by the vendor. Now what? The next few moves will be critical in conducting a proper and effective investigation.

The Investigation

The team investigating the situation should be carefully selected, usually a senior auditor at the company, someone from corporate security, in-house counsel, and other trusted individuals. They should have no conflict of interest (such as persons reporting to Mark might have) that could in any way impact their neutrality or judgment. They will gather documents and evidence, interview employees and perhaps outside vendors, and pursue all leads to determine the extent of the wrongdoing.

It is important that the investigatory team starts with an open mind, and not let preconceived notions of what the facts might be dictate the conclusions reached. Memoranda generated should avoid using the term "fraud," "theft," "cover up," "incompetency," or other conclusory terms, and files should be labeled using similarly neutral language. Investigative team members should be reminded that they are "writing for publication" so they should avoid vindictive remarks or other personal commentary and record just the facts. Final conclusions should not be expressed until after the suspected employee's response to the charges has been obtained and evaluated.

The investigating team must keep in mind at all times that civil litigation, and perhaps a criminal referral, will follow almost inevitably from the work they do. Investigative findings, comments and opinions about mistakes made by the company, theories of wrongdoing that do not pan out, and suspicions against employees that are never substantiated—a more sensitive group of documents can hardly be imagined. Therefore, all reasonable steps should be made to maximize the privilege protections of this information.

In that regard, it is imperative that the company document at the outset that the investigation is being launched and overseen at counsel's direction. All subsequent requests for action should come from a lawyer in writing to maximize the protections afforded. In this way, counsel can oversee the investigation while also watching out for the broader interests of the company.

The company should consider directing the investigation through *outside* counsel to avoid any confusion over the multiple roles often played by in-house counsel. Investigative material, including opinions and conclusions reached by the team, must be labeled as privileged, and separate files should be maintained to segregate the privileged material.

Although the initial information from a routine audit or an anonymous tip is not likely afforded privilege or protection under the work-product doctrine (because it was not gathered at the behest of an attorney or because litigation is pending), subsequent information may be protected

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from discovery if any future investigation is properly handled.[6] The courts will look to the level of involvement of the attorney in directing the investigation or audit.

How likely is it, really, that the facts of the case and statements can be protected from disclosure in subsequent civil litigation? The work-product doctrine generally protects only mental impressions, conclusions, opinions, or legal theories of an attorney.[7] Thus, purely facts or statements, regardless of whether an attorney collected them, are usually not afforded protection under the work-product doctrine.

The facts, however, may be protected under the attorney-client privilege. To assist in thwarting later legal challenges, counsel overseeing the investigation should make every effort to create a paper trail showing that the reports and/or facts derived from the investigation were created:

- for the purpose of securing legal advice;
- by an employee who was acting at the direction of a supervisor;
- at the direction of a supervisor who sought the information to obtain legal advice for the corporation;
- within the scope of the reporting employee's corporate duties; and
- solely for the eyes of those persons within the corporate structure who need to know the information.[8]

Confronting the Suspected Employee

Confrontation of the employee needs to be carefully planned, witnessed, and documented. It should occur at the end of the investigation when all other available facts are gathered. At the interview, the employee's response or "story," including any admissions or concessions, must be documented. This may involve asking the employee to sign a written statement with the account provided. Depending on how the situation develops, this evidence can prove invaluable in later civil or criminal proceedings. It can also prove useful in defending against later complaints of the employment action taken by the company.

Using investigatory resources to learn background information about the suspected employee prior to the interview is an effective tool that should be used cautiously. If there is a legitimate, non-discriminatory basis for personal background investigation (*i.e.*, asset and real property search, court records, etc.) because the company has a good faith basis to believe the employee has engaged in criminal conduct and the investigation will further help determine whether the suspicions are true, then proceeding with the investigation may be warranted. Watch for particular state privacy laws and provisions of the *Fair Credit Reporting Act*[9] to ensure you do not run afoul of existing law. Use good judgment as to whether investigative tactics (including those of third parties hired by you) are appropriate. If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all. Make sure to tailor the information sought to a legitimate business purpose in furtherance of the investigation; don't go on a fishing expedition.

