

Today's heated legal climate: What financial institutions should know about internal investigations

By Andrew J. Morris, Esq.

The collapse of the credit markets and the arrival of the Obama administration have transformed the legal climate. Financial institutions face an unprecedented level of government enforcement activity and a similarly historic surge in private lawsuits. In this heated environment, it is more important than ever for these institutions to recognize serious legal threats quickly and to address them aggressively by conducting strong internal investigations.

While the need for these investigations has never been greater, undertaking them has never been riskier. Government agencies have altered the nature of internal investigations by causing companies to investigate themselves in order, in many cases, to report their own wrongdoing to the United States or shareholders.

To adapt to this new climate, management should know how to recognize when an internal investigation might be necessary. It also should be aware of the steps in a typical investigation. And it should know that a poorly executed internal investigation can be worse than none at all. This article tries to assist managers of financial institutions by summarizing the who, what, why and how of internal investigations.

TODAY'S REGULATORY AND ENFORCEMENT CLIMATE

Financial institutions have been at the center of the ongoing wave of government investigation and enforcement activity. Regulators have, of course, hit hard at lending and financing practices, scouring the long chain of mortgage-related activities from beginning to end.

Other enforcement activity against financial institutions is similarly high. The Obama administration has beefed up key enforcement bodies. It created an Interagency Financial Fraud Enforcement Task Force that brings together the Department of Justice, the Treasury Department, the Securities and Exchange Commission, the Department of Housing and Urban Development, and

federal banking regulators to target areas that include consumer lending and broader financial markets.

At the same time, the Treasury Department's Financial Crimes Enforcement Network continues to enforce a wide range of laws applicable to financial institutions. State and local enforcement agencies are investigating

The attorneys then put the facts in the context of the applicable law and make recommendations to management about how to address the problem. An investigation can be small, involving only a handful of documents and a few witnesses, or it can be massive, covering millions of documents and dozen of witnesses.

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the same activities. Lawsuits by private plaintiffs have spiked as well, alleging a variety of predatory-lending claims, securities fraud charges and so on, and making related derivative claims as well.

WHAT COMPANIES SHOULD BE DOING

In this heated climate, the starting point for most financial institutions remains the same as before: to maintain sound internal controls, strong audit and compliance programs, and good relationships with primary regulators. These practices provide the best approach to lawsuits and enforcement actions, which is to prevent them altogether. These programs also are important if government investigators or plaintiffs' lawyers do come knocking.

WHAT IS AN INTERNAL INVESTIGATION?

No matter how strong a company's internal controls, audit function and compliance programs, its management may get information suggesting a possible legal violation that warrants special attention. This often means an internal investigation. To conduct an investigation, the company's attorneys gather facts by collecting and analyzing the business' e-mails, documents and data and by interviewing knowledgeable employees.

WHY CONDUCT AN INTERNAL INVESTIGATION?

A good investigation enables a financial institution to make an informed decision about an apparent legal problem. An investigation may be required by directors' fiduciary duties to the company. If the institution is an SEC issuer, it also may have obligations to uncover and disclose certain facts once a problem comes to management's attention.

Investigations also can be compelled by the rules of various enforcement bodies. Self-reporting, a familiar practice to banks and other financial institutions, has become central to the enforcement practices of federal and state regulators. Some enforcement agencies specifically consider a strong internal investigation a mitigating factor when they decide whether to file an enforcement action.

The company's level of cooperation, starting with an internal investigation, also can play a formal role in charging or sentencing decisions. An internal investigation also arms the company with information in case it chooses to take a less cooperative tack and litigate against the government.

An all too common mistake is the failure to take a problem seriously enough at the start, even when the initial trigger is an inquiry from the government. Once the government comes calling, even informally, a financial

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institution cannot wait to see whether the United States will take further action and only then start to learn the facts. By then it is too late.

Moreover, once a legal problem comes to light, the sheer fact of delay becomes a problem. Especially for a financial institution, legal uncertainty and a protracted internal investigation can handcuff management and even damage public confidence in the institution.

HOW COUNSEL CONDUCTS THE INVESTIGATION

Investigations vary widely in formality, scope, detail and cost. Typically, however, they involve the following basic steps.

Preserve all relevant materials

The first step is to preserve all materials, including all electronic files in all relevant locations. Counsel will ensure that this critical, and often complex, step is taken quickly and carried out properly.

Retain outside counsel

The other critical step at the outset is to decide who will conduct the investigation. In-house counsel often investigate and resolve matters that are relatively routine. Financial institutions should retain outside counsel, however, if a problem is not routine — if it presents significant legal or regulatory exposure, involves possible criminal activity, implicates company-wide matters such as financial reporting, or touches on the conduct of senior management.

If the problem involves a government investigation, the financial institution should consider retaining not only outside counsel, but also outside counsel that are new to the company. Government investigators are less likely to trust an investigation that is performed by in-house counsel or regular outside counsel. The SEC, for example, specifically asks whether the counsel handling the matter has previously worked for the company.

