



## Special investigations and special committees

### Introduction

The Midwest Audit Committee Network (MWACN) held its seventh meeting on February 11, 2010, in Chicago. Network members, who sit on the boards of more than 25 large-, mid-, and small-cap companies between them, met to discuss challenges and good practices for an audit committee chair involved in special investigations as well as circumstances that warrant the formation of a special committee. Members were joined during the meeting by Chris Wray, partner, King & Spalding, and former assistant attorney general in charge of the Criminal Division at the US Department of Justice (DOJ), and by Marschall Smith, senior vice president, legal affairs, and general counsel, 3M Company. This document synthesizes key issues that emerged from those discussions.<sup>1</sup> For a full list of participants, see Appendix 1 on page 11.

At the network's May 2009 meeting, which centered on fraud and other corporate malfeasance,<sup>2</sup> members pointed out that the audit committee's role in special investigations is complicated: *"This is one area of risk that [in most cases] the audit committee has full responsibility for. All the aspects of the investigation are extremely complex. This is not a two-minute discussion."*

Clearly an allegation of wrongdoing by a regulatory or law enforcement body such as the DOJ or the Securities and Exchange Commission (SEC) can compel the board to form a special committee. In a speech in December 2009, Robert Khuzami, the SEC's director of enforcement, reported that during fiscal 2009, "[The SEC] issued 496 orders opening formal investigations (an increase of over 100% over fiscal 2008)."<sup>3</sup> Lanny Breuer, a US assistant attorney general, said, "One can say without exaggeration that [2009] was probably the most dynamic single year in the more than thirty years since the FCPA [Foreign Corrupt Practices Act] was enacted."<sup>4</sup> At the February 2010 network meeting, members agreed that these findings are consistent with recent experience: *"Pursuing FCPA violations really seems to be the hot-button issue for the government right now."*

Moreover, government officials have publicly stated that they will be focusing more attention on the board and audit committee. Mr. Khuzami remarked during his December 2009 speech that the SEC's "investigations of financial fraud will continue to carefully evaluate whether directors and audit committees played any role in the matters under investigation."<sup>5</sup> Commenting on the government's commitment to pursuing these investigations, Mr. Wray remarked, "Enforcement under the Bush administration was significantly intensified because of the corporate scandals [of the early 2000s]. The new administration[']s

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<sup>1</sup> *VantagePoint* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by members and guests during and after the meeting. Mr. Wray has given permission for selected comments to be attributed; these remarks are not italicized. Other unitalicized, unattributed quotations are drawn from pre-meeting conversations or from conversations of other networks of audit chairs.

<sup>2</sup> The discussions are presented in Midwest Audit Committee Network, "[Fraud and other corporate malfeasance](#)," *VantagePoint*, June 15, 2009.

<sup>3</sup> Robert Khuzami, remarks at [AICPA National Conference on Current SEC and PCAOB Developments](#), December 8, 2009.

<sup>4</sup> Gibson, Dunn & Crutcher, "[2009 Year-End FCPA Update](#)," January 4, 2010.

<sup>5</sup> Robert Khuzami, remarks at [AICPA National Conference on Current SEC and PCAOB Developments](#).



approach] is more of the same and then some. Powerful forces are calling for [enforcement agencies] to prove how tough they are.”

## Executive summary

Although meeting participants were quick to point out that navigating a special investigation is “*definitely more art than science*,” they also believe that “*there are rules of the road that you absolutely need to pay attention to*.” As such, members were eager to share lessons learned, in the spirit of “*if I knew then what I know now*.” The key themes of the discussion are summarized below and described in more detail on the following pages:

- **Actions taken early on in an investigation are critical** (*Page 3*)

Network members agreed that decisions made at the beginning of an investigation are critical. Drawing on their personal experiences, meeting participants discussed several specific instances that warranted special investigations: a shareholder lawsuit, an FCPA violation, and an options backdating situation. When a special committee must be formed, independence, subject matter expertise, and other commitments often determine the committee’s membership. Members weighed the value of self-reporting a proactively launched internal investigation and ultimately agreed that when in doubt, companies should self-report to relevant authorities.

- **Hire the best counsel; expect rigorous project management** (*Page 4*)

Given the far-reaching implications of a special investigation, members said that it is critical to hire good advisers, “*regardless of the cost*.” Members recognized the importance of identifying and hiring independent counsel within 48 hours of launching an investigation and said that it is generally possible to do so. However, they expressed particular frustration with ineffective project management. Some members hired an independent project manager to address this problem; others said project management capabilities will be factored into law firm selection going forward.