If the employee raises new information in the interview that requires further investigation, but the company is concerned about retaining the employee in active status, he or she can be suspended with or without pay pending completion of the investigation. If the employee refuses to cooperate with the investigation, he or she should be reminded that cooperation is an essential function of the job and a failure to cooperate may provide an independent basis for discipline, including termination. Carefully drafted Codes of Conduct or implementing policies will specifically address this issue so the independent basis for action will be clear. Similarly, they will make it clear that retaliation against any other company employee participating in the investigation is strictly prohibited and will serve as an independent basis for action.

When should company counsel advise Mark that he should consult with private counsel? While this is an issue on which in-house counsel may differ, our perspective is not until the confrontational interview has been held. Until that point, it may be argued that the company does not yet have the employee's side of the story, so a final determination of culpability has not yet been reached. Once the employee has answered questions, given his statement responding to the charges, and provided whatever other information that may prove useful to the investigation, it may well be in the company's interest to have the employee engage experienced counsel. Care should be taken, however, to make it clear to the employee that counsel interviewing him/her are counsel to the corporation and not the employee by providing the employee with the "corporate Miranda."[10]

One factor in deciding how to approach the employee will be whether the company needs him or her to address the wrongdoing going forward—such as when a key financial officer is in a unique position to reconstruct the misstated earnings in past financial reports. Will cooperation be forced or voluntary? How badly does the company need the targeted employee's help to further investigate the extent of the fraud or correct the damage? Is the employee at the center of the scheme or a lesser player? These questions must be addressed in formulating your approach.

Action Based on Investigative Findings

Your investigation is complete, you have confronted the employee, obtained whatever helpful information may be gleaned from the employee, and the investigative team has reached the conclusion that fraud has been committed. Once the company has confirmed that wrongful conduct has occurred, action must be taken.

Options for handling the employee include disciplinary action short of termination, suspension with or without pay, or termination. Before communicating the decision to the employee, make sure that an experienced employment lawyer reviews the basis for it. The company must be able to comfortably articulate a non-discriminatory business reason for the decision—preferably something that the average person would understand and accept as reasonable.

The decision and the basis for it should also be communicated to company officers, the board, the audit committee, and any key supervisors. Throughout the investigation, be prepared for an emotional reaction from the company's senior officers or board—anger, frustration, or even an irrational demand for a course of action that is not in the best interests of the company. In-house counsel must manage these issues carefully so that cooler heads prevail.

Until now, things have been handled with great confidentiality. But news of the employee discipline or termination cannot be contained and the company is wise to consider the nature of any response to the natural questions that arise. At this point, the company must decide how to handle the public relations aspect of the situation, at least internally. A consistent message must be formulated and used by management.

Insurance Coverage

In the midst of handling a fast moving internal investigation, containing the information within the company, and absorbing the emotional body-blow of learning that one of your own is a thief or liar, it may be easy to forget the steps needed to preserve the company's insurance rights. After all, this is not a slip and fall claim which would naturally trigger in-house counsel's focus on insurance. The company's risk manager may not even be part of the investigative team. Failing to take proper action relative to insurance can be a costly mistake, one the second-guessers will seize upon to lay blame when the dust has settled.

So when do you act and what do you do? It depends on the language of your policy and outside coverage counsel should be consulted. Generally speaking, the answer is:

> When you know of circumstances that could form the basis for a company loss, in-house counsel should promptly notify the company's risk manager and all brokers handling the company's insurance and bonding policies.

Counsel must follow up with these brokers or directly with the carriers to insist upon *written confirmation* that the necessary parties have received proper notice.

