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CRISIS MANAGEMENT AND INTERNAL INVESTIGATIONS

WHO DOES WHAT WHEN CRISIS STRIKES?
CORPORATE COUNSEL'S POINT OF VIEW

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What you are going to do when crisis strikes will be determined in large measure by what you do day to day.

In a crisis, time is a very scarce commodity. It's too late to plan or set up systems and processes to deal with the crisis. When crisis strikes you will be reacting not planning.

So what should you be doing day to day that will help you when crisis strikes?

To answer that question, it's very important to understand the company's many governance functions and how they work as an overall enterprise process.

It's important because things work very differently in a crisis than they do day to day. Unless you have a good understanding of the underlying reasons, you won't be able to plan processes that will help the company deal with a crisis.

Think of this as a kind of large domino effect driven by clockwork.

One way to approach these issues is to examine roles.

The role of senior management

Senior management runs the business day to day.

When the company's business is running in the ordinary course, senior management exercises pivotal influence to the point of virtually having free rein.

The role of the board of directors

The Board of Directors is ultimately responsible by law for the management of the company.

The most important thing a Board of Directors does is to appoint a CEO to run the business on a day to day basis.

Once the CEO is in place, the Board of Directors focuses more on oversight, financial reporting and monitoring the governance structures that it has put in place.

When the business is operating in the ordinary course with senior management at the helm, the Board of Directors is entitled to rely on management and the reports that management makes to the Board on a periodic basis.

This the mode that most people are accustomed to seeing management and the Board of Directors operating in.

It's critically important to understand that when a crisis strikes, the roles will shift, and shift dramatically.

Why is that?

It's because of the way directors' liability works under the corporation statute.

As soon as the Board of Directors faces a serious situation and needs to make decisions that may have a profound effect on the company's future, the Board's reliance on management may be insufficient to shield directors from liability.

The business judgment rule tempers directors' liability by sheltering the director from the consequences of decisions that turn out to be bad. Provided the directors were reasonably informed when they made the decision. This means some level of due diligence that may easily go beyond the level of information that management provides.

In addition, directors have a due diligence defence which shields them from liability when they rely on professionals. So if anything happens in the life of the company that is serious enough to get the attention of the Board of Directors, the Board of Directors will invariably have to turn to outside independent professional advisors to assist them.

When that happens, senior management will no longer be the only decision-makers. In fact they will find that they become a much smaller part of the equation with far less influence when the company enters crisis mode.

Whether you are a director, corporate counsel, corporate accountant, or external auditor, that inevitable shift in how the company is directed and managed has to be factored into your planning well before you have a full-blown crisis on your hands.

The role of securities laws

Another principal ingredient that you need to take into account in considering the possibility of an eventual crisis, is the impact of securities laws.

For public companies, sitting on material adverse information for very long is not an option. Securities laws require timely disclosure. This reality will act like a heat source in a crisis by building pressure to disclose. Depending on the nature of the crisis, the continuous disclosure pressure will substantially reduce the time management has to carry out an investigation and assessment of the situation the company is facing. It also means that the Board of Directors will have to be informed as far in advance of public disclosure as possible.

Once the Board is informed, as noted earlier, independent experts retained by the directors will enter the picture and management's role will have shifted, making any further action by management potentially very difficult.

One key lesson to take away at this point, is to put processes in place that will detect incidents well before they reach a point where the situation becomes material.

Materiality and the role of internal controls over financial reporting and disclosure controls and procedures

The continuous disclosure rule requires public companies to disclose material information immediately. The basic concept that needs to be understood is materiality. Much has been written about materiality.

Some things are clearly material. Some things clearly are not. Where materiality determinations get tricky is in the broad gray zone in between. Once you enter the gray zone, you are faced with the risk that, with the benefit of hindsight, someone is going to second-guess your materiality determination.

The risk is that the company and its directors will be faced with potential liability to investors who have traded in the company's shares without the benefit of material information. Senior officers share in that risk since the CEO and CFO are now required to certify the accuracy of financial reporting.

These changes in the law stem from the *Sarbanes Oxley Act of 2002* adopted in the US. The so-called SOX rules were largely adopted in Canada following their adoption in the US.

Among the SOX changes was a sharp focus by regulators on accounting controls. Every public company has been required to document its internal controls over financial reporting, to test those controls periodically, and to report any material weaknesses quarterly.

That process focusing on internal control has had the effect of sharpening and making far more robust the neural network of processes in public companies that warn of risk.

Among the indispensable controls are such processes as enterprise-wide risk assessments and whistleblower hotlines.

All these controls ultimately lead to the Board of Directors and its quarterly review of financial results, usually with the oversight of the Audit Committee.

The good news is that the internal control framework is more likely to call attention to the seeds of a crisis well before the materiality threshold is reached.

This means more time for management to assess and mitigate problems before a crisis erupts and the management paradigm shifts influence to the Board of Directors and external advisors and everything spins out of management's control.

The role of corporate finance and accounting staff and internal audit

A company's internal finance and accounting staff and the internal audit team are the first line of defence in warding off a situation that may otherwise become a crisis.

