



Ten Key Factors for Boards To Consider When Weighing an Internal Investigation

- When a complaint reaches a company's board, directors need to assess how serious and detailed it is, and how credible it is at first glance, before deciding how to investigate it.
- If similar complaints have been lodged in the past, that could suggest systemic problems and greater risk for the company.
- An investigation will take on added urgency if the regulators or external auditors are aware of the allegations, or if those may affect pending financial or strategic transactions.
- Other complicating factors: any allegations against management, conduct the company has a duty to report and the potential for financial restatements.

Suppose you are a member of an audit committee and learn about a whistleblower complaint alleging wrongdoing at the company. Maybe it's just an aggrieved former employee, and it has no merit. Maybe you should direct the company to investigate. That would likely save time and money. But what if it's not something so benign? The inherent risks of potential litigation, regulatory action, conflicts of interest, a perceived lack of independence and the possibility of incomplete findings loom large.

In an age when transparency, accountability and corporate governance have taken center stage, deciding when to conduct an internal investigation and who should lead it is becoming more and more important. Striking the right balance between efficiency and trustworthiness becomes critical.

There is no one-size-fits-all solution. And an audit committee may not be

presented with every complaint that warrants some sort of investigation. But, for the complaints that do make their way up to the board level, below is a checklist of issues that an audit committee should consider, at a minimum, when deciding both when to investigate and the form it should take. No single factor is dispositive, but if an audit committee finds itself answering most of the questions posed below in the affirmative, it should strongly consider conducting an investigation itself with help from outside expertise (e.g., forensic auditors, outside counsel).

Assess the Nature of the Allegations

Seriousness: How serious are the allegations? Could they amount to a criminal offense, breach a regulatory standard, or pose a significant risk to the company's reputation?

If the allegations suggest possible criminal activity or regulatory breaches, the stakes become considerably higher, necessitating a thorough and possibly urgent investigation conducted by outside counsel and other experienced professionals. Even if the claims are not substantiated, the potential for reputational damage can be just as consequential, affecting stakeholders' trust, stock prices and the organization's overall standing in its industry.

Outside counsel is often retained in cases that appear serious. By employing outside lawyers, written and oral reports can be protected by attorney-client privilege or the work product doctrine, which may not always protect documents created internally.

Directors should consider the advantages of truly independent advisers, without close ties to the management involved, and whether the executive should be offered his or her own counsel. If experts such as forensic accountants are necessary, they should be hired by counsel to keep their work within the attorney-client privilege.

Depth: Are these allegations detailed, specific charges? Based on the details provided, do the allegations seem credible or verifiable at first glance?

While detailed and specific allegations are more likely to seem credible and can provide a clearer path for verification, it is crucial to recognize that vagueness in a complaint does not inherently undercut its validity. In some

cases, whistleblowers may provide limited information out of fear or lack of complete understanding, but their concerns can still be rooted in very real issues. That said, vague allegations might require a different investigative strategy since they may be nearly impossible to investigate.

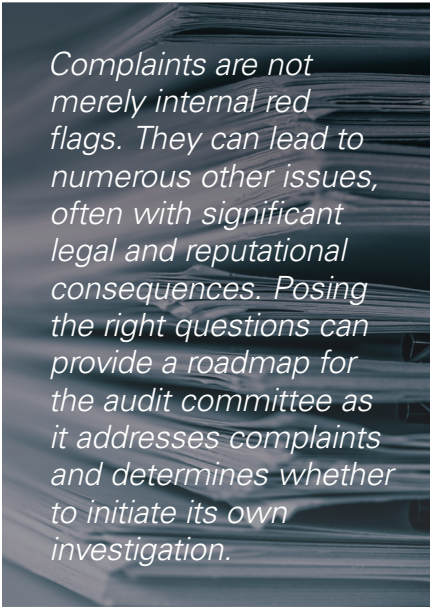
Recurring issues: Have these, or similar allegations been raised before? Were those allegations substantiated?

If other allegations of the same type have been received before, that suggests systemic issues within a company, requiring close scrutiny. Ignoring recurring concerns can exacerbate underlying problems and increase the company's risk exposure.

External Involvement and Impacts

Regulators: Has the individual reporting the issue already taken their concerns to regulators?

If the allegations have been reported to regulators, that escalates the urgency for a robust internal response because an external investigation or subpoena might be imminent. This could catch the company off guard if it is not adequately prepared. The audit committee should consider which regulators have been contacted and what their response may be. In our experience, once it is determined that regulators have been told about the complaint, proactively reaching out to them can make dealings with them more collaborative and less adversarial.