A typical error is trying to determine which policies might provide coverage and narrowing your list of parties to be notified. With the complexity of insurance coverage these days, this is a mistake. Insurance policies that may be triggered include the company's general liability policy, commercial crime/fidelity policy, commercial property policy, and perhaps even an employee fidelity bond. The usual insurance policy conditions to keep in mind include:

- the requirement that the insured provide timely notice of the incident;

ACC Extras on...Employee Law, Embezzlement, and Fraud

- *Internal Fraud: Weeding out the Enemy*
  - Practical Law Article—International Resource
  www.acc.com/resource/v4649

- Indicia of Corporate Fraud
  - This **quick reference** includes a list of pointers to consider when dealing with internal fraud concerns.
  www.acc.com/resource/v3685

- *Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud*
  - This *ACC Docket* article covers 10 red flags you need to be aware of when on the lookout for financial mismanagement and corporate fraud.
  www.acc.com/resource/v7714

- the insured's obligation to provide a high enough level of cooperation with respect to the insurer's investigation; and
- the requirement that the insured should avoid committing any act which could prejudice the insurer's ability to subrogate the claims against the culpable parties. Exclusions often seen are claims for fines, sanctions, and penalties, and also claims arising out of any dishonest, fraudulent, criminal or malicious act, or omission of an insured.

As discussed later in this article, the company at an early stage will have already engaged its own outside counsel to investigate the fraud and perhaps commence a civil action against the wrongdoers. This may well be at odds with insurance policy language, which gives the carrier input or even control over the selection of counsel to pursue the loss. The problem arises because the normal insurance loss involves a past event impacting a simple monetary claim that can be quantified and assessed.

But allegations of internal malfeasance are different. First, the company does not usually know whether it has suffered a loss, or the extent of the loss, until a thorough investigation has taken place—an investigation that for a wide array of reasons should occur under the watchful eye of the company's hand-picked outside counsel. Second, investigation of the claim is fast-moving and complex, it is not conducive to the delays associated with insurance carrier dealings, nor is it of a nature to be handled by a panel counsel insurance defense lawyer. And lastly, there is more at stake in an internal fraud situation than the actual monetary loss—company exposure to allegations of criminal wrongdoing, government compliance obligations, internal employment and HR issues, public image, and business risk issues, etc.

It is for these reasons that we advise companies to select and move forward with the outside counsel of their choice with respect to conducting the investigation, and address later any complaints of insurance carriers over what attorney was selected. We acknowledge that a dispute over the selection can arise with the carrier but, in our experience, rarely does if counsel is selected with experience in such matters.

Indeed, in cases where an insurance claim has been paid and the loss subrogated, we have never seen a carrier reject the continued retention of the original counsel selected by the company (normally a firm that has been involved for months in developing the complex facts and evidence supporting the claim). So long as the company is providing a sufficient level of cooperation and communication with its insurers, the issue can usually be resolved on an amicable basis.

Civil Litigation

At the core of most employee theft cases are common law claims for fraud, conversion, breach of fiduciary duty, as well as statutory violations such as racketeering. Obviously, maximizing the likelihood of recovering at least some of the stolen property or locating other assets to be seized is at the heart of this strategy. But early litigation also provides a mechanism for obtaining provisional remedies such as temporary restraining notices, orders of attachment, or accelerated motions for other preliminary injunctive relief. Assets can be frozen and important evidence preserved.

Indeed, a number of benefits can drive the company toward litigation as a necessary strategy. For better or worse—in cases of this type—message-sending plays a role in the process. Mark has stolen seven figures from the company and everyone is watching to see how it is handled: Anything less than an aggressive response can be viewed as weakness and an invitation for future trouble.

And then there are the criminal authorities to consider. How significant was the criminal wrongdoing later referred to the government if it was not sufficient to warrant a civil action? The investigators and prosecutors want to know that the company takes these matters seriously. The presence of a timely and aggressive civil action helps to answer any doubt in this regard.