- **Conducting a special investigation is often a “withering, draining process”** (*Page 6*)

Members described participating in a special investigation as time-consuming, exhausting, and disruptive. They stressed the importance of communicating with board colleagues throughout the process. Meeting participants also shared several important lessons they have learned from their own experiences with special investigations: do not take actions that will make the situation worse, do not jeopardize privilege, explore advanced hotline functionality, determine whether there is a widespread pattern of fraud, consider how the special committee’s actions may be perceived, and be grateful for clean findings.

- **The committee must also deal with the issues of compensation, document management, and concluding its work** (*Page 6*)

Three additional issues that come up when dealing with special investigations are whether to offer extra compensation to special committee members for their work on the investigation, document management, and concluding the work of the special committee.



- **Sometimes a special committee is warranted for matters that a standing committee cannot address** (Page 9)

Members expanded the discussion of circumstances that merit the creation of a special committee to include “*special situations that result from issues other than fraud and other ugly things.*” Such circumstances include mergers and acquisitions, one-time pension investment decisions, sudden leadership transitions, and certain types of transactions.

### **Actions taken early on in an investigation are critical**

While the life cycle of an investigation comprises “*many moving pieces,*” members agreed that “*what you do early on has a major impact on the ultimate outcome.*”

Meeting participants agreed that balance and flexibility are critical when conducting an investigation, particularly given the tremendous responsibility and time commitment that are involved: “*The thing you need to worry about is balancing doing too much with doing too little. [A situation] does not always need to rise to the level of an investigation with a capital ‘I.’ You need to be careful early on to not make a proverbial mountain out of a molehill. It’s all about balance. The decision usually can be made collectively once you look at all the facts and circumstances and figure out the level this needs to be attended to.*”

Members discussed three examples of special investigations, all of which required the formation of a special committee:

- **Shareholder lawsuit.** “My experience has been participating on a special committee that was formed to investigate a shareholder lawsuit that was initiated against [several] board members ... Our job was to investigate whether there was basis for the lawsuit and whether we should proceed with the allegations against certain board members and members of management.”
- **FCPA investigation.** “We received a call to the ethics hotline regarding an FCPA violation in a foreign location ... There was then another [independent] report, and those two pieces of testimony in confluence is what made us decide to go forward with an investigation.”
- **Options backdating.** “We went through an unfortunate backdating investigation. The initial problem was called to my attention through some academic research highlighting companies that [might have engaged in the practice]. When an analyst [raised the issue], we agreed we needed to do something about this, so we appointed a special committee.”

### **Determining membership of the special committee**

Members agreed that the audit committee often plays a role in internal investigations, but there are also scenarios that warrant the involvement of other directors and/or committees. It goes without saying that all directors are capable of serving on a special committee, though some will have special skills that are



particularly relevant. Members described three other factors to consider when choosing members of the special committee:

- **Independence.** *“The formation of the committee itself was simple because there were only three of us who were not named defendants, and we wanted to ensure we conducted an independent investigation.”*
- **Subject matter expertise.** *“[When we were conducting an investigation,] we needed someone with knowledge of the industry because [the issues] were very technical and not easily understood. We also wanted at least one of our people on the special committee to have a legal background.”*
- **Other commitments.** *“We immediately recognized that this was going to be a time-consuming process, and we wanted to be diligent about it. Therefore [committee membership] was decided based on who was able to commit the time.”*

Members were quick to point out prior to the meeting that regardless of who is ultimately involved in a special investigation, the full board is responsible for monitoring the progress: *“The board votes on everything. Nothing happens in a special investigation unless it’s voted on and reviewed by the full board. These issues are too critical.”*

### Self-reporting

Members agreed that one of most significant decisions the board and the special committee make is whether or not to self-report the results of an internal investigation. Oftentimes, the first step is to confer with the company’s legal counsel: *“We put together what we knew, called our law firm, and they then spent a week looking through it all. In the end, they came back and agreed that we should go to the DOJ.”*

Mr. Wray told members that when in doubt, it is often better to err on the side of self-reporting: *“Usually when companies are doing [these investigations], a lot of it comes down to judgment. DOJ will normally react far better to companies that come in and talk [to DOJ at the outset] than to companies whose violations DOJ finds on its own. Prosecutors can be very intolerant of companies that don’t self-report.”* Mr. Wray went on to offer the insight that when it comes to assessing FCPA violations, *“The initial reaction [of a company] is often to focus on the size of the bribe, which can be pretty small. However, what can be more important to the government is the size of the business obtained, which is much bigger, of course.”*

### Hire the best counsel; expect rigorous project management

Many people say that given the potential implications of these investigations, *“you should get the best possible advice, regardless of the cost.”* A member of the Audit Committee Leadership Network recently remarked, *“External experts who are doing special-investigation work must also have a degree of credibility. A high-priced law firm is hard for some boards to swallow, but it’s worth it.”* Members agreed: *“As soon as we launched the investigation, we immediately knew we needed to hire outside counsel and that we could not rely on the internal legal group alone.”* Moreover, as Mr. Wray pointed out, *“There is a perception – fair or not – that outside counsel is going to be more objective. No matter how thorough an investigation*



by in-house counsel is going to be, it is often presumptively suspected by the government to be a white wash.”