They are in a position to spot unusual variances in income statement or balance sheet items that may be indicative of a problem.

When a problem is spotted, it's important that it be escalated. The most important point of escalation is to the Chief Legal Officer and the law department.

Role of corporate counsel

Why do lawyers become an essential first responder when trouble is brewing?

Because whatever the trouble may be, it's likely to be associated with liability risk, for the company, but also for its directors and officers. The law department will be front and centre in mounting an eventual defense if that becomes necessary, and so the early involvement of the law department is very important, before things get out of hand.

Another reason is solicitor-client privilege. If there is a serious situation that may lead to liability, it's important to preserve as much control over the situation as possible. That means asserting control over the flow of information. Solicitor-client privilege is critical to maintaining the confidentiality of information and keeping potentially damaging information out of the hands of those who might use it to their advantage against the company or its personnel, whether through private litigation or public investigation.

It's therefore prudent to ensure that corporate counsel plays a central role in the company's mandatory whistleblower hotline facility.

Corporate counsel should also be playing a role in the day to day management of the Board of Directors.

The role of corporate counsel, whether as General Counsel or as Corporate Secretary or Assistant Corporate Secretary, is to ensure that information that needs to be surfaced at the Board level gets there. There are two mechanisms at play.

The obvious one is for corporate counsel to participate in materiality determinations with respect to one-off situations.

The other is the role corporate counsel ought to play along with the company's controller's department in establishing and maintaining the delegation of authority rules from the Board of Directors to management.

These rules are in place at the majority of public companies. A fundamental aspect of the delegation rules is determining what situations need to be submitted to the Board of Directors for decision.

Another vital role in the hands of corporate counsel is that of documenting the activities of the Board of Directors.

Corporate counsel should be preparing the minutes of meetings, preserving the records of meetings (i.e. the documents that are tabled with the Board of Directors or its standing committees at each meeting), and ensuring that working files and notes of meetings are destroyed once the minutes are preserved. In this way the records of the Board of Directors and its deliberations are accurately determined and delimited on a day to day basis. This mitigates the risk that in a crisis, it may become unclear what the Board knew, and when they knew it.

More broadly, corporate counsel should ensure that the company has a records retention policy and process in place that is effective. When a situation arises where there is the likelihood of a claim or of litigation, it will be necessary for corporate counsel to determine when a records hold needs to go into effect to make sure that business records are retained and protected from loss, destruction or improper disclosure that may undermine solicitor-client privilege.

In this regard it is vital for corporate counsel to understand the scope of information that must be retained. One of the important ingredients to take into account is the time span factor. Quite aside from the evidentiary needs related to litigation, one of the significant risks in any business crisis is that there will invariably be an impact on financial reporting. Because financial statements are always multi-year disclosure documents, a crisis scenario is not unlikely to result in a restatement of results and the restatement is likely to span more previous years than one might immediately expect. The restatement can, in turn, drive liability for directors and officers, as well as the clawback of past years' performance-based compensation awards. It is therefore prudent for corporate counsel to consult with corporate finance and accounting staff to determine the period for which records need to be retained in the event of a crisis.

Digital records are now pervasise and likely outweigh paper records in terms of importance. The records retention policy and related processes must therefore address digital records and e-mail effectively.

Another thing for all stakeholders to bear in mind is the "up-the-ladder reporting rule" that was adopted with the advent of SOX. In Canada, for instance, regulations adopted by the *Quebec Bar Association* and the *Law Society of Upper Canada* require lawyers in those provinces to report evidence of financial wrong-doing in the first instance to their immediate superior. But, in the event that the lawyer sees that nothing is being done, they have the obligation to report the incident up the corporate ladder until they are satisfied that the information is in the hands of the company's Board of Directors.

This is one more ingredient in the crisis pressure vessel that pushes serious issues up to the Board level where it becomes likely that management influence and control of a crisis situation will shift to the Board of Directors and the Board's outside independent advisors.

The role of outside counsel

One of the chief benefits of outside counsel is that, compared to corporate counsel, they are almost in limitless supply, and have a range of expertise that corporate counsel cannot match.

Once a situation becomes sufficiently serious, such as when the risk of litigation arises, or a claim is made, outside counsel will have to be involved.

The effectiveness of outside counsel will depend on the quality of information they have.

A good day to day practice is to put the company's lead outside counsel on the Board of Directors' distribution list so that the lead outside counsel gets everything that the Board of Directors or its standing committees get. This ensures that the lead outside counsel is, at a minimum, on the same

footing as the directors and understands the day to day level of information that the directors are getting.

Finally, once a situation gets to be very serious, and the need to ensure that the company's claim to solicitor-client privilege is as strong as it can be, outside counsel are a vital player.

The role of the external auditors

External auditors play a special role. Their primary role is to test the accuracy and reliability of the financial information that the company discloses to its shareholders and third parties, including regulatory agencies.

While they act for the company, they are also outsiders, and they have a limited ability to advise the company. The role of external auditors became further limited under SOX rules. Auditors must maintain their independence from the company they audit. The result is that there are many services that auditors routinely provided in the past that are now prohibited services. There are therefore a number of advisory roles that the external auditors are precluded from playing.