Others are watching, too. The board, audit committee, and shareholders are looking to ensure that the company does everything within its power to recover stolen corporate property or right other wrongs. Among them are the company's insurance carriers which may later seek to pay a claim of loss and subrogate in the civil action. Those involved in that decision and later civil prosecution want to know that their insured was diligent in taking appropriate action. These are among the many considerations in commencing a civil action.

As the case proceeds, the company may well face the question of whether to settle with one individual and "flip" them to secure valuable testimony against another involved in the wrongful conduct. This strategy almost always comes into play. The question of when, with whom, and under what circumstances should the company agree to settle their claims with one wrongdoer is dependent on the circumstances presented.

No doubt, the company has much to offer in terms of avoiding protracted civil litigation, and the cooperator has something of value in return, since proving fraud presents a host of challenges and direct testimony of the scheme can be very helpful. This is where the defendant's selection of experienced criminal or civil counsel will help negotiations and a sensible resolution. Less experienced

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counsel often cannot see the "end game" and the larger problems facing his or her client.

At some point toward the end of the civil case, the company will be forced to answer the question of what it needs to settle the claims. Interestingly, the answer to this question is almost always the same. The common elements to any settlement involving claims of employee fraud and wrongdoing are:

- admission and contrition;
- confirmation of scope of wrongdoing;
- compensation, symbolic or otherwise;
- cooperation in pursuit of other wrongdoers; and
- conditional release with protections for later default.

Disclosure of Scope

Part of the purpose of the lawsuit is to use discovery to confirm the extent of the wrongdoing. This element of settlement can be among the most important to obtain. If the company is not satisfied they have received it, settlement discussions should break off. The company simply must know the extent of the scheme and that the actions being taken will fully address it: Any suggestion that some of the cancer remains should be unacceptable to the company and its counsel.

Of course, criminal prosecution cannot be threatened as a means to settling a civil claim.[11] If the company has elected not to pursue criminal charges, the parties can proceed right to the interview. But if a criminal investigation is pending, how can the company obtain the type of candid disclosure mentioned above without appearing to be leveraging one action against the other? The answer is timing. The settlement of the civil action can be conditioned on the disclosure and interview needed.

A deal can be struck while the criminal case is pending that an interview will follow once Mark's criminal liability has been addressed. With a criminal case pending, the settlement agreement can provide that a failure to participate fully in the interview will revive the civil claims and trigger large financial penalties. Part of Mark's motive will be to appear cooperative with the company to the criminal authorities.

How can you know if the disclosure is complete and accurate? First, by the time the interview is held, your investigating team should have a very good understanding of what happened. Witnesses should have been interviewed, documents collected, witness statements taken. Whether the story Mark tells "rings true" and is consistent with the other evidence is the first way to check the disclosure. The second is, where legally permissible, by use of a lie detector test, which, by and large, is remarkably effective in confirming the information.

Make sure to select a reputable examiner, preferably someone who the government authorities rely upon. An excellent website is maintained by the American Polygraph Association (APA),[12] which allows for a database search of members by geographical area. According to the APA, "a valid examination requires a combination of a properly trained examiner, a polygraph instrument that records as a minimum cardiovascular, respiratory, and electrodermal activity, and the proper administration of an accepted testing procedure and scoring system." Some states have an official licensing procedure but many do not.[13]

Mark's criminal or civil counsel may wish to weigh in. The better examiners are known and respected by the criminal defense bar, so selecting an expert should not be difficult. Again, timing can address the issue of coordinating the examination with resolution of the criminal case so that Mark is comfortable answering questions. The civil settlement should provide that a failure to properly pass the test unwinds the settlement and leaves the company able to pursue its civil remedies.