Complaints are not merely internal red flags. They can lead to numerous other issues, often with significant legal and reputational consequences. Posing the right questions can provide a roadmap for the audit committee as it addresses complaints and determines whether to initiate its own investigation.

External auditors: Have the company's external auditors been alerted about the allegations? Have they provided any negative or critical feedback, or preliminary findings?

Like a complaint to regulators, an external auditor's knowledge of a complaint escalates the need for a thorough internal response. We have seen external auditors refuse to sign off on financial statements pending the outcome of an investigation. Addressing the issue with your auditor is particularly pressing when the allegations are raised close to the end of a quarter or fiscal year.

Ripple effects on corporate activities: Could the allegations or the subsequent investigation affect ongoing or upcoming corporate activities, like bond offerings or stock repurchases? Are there any immediate transactions or disclosures that need to be reconsidered or postponed given these claims? Will the company need to communicate these changes or delays, if at all, to external parties or stakeholders?

Allegations and investigations can ripple across various facets of a company's operations, so it is crucial to evaluate any financial implications and the broader effect on business continuity. For example, a complaint reported to regulators, especially if it relates to financial misrepresentation or other serious matters, may prompt an investigation, which, in turn, could delay any major financial undertakings until the issue is resolved or clarified. The complaint may also need to be disclosed during an ongoing strategic transaction. That can result in additional due diligence by the counterparty to

ensure that all pertinent information is disclosed. This process can be time-consuming, leading to potential delays, and in some cases, to a breakdown of negotiations.

Internal Implications and Governance

Senior management or board involvement: Is senior management or the board implicated in these allegations? Would these allegations impact the functioning and decision-making of the company's leadership in the near term even if their conduct was above reproach? Would there be damage to stakeholder trust or the company's public image if the allegations become public?

Allegations targeting senior management or board members are particularly sensitive. Such claims, if not addressed swiftly, can undermine the trust of stakeholders, jeopardize leadership continuity, and raise questions about governance integrity. In our experience, while no one item on this list is dispositive, should the allegations touch upon individuals in the C-suite or even the board itself, an audit committee should strongly consider taking control of the investigation. And depending on the allegations, the board or some members might also have to contemplate recusal or even the formation of a special committee to ensure the investigation has integrity and to avoid a potential conflict of interest.

Duty to report: Are there clear regulatory mandates that require the company to disclose such allegations

to investors or regulators, either immediately or after an internal review? Would these disclosures, if needed, negatively affect the company's relationship with investors and other stakeholders?

Disclosing allegations can impact stakeholders. Investor trust can be shaken by even a hint of potential misconduct. An audit committee may want to direct an investigation that will eventually need to be disclosed to ensure the probe is conducted independently and transparently.

Potential for financial restatement:

Are there specific financial irregularities or discrepancies that are being alleged in the complaint? Assuming the allegations are true, are the alleged discrepancies significant in relation to the overall financial statements — *i.e.*, material?

If the complaint pertains to financial irregularities, companies might need to restate their financials, which can undermine investor confidence and lead to regulatory scrutiny, other potential legal consequences and reputational damage.

Other Legal Risks and Repercussions

Litigation risk: Is there potential exposure to lawsuits if these allegations are verified or if the investigation's findings become public knowledge? Is there any existing litigation or legal considerations that might be affected or complicated by these new allegations?

Litigation over the allegations not only has potential financial repercussions; it may entail reputational damage and the diversion of resources to manage litigation. The allegations may lead to direct legal actions against the company, especially if there is evidence of wrongdoing. That could take the form of civil lawsuits, regulatory actions or even criminal proceedings. If the complaint suggests widespread harm outside the company, it might give rise to class actions. Should the complaint indicate that the company's leadership acted against shareholders' best interests, the company may face a shareholder derivative suit. And depending on the allegations and the nature of any ongoing litigation, the original complaint could be discoverable.

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Complaints are not merely internal red flags. They can lead to numerous other issues, often with significant legal and reputational consequences. Posing the right questions can provide a roadmap for the audit committee as it addresses complaints and determines whether to initiate its own investigation. A proactive, introspective and consistent approach will best promote regulatory compliance and protect a company's broader interests.

Authors

Anita Bandy / Washington, D.C.
Jack P. DiCanio / Palo Alto
Emily A. Reitmeier / Palo Alto

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One Manhattan West / New York, NY 10001 / 212.735.3000