When a serious situation arises, it is likely that the auditors will be involved. But they will also need to keep their distance in order to avoid impairing their independence. Impairing the independence of the external auditors is not in anyone's interest as it could only make a difficult situation more so.

In addition, the information provided to external auditors related to litigation and claims has to be very closely monitored. Sharing solicitor-client privileged information with external auditors is absolutely fatal to a claim of privilege in the US. If a Canadian company has substantial operations in the US, it becomes crucial to manage the information provided to external auditors. In Canada it is possible to share privileged information with external auditors provided case by case measures are taken to ensure that privilege is maintained. A one-time blanket confidentiality undertaking on the part of the external audit firm is unlikely to protect privileged information in most Canadian jurisdictions.

The role of independent and forensic accountants

When a potentially serious situation arises, retaining independent accountants, and, if there is a risk of fraud or intentional harm present, forensic accountants, becomes a necessary step.

It will be important to determine who retains the independent accountant. As noted earlier, the Board of Directors will have little choice but to retain their own independent advisors when a crisis develops. It therefore makes sense to think carefully about whom you may wish to retain before the situation demands it.

It may also make sense to retain those accountants for routine matters that the external auditors can't handle so that they become familiar with the company, before their services are needed in a crisis.

The internal audit department is probably the logical corporate department to develop an ongoing relationship with a forensic accounting firm.

Take the time to plan

All of the roles and processes that will come to play in a crisis situation are also present in the day to day functioning of the company. The company's governance processes ought to work in a clockwork cycle to ensure that major policies and processes are periodically reviewed and kept current.

Among those processes one should find:

- Board of Directors and standing committee mandates and work programs.
- The internal auditor's role and yearly audit plan.
- The company's Code of Ethics.

- The whistleblower process.
- The process for creating and retaining Board of Directors minutes and records.
- The enterprise risk assessment and mitigation process.
- The policies and processes related to internal controls over financial reporting and disclosure controls and procedures.
- The company's business continuity plan.
- The company's records retention policy and processes.

In addition to yearly reviews of the policies and processes that help to detect and mitigate risk at a macro level, micro level planning is essential whenever an internal investigation is begun.

- Keep the team very small. One corporate counsel along the internal auditor is about the right size. It's easy to ramp up a small team as needed and it's best to keep the early investigation planning process among as few people as possible.
- Get a firm grip on information. Corporate counsel should seriously consider having high grade encryption capacity to protect digital information. The right encryption software can guarantee that information can only be shared deliberately and with the right people. The right software can remove the need to share passwords. Forget using the password protection that comes with standard business applications. That's no better than a two foot white picket fence is at protecting your home.
- Once you get an idea of the potential risk exposure, and particularly if the potential risk of liability or harm to reputation is significant, take the time to map out what the outcomes and necessary action steps will be depending on what the investigation uncovers, before you start turning over rocks to see what lurks underneath.
- Among the things to consider are:
    - What steps may need to be taken depending on the potential magnitude of wrong-doing:
        - Simple breach of company policy.
        - Intentional harm or harassment exposing the company or its personnel to minor civil liability.
        - Behaviour that may be a breach of laws or regulations exposing the company or its personnel to administrative sanctions.
        - Intentional harm or reckless behaviour exposing the company or its personnel to major potential civil liability.
        - Behaviour that may be a breach of laws or regulations exposing the company or its personnel to penal sanctions.
        - Behaviour that may be a breach of criminal law.
    - What steps may need to be taken depending on the materiality of the findings:
        - Immaterial situations that require only improving existing policies and processes.
        - Situations that are not material but require action on the part of senior management to adopt new policies or processes.
        - Situations that are clearly not material but have the potential to become material and that need to be brought to the immediate attention of senior management.
        - Situations that are in the materiality gray zone and may need to be reported to the Board of Directors or one of its standing committees.

    - Situations that are material and need to be brought to the immediate attention of the Board of Directors.
    - Situations that need to be disclosed immediately, for instance, those that involve public safety or threats of serious injury or death.

- For each severity step, who needs to be involved? What outside expertise may become necessary? Find out whom to call, before you need to call them.
- Determine how much time you can expect to have to take the steps that need to be taken at each step on the severity assessment of the threat, and plan accordingly.
- If the situation is potentially complex outside expertise will likely be required. Legal, accounting, valuation, proxy solicitation, engineering or other specialized research may need to be done to allow a conclusion to be reached that will be necessary to guide further action. To the extent possible, do that work pre-emptively so that the work product is at hand should the need become acute.
- Consider keeping at least some of these experts on retainer by finding mandates for them as part of day to day business so that they become familiar with the company and its business and will therefore be able to ramp up more quickly when a crisis demands it.
- Corporate counsel should maintain a governance and issues watch. This involves monitoring the press, industry and professional publications and scholarly sources and squirreling away information in files or soft copies on disk. The information needs to be sufficiently organized by topic, and stored in chronological order. The 'watch' files can be worth their weight in gold by making it much easier for the management team, legal counsel, accounting advisors, and other professionals to understand the scope of an issue at the outset or during an investigation.