One final thought regarding lie detector tests: The company should avoid the temptation to rely on them to investigate the charges. Use the test solely for securing compliance with the terms of settlement. This is because *The Employee Polygraph Protection Act* of 1988 (EPPA)[14], forbids adverse employment action against an employee refusing to take the test. Asking the targeted employee to take an exam will restrict the company's ability to terminate him later without opening the door for counter charges that the lie detector results played a role in the decision.[15]

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Compensation

The ultimate sum settling the civil claims is a function of:

- the amount stolen;
- the impact of the theft on the company;
- the level of culpability of the wrongdoer;
- the total financial net worth of the employee and his or her spouse; and
- a cold assessment of what assets are subject to judgment execution in the civil action.

The settlement amount is, to some extent, a symbolic figure designed to punish as much as anything else. Of course, if the loss has been paid by the carrier and the claim subrogated, the carrier will be involved in fixing or at least accepting the settlement sum.

Cooperation

Usually the resolution of the civil action occurs in pieces, with one of the wrongdoers flipping early and others continuing to litigate. Perhaps Mark was working with someone at the outside vendor's accounting group and they were sharing the ill-gotten gains. No matter, an important element in settling claims with the first party who flips is that they will cooperate fully in any existing or future civil litigation.

In order to minimize the bias arguments that will inevitably arise in later litigation, counsel is wise to secure a comprehensive sworn statement of facts which establish and preserve key testimony of the cooperating party as part of the civil settlement. Cooperation means participating in the civil action willingly and honestly, not fabricating testimony just to be helpful to the company.

Conditional Release

The release given in the civil settlement must be conditioned upon the promises and representations by the employee discussed earlier (*i.e.*, passing the lie detector test, honest disclosure of scope, accurate personal financial disclosure, and cooperation with subsequent investigation and post mortem review). Default in meeting any of these obligations should include the right to unwind the settlement even if the claims would otherwise be time barred. They should also carry with them the right to some additional financial penalties to further ensure compliance.

As discussed in this article, a civil settlement has many moving parts and may appear more complicated than it is. Settlements of this type are almost formulaic in that companies always want the same things and the points of leverage are the same against the offending parties. An outside counsel with experience in this area will have the necessary sample documents as you frame your approach.

Government Notification and Referral

There is some debate as to whether a company has an affirmative duty to report internal criminal activity of its employees if the conduct does not violate other laws or regulations governing the company.[16] The comment to ABA Model Rules of Professional Conduct Rule 8.3 suggests that attorneys should "encourage a client to consent to disclosure where the prosecution would not substantially prejudice the client's interests." State laws may demand reporting, and a wide array of regulations governing a company's operations may mandate it as well.

There is, of course, risk whenever the government is contacted about internal company activity. Government investigators and prosecutors are not prone to taking direction from in-house counsel or anyone for that matter. An innocent referral can lead anywhere, including to the prosecution of company employees or vendors not originally considered part of the wrongdoing. And of course, it can lead to the company itself becoming the subject of an investigation. These issues must be carefully addressed before the referral is made and other regulatory agencies are notified.

For these reasons, part of counsel's ongoing assessment is to look at the fraudulent activity from an outsider's perspective—asking whether there are other victims of the criminal activity besides the company and/or whether there are other regulations violated. What if Mark's dummied invoices were from an environmental testing firm that was charged with ensuring that toxic material was properly handled? Years of forged invoices were generated while Mark was supposed to make sure that proper testing and disposal occurred. Now the company has two issues to investigate—how much did Mark steal and was the testing performed?

Even if the company has concluded that the work was performed, the criminal referral will raise this same

question and the government will want it answered to its satisfaction. The company must consider notifying relevant government agencies in a manner that assures regulators that the situation is being handled responsibly. It is a delicate moment because the company cannot control the regulators' reactions. But ignoring the situation should not be among the options considered because it is a sure way to create suspicion and a negative reaction down the road.

On the question of timing, there is built in flexibility which allows the company to investigate the allegations first, before making a determination that criminal wrongdoing or regulatory violations have occurred. The last thing the company wants is to accuse an employee of a crime only to find later that it was wrong or it could not prove the charges (exposing the company to retaliatory claims of defamation, unfair employment action, or malicious prosecution). The investigation period gives the company time to take stock and make some strategic decisions about whether making a referral is warranted or desirable.

