

# HOW TO CONDUCT A FRAUD INVESTIGATION

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On a daily basis, our society is bombarded with newspaper and television stories headlining alleged or suspected fraudulent corporate activity. More and more, the responsibility for dealing with these allegations of fraud is falling upon the shoulders of HR managers, adding to the already increasing scope, complexity, and challenge of the HR role. How should a HR manager identify fraud, and what are the skills needed to answer this question and investigate the allegation of fraud? What options are available to HR managers when confronted with suspected internal fraud?

Fraud comes in a variety of forms including: fraudulent financial statements, financial fraud, accounting irregularities, environ-

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mental and health care violations, or asset misappropriation, just to name a few. Major fraud scandals and dramatic monetary losses resulting from the fraud have led legislators and enforcement agencies to change the federal and state regulatory environment, and this, in turn, has changed how HR professionals must deal with suspected workplace fraud. Even though employers should first of all understand the necessity of a preventive approach to fraud in today's workplace, there are many instances where an internal investigation is necessary. Employers can and do successfully conduct internal workplace investigations. The goal of this article is to instruct the HR manager about the potential issues surrounding an investigation and when it might be appropriate to seek outside advice. Also, this article attempts to instruct the HR manager about the issues of employee whistleblower protection and how it pertains to different situations throughout the internal investigation.

## **MECHANICS OF A FRAUD INVESTIGATION**

Before the issue of fraud arises, employers and human resource managers can attempt to prevent or greatly diminish the likelihood of workplace fraud if certain issues are addressed early on. Education, training, and written policies and procedures addressing internal fraud are systemic devices that a company can use to deter or prevent internal fraud. Combined with systemic devices and preventive efforts, addressing the fraud up front through consistent enforcement and sanctions, (including discharging employees who commit fraud), will send a clear message to all that it will not compromise its integrity.

Once an allegation of fraud arises, the company is faced with many considerations, several of which are discussed below. The twelve questions that follow generally represent the different stages in an internal fraud investigation and will facilitate the HR professional's evaluation of the allegation of fraud.

### **Should the company even conduct an internal investigation?**

Some practitioners argue that with all the regulations, and increasing strictness in the application of those regulations, a better alternative for a public company — particularly one that merely suspects fraud — is to leave the matter alone. They caution that if the company conducts an in-house investigation and prepares a written report in connection with the investigation, a governmental agency could use that report as a road map for conducting its own investigation. Yet, allowing the fraud to go unaddressed in any company could be problematic. Sound business and legal judgment supports conducting an investigation but proceeding with skill, caution, and confidentiality. In the end, an internal investigation should be conducted if for no other reason than to stop the fraud or send a message throughout the company that fraud will not be tolerated.

### **What is the extent and pervasiveness of the fraud?**

Assuming the company decides to conduct an investigation, an investigator must continually address the timing, scope, and viability of conducting an internal investigation. (1) *Timing*: a fraud investigation must be prompt and swift. (2) *Scope*: if the alleged fraud involves high level employees, an investigator must get the support of the top level executives to conduct an investigation and to have full authority to interview those high level employees.<sup>1</sup> (3) *Viability*: the seriousness, duration, and frequency of the possible fraud will help in determining whether an internal investigation can competently and swiftly uncover and deal with the fraud. Addressing these issues will

give the investigator the clearest picture of the extent of the fraud in the company and possible needed safeguards — *i.e.* as document retention, external advice, and security concerns.

### **Who conducts the investigation?**

HR managers are increasingly being called upon to conduct in-house investigations. The question of whether to bring in law enforcement, a regulatory agency, external audit teams, a private law firm, or handle the matter in-house is an open one. This decision is fact and case specific, and will depend upon the duration and breadth of the potential problem as well as potential in-house investigatory skills. Many times the in-house investigations are coordinated with outside counsel. If the company initially decides that it will conduct an internal investigation instead of an external investigation, the roles of the individuals involved in the investigation should be clearly delineated. If the investigation is conducted in-house under the supervision of an HR manager, the benefits may include: (1) heightened knowledge about the company's business, employees, and procedures; (2) increased control over the investigation as well as the possible resulting publicity; and (3) an unfiltered view of the fraud and the extent of it. Keeping the investigation in-house will also prevent possible problems with the Fair Credit Reporting Act (FCRA).<sup>2</sup> The FCRA applies generally to workplace investigations, but does not apply when the investigation is done completely in-house.<sup>3</sup> On the other hand, the disadvantages to keeping the investigation in-house may include: (1) lack of attorney-client privilege; (2) insufficient training

in carrying out fraud investigations; (3) less objectivity than an external investigation; (4) possible conflicts between the company's well-being and management's professional obligations; and (5) possible loyalty issues between the investigator and the employees and lack of support.<sup>4</sup> Although some of the disadvantages are not damaging to the company generally, the existence of such factors when conducting an in-house investigation might be problematic.