The government may even refuse to engage in negotiations until a company retains

new outside counsel. This reflects the government's view that it is important for the company to bring in counsel that have no stake in justifying the underlying conduct and no incentive to defend current management at the expense of the company itself.

Retention of new counsel also can be dictated by ethical considerations. In some cases, more often in smaller companies, in-house or regular outside counsel have given advice about the events underlying the investigation or have approved a policy or decision at issue in the investigation. That counsel cannot properly investigate its own activities or judge its own earlier decisions.

All participants in the investigation must understand that outside counsel represents the financial institution itself and not the directors, the CEO, or any other officer or employee. Cases do come up in which counsel can safely represent multiple clients, such as the company and its directors, but if the interests of any individuals diverge at all from the interests of the business, those individuals need their own attorneys.

In some cases, the company may want to preserve the ability to say that management violated company policy or acted without the permission of the board, and it cannot make this defense while sharing counsel with management. Because it often is unclear at the beginning of an investigation whether company and individual interests might diverge down the road, companies and officers often retain separate counsel from the start.

Establish contact with the lead government attorney

If the internal investigation was triggered by a federal inquiry, one of counsel's first steps will be to talk to the appropriate government attorney. Counsel will try to establish a professional relationship and learn as much as possible, including the goal or purpose of the investigation. These conversations can give counsel some idea about what the government knows, what it wants to know and the nature of ongoing investigations.

In particular, the company's counsel will try to learn how the government views the company: benignly, as a mere third party from which it seeks information to use against some other target, or less benignly, as a target itself. Different enforcement agencies give different amounts of information about what they know and how they view a company.

Create written guidance for the investigation

At the outset, the company should put the purpose and goals of an investigation in writing. In particular, it should state clearly that it is undertaking the investigation to address a legal concern rather than a purely business one. In many cases the board should memorialize this information in a resolution. Documenting the purpose of the investigation lays a foundation for the attorney-client privilege, thus improving the company's ability to protect the investigation and its results from compelled disclosure.

The company also should consider informing relevant employees about the investigation. It can distribute a memorandum that describes the inquiry and instructs employees to cooperate with company counsel.

The memorandum also might tell employees whether the company will provide them counsel of their own. It also can notify employees that they might be approached by a government agent, that they are entitled to consult counsel if they talk to the government and that if they do talk to the United States, they should be truthful.

Collect materials and conduct interviews properly

One of the most difficult, expensive and perilous parts of an investigation is the process of working with electronic materials. These materials can be vast in quantity. Preserving, locating, collecting and analyzing them can be complex.

Experienced counsel will take care of this process. Management should be aware, however, that electronic records present a particularly dangerous minefield. Unless this phase is executed properly, it can create entirely new legal problems. A failure to identify and preserve all relevant electronic material, even if the failure is accidental, looks very bad to government investigators. Errors can weaken the company's efforts to demonstrate its goodwill and can even trigger criminal penalties.

Counsel also must make sure to conduct employee interviews properly, so that the company can use the results of the interviews in its defense. In particular, counsel will give each employee a “corporate Miranda warning,” making it clear that counsel represents the company and not the employee.

Keep the board informed

The financial institution should identify a specific in-house counsel, manager or officer to act as the liaison with outside counsel. If the investigation needs to be independent of management, counsel should brief the board directly. Often a committee of directors acts for the board. These directors should oversee the actions of outside counsel, assess counsel’s findings during the investigation and receive the report when the investigation is completed.

by the risk that it would be used against the company in later litigation by private parties. If that is the case, counsel might recommend not putting its findings in writing.

Future exposure is a concern because, once the company discloses its conclusions to the government, private litigants often can force the company to disclose that information to them as well. Counsel will advise the company about how to minimize the dangers from this potential “follow-on” litigation.

Make any required disclosures

If an investigation uncovers ongoing legal violations, a financial institution is obligated to stop them. It often is required to report the violations to its regulators. In some cases, it may be obligated to disclose even the existence of an investigation. This might be necessary to satisfy requirements to report to primary regulators or to comply

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Create an appropriate record

When the investigation is completed, counsel will make a recommendation about whether to put the results in writing. If a financial institution wants to use the investigation with the government, it has no choice but to create a written report. In some cases, however, the need for a written report is outweighed

with securities laws, insurance policies, agreements with banks or obligations to independent auditors. An institution might need to disclose an investigation to ensure that public statements that the company makes are not misleading. Counsel will work with the company to identify and comply with disclosure requirements.

CONCLUSION

The information generated by a sound internal investigation enables a financial institution to make informed decisions. By acting early and vigorously, while avoiding missteps that create entirely new problems, a company maximizes its ability to evaluate its exposure, preserve its options and put itself in the best possible position to address its most serious legal problems. **WJ**



Andrew J. Morris is a member at **Carr Maloney PC** in Washington. He represents clients, including financial institutions, in complex matters, such as investigations and enforcement actions by various governmental bodies. He can be reached at (202) 310-5523 or ajm@carrmaloney.com.