There can be a fair amount of strategy in making a successful referral including evaluating whether one is warranted, addressing issues of selecting the prosecuting agency, addressing which regulatory bodies should be notified and in what manner, deciding when to make the referral, determining the key point of communication for the company, and setting the tone for the aggressiveness of the referral as a victim of the crime.

In making a referral, counsel must be prepared for a complete and unrestricted look at evidence gathered from the investigation. This is so because asserting any claim to privilege, while well within the company's rights, will be viewed as uncooperative. The US Sentencing Commission voted in March 2006 to eliminate the language from the Federal Sentencing Guidelines that required corporations to waive the attorney-client privilege if they wanted to earn credit for cooperation. Even with this change, however, companies should be prepared for the government's assumption that the privilege will be waived and the prosecutor's negative reaction if it is not. The last thing the company wants is to raise questions in the government's mind as to its own level of cooperation and involvement in the wrongdoing.

Properly managed, a criminal referral will minimize the chance that the government will blame the company for the acts committed while also establishing a solid working relationship with the investigators and prosecutors. A strong relationship is marked by mutual cooperation and respect, a level of trust that the company is being forthright in disclosing information and addressing the situation, a diligent pursuit of the investigation and prosecution, at least periodic communication, and keeping a balanced perspective in terms of other priorities of the prosecutor's office and the company.

Admission and Contrition

It may sound trite, but after all the time, trouble, expense, and public embarrassment of addressing internal fraud and theft, companies often times insist on obtaining a formal admission of wrongdoing and an "I'm sorry" from the employees. With the amount of leverage involved, this element of settlement normally can be achieved rather easily. People in Mark's position usually have little bargaining position.

In most cases, the criminal authorities can be substantially aided in their investigation by the work already done by the company's existing legal team—particularly when the fraud is complex and document-intensive. Sharing information is an inevitable part of the cooperative relationship. The company must assume that information provided to the government will be later shared with the employee's criminal defense counsel, if it falls under Federal Rule 16 or constitutes *Brady* material.[17]

As discussed before, relevant fact-based records may be the subject of disclosure requests in later civil litigation. But the more sensitive documents to consider are the investigative reports which may be generated by the company's internal team or referral memorandum provided to the government which lays out the company's findings. Both documents are likely to contain opinions and conclusions, along with other potentially sensitive information such as lie detector test results and evidence which is critical of the company in allowing the malfeasance to occur. The company should review and consider the content of these documents before finalizing them for government review.

While the "defensive" thinking discussed above is part of making an appropriate referral, counsel should remember the numerous positive advantages of triggering a prosecution against the offending employee. On the plus side, the presence of a parallel criminal prosecution when pursuing civil claims is obvious. The civil case may be temporarily delayed or even stayed by the criminal case, but the resulting conviction can provide invaluable support in pursuing the civil action.

Many times, the elements of the crime admitted or forming the basis for the conviction are the same as in the civil litigation, giving the civil team irrefutable admissions

or even collateral estoppel/issue preclusion impact on key elements in the civil case. Huge savings in time and money can be achieved in letting the criminal case play out on a parallel course with the civil case.

At minimum, pressing the civil action during the prosecution of a criminal case can give rise to Fifth Amendment testimonial assertions which, in turn, generate valuable negative inferences in the civil action. An unrebutted negative inference can, under appropriate circumstances, provide strong evidence supporting a dispositive motion and an accelerated victory in the civil action.[18]

And of course, a pending criminal prosecution presents the opportunity to avoid the need for any civil litigation at all, when a monetary recovery is secured by way of restitution in the criminal case. The opportunity to avoid protracted and embarrassing civil litigation against the offending employee by obtaining a comprehensive Judgment of Restitution in the criminal case is no doubt appealing.

