

Audit committees need independent counsel

This is best practice if an audit committee wants independent advice or needs an independent investigation.

BY FREDERICK D. LIPMAN AND JOSEPH G. POLUKA

There is some difference of opinion as to whether the audit committee of the board of directors of an organization (whether public, private, or nonprofit) needs independent counsel for the purpose of advising the audit committee and for the purpose of conducting internal investigations.

Those who advocate using internal personnel for these services argue that this is more cost efficient. Although it is true that there is a cost to using independent counsel, there is also a cost, which could be exorbitant, from the failure to properly advise the audit committee and to properly investigate accounting, auditing, or enterprise risk issues. Moreover,

failure to use completely independent counsel for the investigation can create the appearance of a “cover-up” and deprive the organization of any “cooperation credit” with governmental authorities.

Complaints made to the audit committee about accounting, auditing, or enterprise risk issues are sometimes investigated by internal personnel who do not possess either the forensic skills necessary to uncover all of the relevant facts or have the independence from top management that may be necessary to conduct a full and fair investigation. These internal personnel may be members of the HR department, internal auditors, or inside counsel. Even a transactional corporate lawyer who serves as inside counsel may not have the necessary forensic skills. There is no required training to become an internal auditor that necessarily provides the auditor with the skills to interrogate witnesses. Members of HR departments typically have even less qualifications to do so.

Internal investigations by non-legal personnel may not have the protection of the attorney-client privilege or the work product doctrine and may be discoverable by third parties, including shareholders. Likewise, even an in-



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vestigation by an inside counsel who is also an officer of the organization may not necessarily be protected by these doctrines. Each of these internal personnel are dependent for their jobs and their compensation on the goodwill of top management. When an internal investigation is commenced, no one can be absolutely certain that there is no culpability of top management in the accounting, auditing, or risk issues.

Risk of being conflicted

If any outside counsel is being used to investigate accounting, auditing, or enterprise risk issues, it is not unusual for top management to prefer that such investigation be conducted by regular outside counsel for the organization. The problem with using regular outside counsel, assuming they have the necessary forensic experience, is that they are not independent of management. The continuation of their legal representation may be dependent upon retaining the goodwill of top management. Accordingly, if there is any risk that there is culpability of top management, then regular outside counsel is placed in a conflict position.

An example of the worst practices in using outside regular counsel to investigate an accounting complaint is the Enron case. On Aug. 22, 2001, Kenneth Lay, Enron's chairman, received a letter from an Enron accounting executive, Sherron Watkins, which requested an internal investigation of her allegations of accounting fraud. She specifically requested that the investigation not be conducted by the regular outside counsel for Enron, and that Arthur Andersen LLP, the Enron independent auditor, not be involved in the investigation. Mr. Lay, who was subsequently convicted of conspiracy and fraud crimes, delegated the investigation to inside counsel, who then hired regular outside counsel to conduct the investigation, thereby ignoring Ms. Watkins' request not to use regular outside counsel.

The regular outside counsel for Enron, and the Enron internal general counsel, agreed upon a very limited investigation that did not involve obtaining an independent accountant's opinion on the work of Arthur Andersen, even though accounting issues were the heart of Sherron Watkins' complaint and even though she had specifically requested that Arthur Andersen not be involved in the investigation.

At the end of the very limited investigation that relied in part upon the assurances of Arthur Andersen, the regular outside counsel gave Enron a report that in general found no substance to Ms. Watkins' complaint. A separate investigation completed shortly after Enron's bankruptcy by an independent board committee, using completely independent counsel, found significant substance to Ms. Watkins' complaint.

If an audit committee wants independent advice and an independent investigation, then the best practice clearly is to use independent counsel. Anything less may not satisfy either the U.S. Department of Justice, the SEC, or other government regulators, and may cause the investigation to lose credibility. If the investigation loses credibility, then the U.S. Department of Justice will not give any "cooperation credit" for purposes of determining whether the organization or other persons may be indicted, and the SEC and other governmental authorities will not credit the investigation for purposes of enforcement actions. ■

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