### **Who is being defrauded?**

If the harm is internal, the company can deal with the issue through targeting the offender and dealing with the offender appropriately, definitively, and swiftly. If the harm is external — *i.e.* a vendor, supplier, customer, or shareholder—the company should analyze how to rectify the current situation with the outside parties. In these situations, outside advice should be sought, and the investigator and the employer must be aware that companies are generally liable for the fraud committed by its directors, officers, employees, and agents.<sup>5</sup>

### **Should the employee have known that certain conduct is fraudulent or against company policy?**

In answering this question, a company must examine its policies and procedures, its education and training concerning workplace fraud, and its outward commitment to preventing internal fraud. The answer to this question is important later on in the investigation process when the company will have to decide what to do with an employee who is found to have engaged in fraudulent acts either against the company or against external entities.

### **What is the purpose of the investigation?**

Either through an anonymous tip, an external source (supplier, vendor, etc.), a suspicion from upper-management, or a complaint from an employee, someone in management realized that there may be fraud going on in the company and it must be ferreted out. The company realizes that the goal is to either (1) find fraud or no fraud or (2) find fraud and identify who is responsible.<sup>6</sup> Prior to any interviewing, the investigator should have a clear understanding of the alleged violation, any documents or statements that support the violation, and a working knowledge of the area to be investigated. Next, the investigator (1) gathers as many facts and documents as possible, (2) develops a strategic order to interview the employees or the accused, and, finally, (3) establishes some sort of measuring system by which to gauge the credibility of the sources of the information.

### **How will the investigator document the investigation?**

On the one hand, documentation is vitally important to show that the company took the complaint seriously and investigated the matter. On the other hand, if documentation is not done properly it could lead to numerous complications.<sup>7</sup> The decision of how to document the interviews should be made with regard to the specific facts of the case. In particular, before an interview, the investigator must decide to either take notes, take notes and then have the interviewee initial them, or have the interviewee sign a written statement in order to support allegations and prevent possible problems in the future with inconsistent stories. Whatever

type of recording the investigator decides to use runs the risk of either too little recorded factual information and “faulty” memories in the future or too much information that could be damaging to the company in the event of a lawsuit (any records generated throughout the investigation may be subpoenaed). Any legal questions about what documents will be discoverable should be directed to legal counsel.

### **How to conduct an interview?<sup>8</sup>**

The investigator should initially inform the employee why the investigator is there and what is going to be discussed with the interviewee. For example, “there are issues concerning the way the goods are accounted for” or “how the cash management system is being administered” are two ways in which the investigator can avoid saying “fraud” while at the same time informing the interviewee of the purpose of the interview. All employees interviewed should be informed that it is expected that they will keep the information discussed and the fact that the interview took place confidential (See Whistleblower section for possible issues). The investigator should inform the interviewees that the company cannot promise absolute confidentiality, in order, among other reasons, to minimize the possibility of allegations of defamation<sup>9</sup> or self-publication defamation.<sup>10</sup> During the actual interview, focusing on who, what, where, when, and how questions about the alleged fraud will present the company with a complete picture about the scope of the alleged fraud. Inquisitive language encourages open communication, whereas accusatory language will tend to

agitate an employee and make the employee less forthcoming.

### **What happens when an employee does not want to cooperate?**

In general, every employee owes a duty to cooperate and a duty of loyalty to the employer. This duty obligates an employee to comply with the directions from the employer during an internal investigation as long as those directions are reasonable. Unwilling or untruthful employees should be dealt with immediately. Regard must be given to the employee’s possible contractual rights, federal and state law, and the specific facts of the situations. Before terminating an employee for failure to cooperate with an internal investigation, the company should consider a common issue of the employee requesting to have an attorney present.<sup>11</sup> In the initial investigatory stage, most companies do not allow individuals to have an attorney present, but the investigator should be aware of possible interview requirements.<sup>12</sup>

### **How to evaluate the findings of the investigation?**

The conclusion of the investigation will result in finding fraud, no fraud, or no conclusion. No matter what the investigator finds, the investigator should be careful to support any findings with facts. Thus the following “global” checklist will be helpful to a company faced with a decision about how to proceed after the completion of any investigation:

- Assess offenses or possible offenses.<sup>13</sup>
- Review company policies and procedures to assure that they cover the alleged violations.