Setting aside these home-run impacts, the advantages of the company drafting behind a criminal investigation—with its much larger breadth and jurisdictional reach—is clear. Voluntary witness interviews, grand jury subpoenas, and the full weight of a state or federal prosecutor's office behind an investigation can help gather evidence at a speed and in a manner that cannot compare with the discovery mechanisms available in civil litigation.

Deciding where to refer the criminal complaint in terms of government agency depends on a number of factors including the nature and proof of the wrongdoing. In addition to the cold assessment of what state or federal laws have been broken, other considerations come into play including:

- jurisdictional reach of the prosecuting office;
- resource availability of that office;
- strength and reputation of the office in pursuing complex white collar cases; and
- the relationship the company and its outside counsel enjoy with the offices under consideration.

In making the referral, it is important to establish a clear and single line of communication between the company and the government. The best contact point is the lead company counsel overseeing the internal investigation, since it allows for the regular oversight of questions posed by the government, assurance that complete and accurate information is provided, and the ability to monitor the direction and scope of the investigation from a more objective vantage point.

The last point is one of timing and controlling information. On the theory that some control is lost once a government investigation is triggered, in-house counsel are well served to know as much as they possibly can before making the referral, first completing the entire investigation before referring the matter to those outside the company. Most investigations of this type—involving claims of employee theft or fraud—are conducted as a high priority item that is expeditiously handled by the internal investigative team.

As the investigation proceeds, in-house counsel should assume that the corporate rumor mill will eventually pick up that something is going on. The challenge is to conduct a complete investigation before filing charges of criminal wrongdoing, while not waiting so long that valuable evidence is lost or the company becomes the subject of criticism for not making a timely referral. Daily assessment of these competing goals must occur, with outside counsel assisting the senior decision-making team in terms of when to contact the authorities.

Remedial Steps—Can it Happen Again?

Typically, a company has spent six figures in detecting, investigating, pursuing, and fully addressing the wrongdoing. The matter has gone on for months, if not years, and there is enough embarrassment to go around. It is natural to want to close the case and move on. But counsel is well-advised to conduct a complete post-mortem of the events leading to the fraud.

The company's board and shareholders, the audit committee, corporate security, and the company's outside insurance carriers, among others, have a vested interest in understanding how Mark's scheme was able to be formulated and successfully carried out. What improvements can be made to avoid it ever happening again?

This is where securing Mark's post-resolution cooperation can be particularly helpful. If the criminal case ends in some form of plea deal and a good working relationship has been established with the prosecuting authorities, the company can often secure this type of interview as part of the restitution package. As discussed earlier, such a meeting should certainly be negotiated as part of any civil settlement.

And who better to advise you regarding what controls need adjustment than Mark, the person who found a way around them? This meeting should be held after all other aspects of the case have been resolved so that Mark feels comfortable speaking freely. Often, someone in Mark's position is relieved to talk frankly outside the criminal and civil proceedings.

Take advantage of the opportunity presented for real candor to get the most from the interview. Prepare your outline of questions so that you understand every step of

the scheme, what controls were compromised, and how the fraud was successfully perpetrated.

Once you have a full understanding of what happened, ask Mark what would have stopped him and what suggestions he has for improving controls. There is often a twisted pride in the accomplished theft and a desire of the wrongdoer to tell his secrets. Take advantage of it. Of course, others in accounting, operations, human resources, and elsewhere can be helpful in developing a short list of improvements to the company's internal controls.

Minimizing Risk Through Prudent Corporate Governance

Much can be learned from managing an internal fraud investigation and prosecution, as painful as such an experience can be. New controls and procedures can be identified, adopted, or improved upon. Lessons can be learned that can substantially improve the operations of a business.

In any organization, however, the human factor makes corruption a risk at any level—a risk that can never be fully eliminated. Because the complex machine of corporate decision-making ultimately boils down to people, there are no controls or safeguards that can 100 percent assure protection against greed. The best minds behind formulating new controls and firewalls can always be outsmarted by the criminal imagination.

