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# HOW TO HANDLE CONFIDENTIAL INVESTIGATIONS OF BANK ACTIVITIES

Avoiding mistakes and unnecessary exposures during private inquiries

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Scenario: In the course of a safety and soundness examination, bank examiners identify certain unusual transactions and bring the issue to the attention of management. Management, in turn, recognizing the potential severity of the issue presented, decides that the matter should be referred to the Audit Committee of the bank's Board of Directors for appropriate action. Now what?

Not every issue with the potential for substantial risk of financial or reputational loss warrants a special investigation conducted by outside, independent counsel.

However, if the circumstances suggest the possibility of significant employee or customer negligence or misconduct, or violations of law or regulations, the prompt authorization of a full, independent, and confidential investigation may be the best approach, particularly because it demonstrates to regulatory authorities that the board and bank management acted with both dispatch and a desire to correct any identified deficiencies.

Of course, authorizing and conducting a confidential investigation is separate from, and does not supplant, the requirement that the bank file any necessary suspicious activity reports.

Here are some of the key issues to be considered for the confidential investigation.

Who is the client?

While management could authorize the investigation and hire independent counsel, it is more common for the board, formally, to authorize the investigation and to delegate to the audit committee the responsibility of hiring independent counsel and overseeing the inquiry. In this case, the client is the audit committee, and the engagement of counsel and other third-party specialists is done through the committee.

Preserving privilege and confidentiality

The final report of independent counsel and all work product produced in the course of the investigation must be protected from mandatory disclosure to third parties, particularly what otherwise might be required in litigation that might arise as a consequence of the investigation or otherwise. Unless otherwise waived by the client's disclosure, the attorney-client privilege and the attorney work product doctrine should protect both the contents of the final report and the work product produced in the course of the investigation from discovery by third parties. See, for example, Rule 26(b)(3) of the Federal Rules of Civil Procedure; section 2018.30 of the California Code of Civil Procedure. Disclosure to bank regulatory agencies under circumstances where privilege is protected is discussed below.

Initial focus of the investigation

Upon being retained, counsel must quickly build an understanding of the nature and potential breadth of the investigation. This requires that counsel be fully conversant with both banking law and regulation as well as banking practice and the regulatory interaction between a bank and its regulators. To this end, there should be an early meeting with the client to enable counsel to fully appreciate the relevant facts and circumstances as well as those facts which will need to be determined in the course of the investigation and which will form the basis of the conclusions the report will reach. This may include any relevant communications with the bank regulatory agencies and recent exam reports issued to determine if the issues previously were brought to the bank's attention.

### Managing the investigation environment

In any organization, banks included, word of an outside investigation often triggers rumors and "water cooler" speculation.

This is especially true if the discussions and actions taken at a board meeting authorizing a confidential investigation become known. Keep the gossips at bay through a carefully planned and monitored program initiated by senior management of keeping a tight lid on the confidential investigation while making sure that all who have need to know of the ongoing investigation are aware that the investigation process was authorized by the board. Once the plan of the investigation has been established, managers must be alerted to the need for complete cooperation and confidentiality in the ranks.

At the same time, management should manage the reputation risk that might arise during and at the conclusion of the investigations by utilizing public relations consultants in order to be ready to address any public notoriety that might arise.

### Forensic assistance and similar special skills

Counsel should consider retaining investigators, forensic accountants, e-discovery vendors, and other consultants as

appropriate to the nature and scope of the investigation.

These consultants should be retained by counsel to preserve the attorney-client and work product privileges.

In turn, the plan for the confidential investigation should include the views of those consultants. Ordinarily, the use of the bank's internal forensic skills (such as the internal audit department) should be minimized or discouraged, notwithstanding any potential cost savings, so as to protect the work product from disclosure to third parties.

Note that the cost of this forensic assistance is borne by the bank.

Establishing the plan of investigation

Answers to key questions will help get the inquiry off to a good start:

- • What is being investigated?

Unless client and counsel clearly understand the precise nature of the investigation, with a laser-like focus, a confidential investigation at a bank can easily veer into areas that may have only a tangential connection to the matter under inquiry.

This is especially true because policies and procedures are an integral part of banking operations and something that bank regulatory authorities examine regularly as part of a safety and soundness examination. The tendency is to want to cover every possible angle that might assist in the final analysis of the facts and circumstances at issue.

The risk is that time and resources are spent on ultimately unnecessary tasks. In this connection, the judgment of counsel of what is material to the investigation must be followed. Otherwise the entire investigation runs the risk of being deemed a "whitewash."

- &bull; Who will lead the investigation?

In a confidential investigation, experience is the key. Counsel must have a clear understanding of the issues and of the methodology that needs to be followed. Often, this leadership is best exemplified by counsel with law enforcement experience, such as is provided by service with a U.S. Attorney's Office, jointly operating with counsel thoroughly familiar with banking law and regulation and bank operations.

- &bull; How will records relevant to the investigation be maintained?

In today's business environment, electronic records are prevalent but not necessarily the only means of communication. The client must take instructions from counsel in causing the safeguarding and production of all relevant records, which would include business records; e-mails to and from relevant bank employees; video recordings of bank activities; and records provided by third-party vendors, if relevant.

Counsel must have access to all these records in an efficient manner. In order to preserve the evidentiary value of these materials, often counsel needs to retain an independent third-party e-discovery vendor to collect and process data. Failure to adequately preserve relevant documents and electronic materials can result in regulatory criticism; imposition of monetary, evidentiary or issue sanctions in subsequent civil litigation; and, in egregious situations, prosecutions for obstruction of justice.