- Decide whether the offense is historical or on-going.
- Address parallel issues of governmental intervention, shareholder derivative suits, and third party actions.
- Decide whether a final report should be written.
- Consider what steps should be taken as to disciplining the employee or terminating the employee.
- Address public relations issues and possibilities of disclosing the fraud to the appropriate regulatory agency or criminal agency.<sup>14</sup>

#### **To whom does the investigator report?**

Reporting to the correct decision-maker in a respective area — *i.e.* accounting, division head, president, etc. — is essential to conducting a fraud investigation. Embarrassment often accompanies fraud investigation, especially by the one who might have overseen the area where the fraud was committed. The investigator should make sure that the person to whom she or he reports is someone who will take action pursuant to the investigation's findings and consistent with the company's policies and procedures. Just as promptness was important during the internal fraud investigation, promptness and accuracy is critical when reporting to the decision-maker.

#### **How to handle the actual termination?**

After the completion of the investigation, if it is determined that an employee has committed fraud, the employee can be terminated immediately. The employee should be told clearly and concisely the reason for the termination.

In informing the employee of the reason for dismissal, the employer, if possible, should link whatever fraud the employee committed with one of the specific company's policies and procedures. This will allow the employer to inform the employee that the termination is a response to a *violation* of a company's policy and procedure instead of an undefined fraudulent act. Taking this approach reduces the possibility of falling into a trap of the legal definition of fraud and minimizing the risk of countersuits. There should be documentation of the meeting with particular emphasis on what the accused admitted or denied.

#### **WHAT INVESTIGATORS SHOULD KNOW ABOUT WHISTLEBLOWER LAW**

HR managers are aware of the various protected categories ranging from age, sex, nationality, ethnicity, disability, and union activity. Recently, the issue of whistleblower protection has been in many national headlines. Since employees are consistently increasing their awareness of the protected category of whistleblower protection, HR managers should also be aware of the changes to whistleblower protection in order to treat employees with due regard to their appropriate rights and protect themselves.

Whistleblower status could possibly affect different stages of the internal fraud investigation process — including a decision to discharge an employee. When an employer discharges an employee for fraudulent acts, the employee might claim that the real reason for the termination is not the alleged fraud, but due to the fact that the employee is a whistleblower. If the employer has solid facts to support

the allegation of fraud and has been consistent in applying discharge as a penalty, the employer should be on safe grounds to terminate the employee. Although this may not prevent an employee from bringing an action, it should put the employer in a defensible position.

Even with the facts to support the allegation of fraud and a consistent application of discipline to fraudulent acts in the company, the employer should proceed with caution if: (1) the employee makes an allegation of workplace or external fraud either to a superior, a governmental or regulator agency, or criminal agency right before termination; (2) the employee claims that there was coercion to commit the fraud; or (3) the employee was prevented from disclosing the fraud through threats of dismissal by the company. Also, the employer should be aware that even though an employee committed workplace fraud, if the employee subsequently discloses the fraud to governmental or regulatory agency, the court might still afford whistleblower protection to that employee.<sup>15</sup>

During the interview stage of the fraud investigation process, an employer must be aware of the issue of instructing the interviewee (the employee) about the expectation of confidentiality of the interview. In 2002, Congress enacted the Civil Whistleblower Retaliation Provision in the Sarbanes-Oxley Act of 2002 (the Act), which put employers on notice about terminating whistleblowers even in at-will employments at publicly traded companies.<sup>16</sup> The Act states that the company or its agents may not “discharge, demote, suspend, threaten, harass, or in any other manner discriminate

against an employee”<sup>17</sup> for any lawful act by the employee to disclose fraud in the company. Thus, during the interview, the employer must make sure that the company’s expectation of confidentiality on the part of the employee does not reach the point of threatening or harassing the employee from potentially making a disclosure under a whistleblower statute.

Employers should also be aware of their respective state statutory whistleblower protection. While the general rule to at-will employment is that an employee can be dismissed at any time, some states protect at-will whistleblower employees under a public policy exception or statutory scheme. For example, New Jersey has a strict whistleblower provision,<sup>18</sup> and the courts have interpreted its whistleblower statute to include retaliation allegedly taken against an employee who reports a co-employee’s fraud without any company complicity in the fraud.<sup>19</sup>

Lastly, employers should be aware that various regulatory agencies are adopting rules and regulations to implement the standards of the Act’s whistleblower protection. One in particular, the Occupational Safety and Health Administration (OSHA), issued an interim final rule establishing the procedures and time frames for the handling of employee complaints to OSHA.<sup>20</sup> Besides OSHA’s interim final rule establishing the procedures and time frames for handling the investigation by OSHA, its rules and regulations also address the appeals of OSHA decisions to an administrative law judge, hearings by administrative law judges, and judicial review of the Secretary of Labor’s final decisions.<sup>21</sup>

## CONCLUSION

Companies must face the realities of workplace fraud. A company’s legal responsibilities are increasingly dictated by regulations from many different governmental agencies’ requirements. At first glance, conducting a workplace fraud investigation might seem daunting, but in reality, it is only slightly different from any other workplace investigation. As with all investigations, preparation, documentation, findings of credibility, and conducting the investigation in a fair and impartial manner are the essential characteristics of a thorough and successful investigation.