### **Quickly retain counsel with relevant experience**

Audit committee chairs who have been through investigations agree with the member who remarked prior to the meeting, “I think the broader lesson we learned of bringing in expertise and knowing when to bring them on board – as early as possible, in my opinion – is important. We thought initially we could do a lot of things ourselves, but none of us had ever been on a special committee before, and we soon learned the importance of using [resources] wisely.” Another seasoned audit committee chair mused, “If I had known then what I know now, I would have done a lot of things differently. Right from the get-go I would have focused more on the advisers I was using.”

Members agreed that immediately assembling the right legal team is a critical step in the process of conducting most investigations. Many members agreed with the audit committee chair who remarked, “*At the end of the day, while it’s important to hire counsel quickly, it’s not hard. It might take 48–72 hours, but it can definitely be done. Can it be helpful [to keep a law firm on retainer]? Yes. Is it critical? No.*” Another member concurred, reporting, “*We initially had thought we wanted to hire a [local] firm, but many of them were conflicted. We got a list from our internal legal team and had interviewed four law firms within 48 hours.*” A final member pointed out, “*The law firm you pick often relates to facts and circumstances, so sometimes it can actually be fairly hard to determine [who to retain] ahead of time.*”

However, one member described the advantages of proactively identifying independent counsel: “*We pre-qualify a law firm in advance, or at least an attorney who we deem to be independent and who agrees to remain independent. [During a previous investigation,] it took us three weeks before we found a couple of firms who we could talk to that weren’t already retained by the company. I [vowed] afterwards that we would never go through that again, so now, at all the companies I’m involved with, we have identified someone we can go to immediately if something breaks.*”

### **Ensure effective project management**

“*Show me the work plan,*” one audit committee chair said. Indeed, members voiced consistent surprise and frustration at their external legal teams’ quality of project management, which members often felt could have been improved. One meeting participant currently involved in the early stages of an investigation shared, “*At a micro level, we’ve been surprised that law firms do not have the appearance of better project management. We keep waiting for them to come in with a checklist. Maybe I should have forced the issue earlier – our desire for a better outline of the structure of the investigation.*” Another member with similar experiences remarked, “*It’s hard to [reinforce to the law firms] the importance of scheduling project management. The lawyers look at you like you’re nuts.*”

One member described a time when the audit committee actually hired an independent project manager – a lawyer with whom the board was already acquainted: “*We put a project manager in place from outside the company ... It was clear that the audit committee needed someone independent of the company to advise and assist them. After being accepted and approved by the board, [this individual] was the one who*



*marshaled the resources for the forensic accounting. There's definitely a need for resources for the company that are independent of the company. We thought it was advantageous for the person to be independent of management in this case." In response, many members agreed that "[going forward], we should make sure [project management] is part of the selection criteria for choosing a law firm."*

### **Conducting a special investigation is often a "withering, draining process"**

Meeting participants said that a special investigation often becomes a full-time job: *"These are gut-wrenching, time-consuming, Sunday-to-Saturday matters. The reason you need to pick the committee very carefully is because these people need to understand this is now their full-time job."* Mr. Wray pointed out, "For those directors who have lived through [an investigation], a consistent theme is that it leaves a lasting and detailed memory."

Seasoned directors not only reported that they *"could not believe how much work was involved,"* they also spoke of how disruptive the process can be: *"If you're not working on it, you're worrying about it."* Added another member, *"I will say that [the investigation] was very disruptive to the company. It becomes very personal and often requires a great deal of sensitivity."*

The full board must be kept informed of the status of the investigation and the progress of the special committee: *"Maintaining continuous and effective communication is key."* However, members pointed out that in the case of some special committees, particularly those formed to evaluate shareholder litigation against specific board directors, communicating effectively can be a challenge. In a pre-meeting conversation, one member said, "Each board meeting, I would give a one-and-a-half-minute [update] saying, 'The special committee met and we're on schedule, etc.' Something really brief like that. This was a case where we had to separate ourselves from the full board. It was difficult, but it was necessary."