- &bull; How will interviews with outside and inside parties be arranged?

An investigation usually requires three dimensions. The review of records and other documents provides counsel with invaluable insight into the activities being investigated. Nevertheless, interviewing witnesses, particularly bank employees, generally provides critical information for investigators.

Employees risk their jobs by failing to cooperate. However, third parties cannot be compelled to be subject to an interview and often this requires the intervention of the client to arrange.

Employee interviews should be conducted in the presence of counsel and any relevant forensic assisting parties. It is particularly important that the retained investigator be present to ask questions but also to document the interview for later use by counsel.

- &bull; Who will handle investigative analysis?

Typically the results of the investigation will be documented in a written report. The basis of the report is an analysis of documents, investigatory material, and interview notes. The input of all parties is essential to this process.

Thus, any estimate of the time necessary to complete a confidential investigation must take into account the considerable time normally devoted to the investigative analysis and the writing of the report. Often the need for another round of follow-up interviews or further document reviews becomes apparent as the primary actions and results are reviewed and analyzed.

### Conducting interviews

As noted above, employee interviews are critical once the other elements of the investigation are in place. Generally, interviews are most productive when they are not conducted as adversarial interrogations but rather as mere fact-finding activities.

However, to protect the bank, certain procedural requirements are necessary. These are often referred to as the "Upjohn" warnings, so called because of a U.S. Supreme Court case in which they were first elucidated. They can be summarized as follows:



Also, in the course of the investigation counsel may become aware of employee conduct that may warrant that the bank take personnel action. For that reason, employment counsel for the bank should be consulted before the bank initiates any personnel action, both as to the process to be undertaken and the appropriate timing of it.

Often, interviews of bank employees reveal incidents or lapses that suggest the interviewed employee should be disciplined. This runs the risk of the employee claiming that he or she is a whistle-blower and that the discipline is retaliatory because of the information revealed in the course of the investigation. No personnel action of this kind should be taken without consultation with the bank's employment counsel, due to the bank's potential exposure.

#### Periodic reporting to client

Prior to delivery of the final report, it is normal for counsel to brief the client's representative regarding the progress of the investigation. This often will include keeping the client abreast of costs and expenses being incurred.

#### Written report elements

At the conclusion of the investigation, it is customary to deliver to the board of directors (or a designated committee) a written report containing the findings of the investigation. The report will also include observations concerning matters made apparent to the investigating team and any recommendations for correcting deficient or improper behavior based on the conclusions reached in the investigation.

The final report should be transmitted with a clear statement that it is subject to the attorney-client privilege and the attorney work product privilege.

Important: The report should contain an admonition that the report is confidential and that dissemination to third parties will constitute a waiver of the privilege. That waiver could subject the report to discovery by third parties if private litigation or regulatory or criminal proceedings were to be commenced thereafter.

Should regulators get a copy?

It is not uncommon for banking regulators to ask for a copy of the final report, particularly if the matter that is the subject of the confidential investigation was identified during an examination.

In this connection, absent other considerations, the bank should be comfortable in delivering the report because the submission of any information to any federal, state, or foreign banking authority in the course of a supervisory or regulatory process concerning the bank will not waive, destroy, or otherwise affect any applicable privileges. (See Section 18(x) of the Federal Deposit Insurance Act, 12 U.S.C. Section 1828(x).)

There has been a recent trend for bank regulators to want to review not only any written report of a confidential investigation, but also to review the materials used by counsel in formulating its conclusions and to interview counsel as to the process and procedures that were undertaken in conducting the investigation. Counsel should be prepared for these additional requests--and to defend the objectivity and independence of the investigation.

#### Other disclosures to consider

Note that the statute cited above does not protect disclosure to other parties, such as the bank's outside auditors, law enforcement agencies, and, if the bank's shares (or that of its holding company) are publicly traded, the Securities and Exchange Commission.

So caution must be exercised. Any desired or requested disclosure to these parties must be considered only in light of other privileges that may apply and thus protect against third-party disclosure.

Management and the board must also be aware that the bank regulatory agencies could make formal criminal referrals to federal or state prosecutors if the investigation identifies any apparent criminal activity by employees or bank customers.

In addition, a criminal investigation could result from the filing of any Suspicious Activity Reports relating to conduct identified as part of the confidential investigation.

#### Public disclosure potential

If the bank or its holding company is a public company, consideration will have to be given to the need for timely public disclosure of the material facts and circumstances set forth in the report. The bank's securities counsel should be consulted in this regard.

What now? Follow-on action by the board

The delivery and presentation of the report of the confidential investigation is not the end of the process but, rather, the beginning.

The identification of lapses, deficiencies, failures to follow bank policies and procedures, and failure to comply with applicable law and regulation will require that corrective steps be taken. It is the board's responsibility, as part of its oversight function, to assure that management takes the appropriate remedial actions.

Banks operate today under a regulatory microscope. If the regulatory agencies deem the identified conduct as pervasive and egregious, formal regulatory action may be taken against the bank, such as a cease-and-desist order. The board will play a major role in the negotiation and implementation of such an order.

Overall, given the headlines in the financial press about wrongdoing at a number of large institutions and the continued pressure on directors and officers of failed banks to be charged with liability for losses incurred by the Deposit Insurance Fund, it is safe to assume that there will be increasing calls for confidential investigations, whether initiated by regulatory inquiry or by attentive boards of directors.