## NOTES:

1. Upper level managers might have contractual rights of varying degrees, possibly including a right to company-paid representation. Also, employees might have certain rights addressed in endnote nine.
2. 15 U.S.C.A. § 1681 et seq. See also, “Vail Opinion Letter from FTC Commission Staff” (April 5, 1999), at <http://www.ftc.gov/os/statutes/fcra/vail.htm>. While the Opinion Letter refers directly to sexual harassment, the statute’s broad definitions include other internal investigation conducted by outside entities.
3. 15 U.S.C.A. § 1681.
4. This list is merely illustrative and not exhaustive.
5. *U.S. v. Automated Medical Laboratories, Inc.*, 770 F.2d 399 (4th Cir. 1985); *U.S. v. Cincinnati*, 689 F.2d 238, 241-42, 11 Fed. R. Evid. Serv. 423 (1st Cir. 1982).
6. If the internal investigation’s findings are insufficient to make a conclusion, the company might rethink soliciting the advice of an external source.
7. Documentation of a fraud investigation is a complex matter and beyond the scope of this article.
8. The current NLRB policy is that before an interview with an employee, the employee, represented by a union or not, has the right to request that a co-worker be present at an “investigatory” interview if that employee has a reasonable belief that the interview might result in disciplinary action. *Epilepsy Foundation of Northeast Ohio*, 331 NLRB No. 92 (2000); *National Labor Relations Board v. J. Weingarten, Inc.*, 420 U.S. 251,

95 S. Ct. 976, 43 L. Ed. 2d 171 (1975), *conformed to*, 511 F.2d 1163, 89 L.R.R.M. (BNA) 2192, 76 Lab. Cas. (CCH) ¶ 10829 (5th Cir. 1975). Also, unions might have specific rights that affect the confidentiality of the interviews.

9. Defamation is the “act of harming the reputation of another by making a statement to a third person.” Black’s Law Dictionary (1996).
10. In order to maintain an action for defamation, the employee must be harmed by “unprivileged publication of false and defamatory” information communicated to a third party. In general, there is no publication where the employer communicates the alleged slanderous statement to the employee who then communicates it to a third party. Yet, some courts have recognized the doctrine of self-publication defamation as a narrow exception to the rule requiring publication to a third party.
11. In *Porterfield v. Mascari II, Inc.*, 374 Md. 402, 823 A.2d 590, 19 I.E.R. Cas. (BNA) 1697, 148 Lab. Cas. (CCH) ¶ 59740 (2003), the court found that an employee who alleged that she was wrongfully discharged for implying an intent to seek legal advice did not state a claim for wrongful discharge. See also, endnote nine for a discussion of the *Weingarten* rights.
12. This topic is outside the scope of this article.
13. The decision to terminate an employee should take into consideration whether there was a series of offenses or a single serious offense or other contractual obligations. In the case of fraud, one instance should be enough for termination.
14. This list is not exhaustive but merely illustrative. The specific issue of disclosure is a complicated topic and outside of the scope of this article.
15. When the whistleblower is involved in wrongdoing, courts have often excused the employee’s own misconduct. See, *Paolella v. Browning-Ferris, Inc.*, 973 F. Supp. 508 (E.D. Pa. 1997), *aff’d*, 158 F.3d 183, 14 I.E.R. Cas. (BNA) 705, 137 Lab. Cas. (CCH) ¶ 58505 (3d Cir. 1998).
16. Sarbanes-Oxley Act of 2002 P.L. 107-204, § 806.
17. Sarbanes-Oxley Act of 2002 P.L. 107-204, § 806.
18. N.J. Stat. § 34:19-3.
19. See, *Higgins v. Pascack Valley Hosp.*, 158 N.J. 404, 730 A.2d 327, 15 I.E.R. Cas. (BNA) 289 (1999).
20. 29 C.F.R. Part 1980. This is the interim final rule effective on May 28, 2003 of the Procedures for the Handling of Discrimination Complaints Under § 806 of Sarbanes-Oxley Act.
21. 29 C.F.R. Part 1980.