The best we can do is minimize the risk through prudent corporate governance and operations, and be ready to take appropriate action when wrongdoing is suspected.

Have a comment on this article? Email editorinchief@acc.com.

NOTES

1. The "story" described below is a fictional account; however, it is loosely based on the post-conviction explanation of a senior corporate officer for his seven-figure embezzlement scheme carried out over a ten-year period.
2. Available at: *www.ussc.gov/2005guid/gl2005.pdf.*
3. 18 U.S.C. § 3553.
4. *See* UNITED STATES SENTENCING COMMISSION GUIDELINES MANUAL, § 8B2.1 *et seq.* (2005), available at: *www.ussc.gov/2005guid/gl2005.pdf.*
5. *See www.ussc.gov/corp/ORGOVERVIEW.pdf.*
6. *See First Chicago Int'l v. United Exchange Co. Ltd.*, 125 F.R.D. 55 (S.D.N.Y. 1989).
7. *See* Fed. R. Civ. P. Rule 26(b)(3) (2006) and your respective state's statute.
8. *Diversified Industries, Inc. v. Meredith,* 572 F.2d 596, 609 (8th Cir. 1977); *see, e.g., First Chicago,* 125 F.R.D. 55; *see, e.g., Harper & Row Publishers, Inc. v. Decker,* 423 F.2d 487 (7th Cir. 1970). Every precaution should be made to adhere to these points, especially the last one because dissemination of the information to a third-party with no need to know the information may constitute a waiver of the privilege.
9. 15 U.S.C. § 1681 et seq.
10. *See* MODEL RULES OF PROF'L CONDUCT R 1.13(a); see also *www.law.cornell.edu/ethics/comparative/index.htm#1.13,* for a comparison of each state's rule. To prevent ethical violations and/or disqualification from representing the corporation, before interviewing an employee, "Miranda" style warning should be set forth to the employee. The lawyer should ensure that the employee is fully aware of and understands the following vital points: that the lawyer does not represent the employee; that the employee's statements may not be privileged, especially when they relate to the organization's business; and that the employee is advised to obtain independent counsel.
11. *See e.g.,* MODEL RULES OF PROF'L CONDUCT R. 8.4 (2004); *see also www.law.cornell.edu/ethics/comparative/index.htm#8.4,* for a comparison of each state's rule.
12. Available at: *www.polygraph.org.*
13. For a list of licensing offices, see *www.polygraph.org/statelicensing.htm.*
14. 29 U.S.C. § 2001 *et seq.*
15. For a brief summary outlining the "checklist" for both employers and polygraph administrators *see www.polygraph.org/eppa.htm.*
16. *See, e.g.,* 18 U.S.C. § 4 (Misprision of Felony statute); *Shehorn v. Daiwa Bank, Ltd.,*, No. 96 C 1110, 1996 U.S. Dist. LEXIS 7905 (N.D. Ill. 1996) (applying 18 U.S.C. § 4 to corporations).
17. *See* Fed. R. Civ. P. Rule 16 (governing pretrial conferences, scheduling and case management); *see also Brady v. Maryland,* 373 U.S. 83, 83 S. Ct. 1194 (1963). In a criminal proceeding, evidence in possession of the government material to either guilt or punishment of the accused is deemed "Brady material." Any evidence that can be designated as such must be turned over to the accused in accordance with the Due Process Clause of the U.S. Constitution. While viewed by some as a broad form of additional discovery for the criminal defendant, it is actually just a narrow way in which an accused can obtain information bearing only on his guilt or sentencing.
18. *Securities and Exchange Commission v. Global Telecom Services, L.L.C.,* 325 F. Supp. 2d 94 (D.C. Conn. 2004); *see also, Willingham v. County of Albany,* No. 04-CV-369 (DRH), 2006 U.S. Dist. LEXIS 46941 (N.D.N.Y. July 12, 2006).