When possible, it is best to communicate with board colleagues *"early and often."* One member reported, *"When we initially shared our findings, [one board committee] said it was going to need a lot more time [to understand]. Don't assume everyone necessarily is 'in your world.' I think it's really important to educate people because we really had to bring [this committee] along. Don't just assume everyone is on the same page."*

### **The committee must also deal with the issues of compensation, document management, and concluding its work**

Members highlighted several additional issues that come up when dealing with special investigations or a special committee.

#### **Compensation for special-committee members**

At the February meeting, members reported that their companies have considered – and in some cases authorized – additional compensation for directors serving on a special committee. Members highlighted



several reasons why an additional special-committee fee might make sense:

- **It recognizes the extraordinary time and effort involved.** *“The board recently voted and agreed extra pay should be given to special-committee members after it was determined that we had met for more hours than the whole board and every committee combined.”* Another member remarked, *“I don’t know why a special committee would ever feel badly about taking extra money. It’s a full-time job.”*
- **It signals independence.** *“The law firm we were working with felt strongly that we should establish a pay schedule for the special committee to draw a line of independence from the other board duties. We declined initially, but as we went along, their rationale actually started to make sense.”*

### Document management

Members discussed the challenges of document management and retention. One member highlighted the conflicts that can potentially arise with enforcement agencies: *“When the special committee was formed and we went to a new attorney, that law firm determined that the initial electronic document search might not have been thorough enough. A new document search surfaced 300,000 pages of additional electronic documents, and although this search didn’t actually find any information pertinent to the investigation, it caused great consternation at the SEC when we called to tell them we had 300,000 more documents ... We have since contracted someone to put in a better document management system throughout the whole company.”*

Many members reported concern about email search algorithms: *“We had some frustrations with our email search capabilities [during a previous investigation]. We used a software package that went through all the emails and flagged the ones to look [at], but there were too many to sort through entirely. I wish we had been able to design something that narrowed the search down better ... We’re thinking about how we can get our arms around that more.”*

### Concluding the work of a special committee

Several members said that one of the most troubling aspects of an investigation is its potential to drag on and on, without an end in sight: *“When you’re part of a special committee, you have to remember to disband. In our case, the judge hadn’t made his ruling yet, but meanwhile there was a resolution saying we were the only people authorized to talk about [the investigation]. It’s important to get closure.”*

Members pointed out that investigations launched by regulators *“can take years to formally close out,”* and they contemplated the implications of that fact for special committees. In 2008, the average length of a DOJ investigation was three years, and experts predict the length *“is not likely to drop, given the complexity of the compliance programs likely to be pursued as a result of investigations growing out of the current financial*



crisis.”<sup>6</sup> Moreover, several current investigations under way include an option allowing the DOJ, at its discretion, to extend the terms for a year or more to monitor compliance.<sup>7</sup>

***“If I knew then what I know now”*: Lessons learned from special investigations**

- **Don’t make it worse.** *“[During our investigation,] the CEO immediately wanted to go in and [fix things,] but we can’t do that, because we don’t want to look like we’re trying to do an internal cover-up.”* Mr. Wray agreed: “Whatever you do, don’t make it worse. Almost every company that has gotten into really big trouble ended up there less because of the original problem itself than because of how the company handled it ... You can go through example after example of companies who did something to make a potentially defensible situation much worse. “Deal with document preservation right from the beginning,” he warned.
- **Don’t jeopardize privilege.** In the same vein as not making things worse, Mr. Wray said, “Do not let well-meaning executives go do their own fact finding. If not part of the counsel-led investigation, they will fall outside the privilege and can even be viewed by the government as trying to distort or cover-up.”
- **Explore advanced whistleblower hotline functionality.** *“We use a service with our hotline that allows us to communicate [confidentially] with an anonymous [whistleblower].”* This member reported that in one case “we were able to clear an investigation because we could call the person back” without the individual ever being identified.
- **Determine whether there is a pattern of fraud.** *“It’s important to keep in mind that if [fraud] is happening in one place in the company, it could be happening anywhere. Taking a more holistic approach to the investigation can be a good thing.”*
- **Consider how the committee’s actions may be perceived.** Mr. Wray advised members, “Having appreciation for 20/20 hindsight is important. [As you conduct the investigation], ask yourselves, ‘How would I later defend and justify my actions – or inaction – to the DOJ?’”
- **Appreciate the value of clean findings.** Mr. Wray observed, “Quite often these investigations result in benign findings and you’ll sometimes hear boards wonder if it had been a waste of time. That’s shortsighted. Think of the analogy to a high-end medical exam. If you get a clean bill of health, you would never walk away and say, ‘Wow, what a waste!’”

