

Investigations as an opportunity to reformulate operational response to business risk

BY TOM WARDELL AND JOSEPH BLANCO

In the years since Enron, corporations have been confronted by wave after wave of compliance and governance questions. The wave of investigations we are now experiencing formed up approximately two years ago and appears to be gaining strength rather than subsiding. It was stimulated by the accounting scandals which underlay the 2002 reforms in the United States. Those in turn led to an increased number of special investigations at the request of auditors. The options-backdating scandal created another set of issues requiring investigation, but the subject matter has expanded well beyond the accounting matters to address a myriad of issues, including violations of the Foreign Corrupt Practices Act, participation in price-setting cartels and the failures to comply with environmental or food and drug regulations. In addition, the added responsibilities placed on directors combined with the increased scrutiny and pressure being applied by a wide array of regulators including the US Department of Justice, the SEC, the European Commission, the New York Attorney General's Office, and newly created or energised competition authorities in countries around the world, have made directors more sensitive to the quality of the information and recommendations received by them from management.

This year's compliance and governance wave appears to be risk assessment. The SEC has continued to press risk assessment as a disclosure issue. The Sentencing Guidelines, and now several versions of best practices, suggest ongoing risk assessment is an integral part of any sound compliance program. Committees and boards are encouraged by the quarterly reporting process to assess risk. And the *Caremark* standard of care required of directors is now being extended to require that boards assure themselves that processes and systems are in place to allow boards to understand fully a given corporate problem. In such an environment, the investigation can (and should) be a

strong tool for boards of directors to: (i) develop a full understanding of the risk as well as the opportunity that resides within the risk; (ii) gather information about operational issues; and (iii) protect themselves.

An investigation, by its nature, results from an incident or pattern of behaviour that is suspected of falling short of some standard for conduct anticipated from the environment in which a company operates. If used effectively, the resulting investigation can be a tool for management and the board to develop a response to that incident or pattern which not only adequately resolves the immediate problem but more importantly adds value by ensuring that the business practices are adequate to address the underlying risk.

The standard of conduct violated may be embedded in a statute, a regulation, an expectation created by the company's own Code of Conduct, or it may simply be an operating procedure. The misconduct triggering the investigation will always be conduct which appears inconsistent with the articulated standard. For example, a company's methods of handling its environmental issues will have been developed in response to the regulatory framework imposed upon the company by the jurisdictions in which it operates. Consequently, the business practices used to address the risk are those that are designed to produce the most efficient operating result while avoiding the consequences of violating the environmental standards in any given jurisdiction. Continuing that example – depositing manufacturing waste in a river had the same negative effect on the river before and after the regulatory frameworks were put in place. Nevertheless, business practices were changed as a result of the imposition of environmental regulatory frameworks which elevated the risk associated with a release. The need for an investigation results from violations of the environmental standards – whether they are imposed solely by regulation or by company policies as well.

In short, the investigation is precipitated when the business practice fails to address the business risk adequately. The misconduct may be of one or more individuals but unless it is deliberate (such as theft), which is rare, the misconduct occurs because the applicable business practice did not eliminate the risk it was designed to meet. This can happen for any number of reasons, including: (i) the practice itself was designed insufficiently; (ii) operational circumstances have changed since the practice was developed; (iii) the practice, although initially properly designed, may have evolved into an inadequate practice; (iv) employee turnover may have created a knowledge gap; and (v) individuals knowingly and deliberately behaved in a way contrary to that practice. (Even in a case of blatant disregard, the focal point of the investigation will be whether there are indefinable factors that caused the employees to choose an alternate business practice to address the risk over the compliant business practice and the failure of the related compliance and monitoring programs to prevent the infraction, as described below.)

Many of these problems become even more acute in a larger enterprise because there will be multiple locations across multiple jurisdictions; the experience level and talent of local managers will vary widely; and practices compliant in one jurisdiction can be imported into another in which they are non-compliant.