<sup>6</sup> Gibson, Dunn & Crutcher, [“2008 Year-End Update on Corporate Deferred Prosecution and Non-Prosecution Agreements.”](#) January 6, 2009.

<sup>7</sup> [Ibid.](#)



## Sometimes a special committee is warranted for matters that a standing committee cannot address

Members noted that special committees are sometimes formed to undertake a significant project, to review an issue that the board does not feel it has time to adequately address otherwise, or to deal with a matter that the board's standing committees cannot take on. At the February network meeting, members reported forming special committees to address such diverse issues as:

- **CEO succession planning.** *"We wanted to complete [the CEO search] quickly, so we formed a committee. Every two weeks we had a call with the full board to keep them updated on our progress. We gave the board an opportunity to talk to all candidates, and they ultimately chose to trust the committee's decision. It ended up working very well."*
- **Mergers and acquisitions.** *"Our business has grown based on acquisitions, so we have a separate transactions committee to assess [acquisitions]. When a transaction starts to get hot, the CEO and I will get together and decide if it should go to the transaction committee for review."*
- **Pension fund transaction oversight.** *"[At one point] we wanted to use pension assets to purchase [undervalued] company stock. People get nervous when you do that, so we appointed a special committee to oversee the process."*
- **Certain types of transactions.** If a potential conflict of interest emerges, such as in a deal that triggers significant change-in-control compensation arrangements, the board may form a special committee: *"I once sat on a special committee when we were undergoing the process of selling the company. We had unsolicited offers from private equity firms, and we formed a special committee of independent directors to consider the offers."*

## Conclusion

MWACN members agreed that directors are likely to experience a special investigation at some point, given the heightened risk of fraud during periods of change and the government's pledge to increase prosecution. Members reported *"feeling much better prepared after having this [meeting] discussion."* Many believe there are additional courses of action that boards and management can take to prepare their companies for handling a special investigation and forming a special committee, should the need arise.

Mr. Wray reminded members, "A lot of these issues relate to tone-at-the-top, and that's where the audit committee can be useful. Encourage a culture where people will raise issues. There has to be a certain level of trust that identifying and escalating potential problems will be well-received." Members suggested that scenario planning may also be useful: *"Repetition is the mother of all skill. Therefore, scenario planning as a part of crisis management could be useful. If an FCPA issue in China came to light today, who would be the first person you would call? I don't know if we think that through as much as we probably could."*



## About this document

The Midwest Audit Committee Network is a group of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*VantagePoint* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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### **Appendix 1: Participants at the network meeting**

The members of the network who participated in the meeting were:

- Dave Burritt, Audit Committee Chair, Lockheed Martin
- Cheryl Francis, Audit Committee Chair, Morningstar
- Lorette Koellner, Audit Committee Chair, Sara Lee
- Dave Landsittel, Audit Committee Chair, Molex
- Rich Roedel, Audit Committee Chair, Brightpoint
- David Schwartz, Audit Committee Chair, Walgreen
- Al Smith, Audit Committee Chair, Simon Property Group
- Dennis van Mieghem, Audit Committee Chair, AEGON USA
- Donna Zarcone, Audit Committee Chair, CIGNA

The following members were not able to attend the meeting but took part in post-meeting discussions:

- Howard Carver, Audit Committee Chair, Assurant
- Sandy Helton, Audit Committee Chair, Covance
- George Off, Audit Committee Chair, Telephone and Data Systems

Ernst & Young partners participating in the meeting included:

- Tony Anderson, Midwest Area Managing Partner
- Rich Bonahoom, Midwest Accounts and Business Development Leader
- Jim Logothetis, Global Client Service Partner



## Appendix 2: Questions on special investigations and special committees for audit committees to consider

- ? What kinds of issues tend to be investigated by audit committees? By the full board? By a special committee?
- ? What determines the board's response when a situation is initially identified?
- ? When should the audit committee get involved in special investigations?
- ? What factors generally dictate the membership of special committees?
- ? What is the role of each participant in a special investigation? What is the specific role of the audit committee and its chair?
- ? What has been your experience in working with outside advisers, such as external audit, outside counsel, or forensic accounting consultants, on investigations? What has worked well? What are some pitfalls to avoid?
- ? Who recommends advisers to the company? Who is responsible for vetting them? On what basis are they selected? Who has the final say in hiring advisers: management, the board, or the audit committee?
- ? What are the pros and cons of paying special committee members extra money, either for their time or to guarantee independence?
- ? How do you know when the work of a special committee is done? What can you do to communicate that to all relevant stakeholders?