The company responding to this situation with an investigation can scope the investigation in either of two general ways: look for the culprits and punish them and pay the related fines; or frame the subject matter and scope of the investigation precisely around the question "In what ways did the related business practices fail?" The latter is far more effective. To scope the investigation so and conduct it accordingly empowers the investigator as well as the company to look not only at the misconduct but at the opportunity for redesign of business practices. In other words, identify ►►

and treat the underlying causes and not merely the symptoms. And this in no way diminishes the company's ability to get at wrongdoing if wrongdoing has occurred.

By conducting the investigation focused on the practices, a company is able to: (i) seek the cooperation of all those who are touched by the business practices in question and the misconduct triggering the investigation; (ii) fully assess the risk anew; and (iii) design a response that meets the needs of the present problem – including punishment or discharge of any culprits – and that will provide more effective practices for the foreseeable future.

An investigation focused on the business practices can be conducted in a non-hostile, collegial manner which is important to getting the whole story. In many investigations, an interviewee is faced with an outside lawyer, an unfamiliar legal situation, whose closest point of reference for the interviewee may be a crime drama, and anxiety over the outcome of the investigation and whether the interviewee's and his or her family's livelihood are at stake. If employees are treated as defendants, they behave as defendants. They are careful with their answers. They are only as cooperative as necessary and only as forthcoming as they think their own best interests may require.

If, on the other hand, interviewees are asked to engage in a more recognisable process of identifying a business issue – business practices failed to ameliorate risk – and seeking a collaborative solution, they will be more likely to engage in the process. If they are asked to assist in assessing the risk that the business practices were designed to address, which resembles the process they would experience if asked to help formulate a response to a competitor's new product, they will much more

easily be fully responsive. Companies will also obtain the creativity of employees in responding to the future impact of the risk. And only those whose behaviour requires sanctioning need be sanctioned. The others will have gotten the message and, because they will have been brought into the process that is responsible for the coming changes, they will more readily accept those changes.

In one sentence, such an investigation can get to a full understanding of the risk involved and thereby develop a response that is more broad-gauged and more likely not only to solve the present problem but to prevent a future one on the same subject matter.

Any investigation is also an opportunity to address other aspects of risk response – the status and quality of the company's compliance system and its methods of monitoring the efficacy of the business practices to address risk. Any investigation in which misconduct is found will suggest that a compliance system needs to be modified. Any solution to the business problem raised by the investigation will require that the same solution be grafted into the company's existing compliance system. It may be that additional components of the compliance system can, or should, also be modified.

Any company's compliance system is only as good as the monitoring function in place to identify risks, measure behaviour and ascertain missteps. Consequently, each investigation is an opportunity to assess the status and quality of the company's monitoring functions. Usually the deficiencies that show will be those of detection and training. Companies are often far better at execution once a violation has been found. They avoid spending resources on risk identification, detection and training. But prevention is far less expensive than the cost

of redesigning operations, facing the disruption of an investigation, paying any fines that may be relevant, or experiencing the upheaval of discharged or reassigned employees. While the resource expenditure – especially for an extensive training program – may appear large and unnecessary, absent an incident which precipitates an investigation, the sheer cost of an investigation itself is often more than the combined costs of a good training program frequently administered and the modifications to a regularly monitored compliance system and risk assessment program. A broadly focused investigation will provide valuable insights into how a particular company's systems can be modified to identify, address and monitor risk more effectively.

No investigation is wanted or comfortable. By definition, the investigators have been given a broad-ranging charter which includes the need and the power to be disruptive. Nevertheless, if the attack is one of problem-solving, the response of employees will be more positive, disruption will be minimised and the full scope of the underlying problem is more likely to emerge. Additionally, the company and the board can exit the process with reconstituted business practices designed to address more effectively the subject risks. Treating the investigation as a case study of how a company collectively failed and what it should do in the future to prevent other failures does not prevent the company from punishing wrongdoers, but the punishment is largely a by-product of a process focused on more effectively managing risk in the future. ■

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