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Using Effective Internal Reporting to Understand and Mitigate Corporate Risk

By Caleb Hayes-Deats

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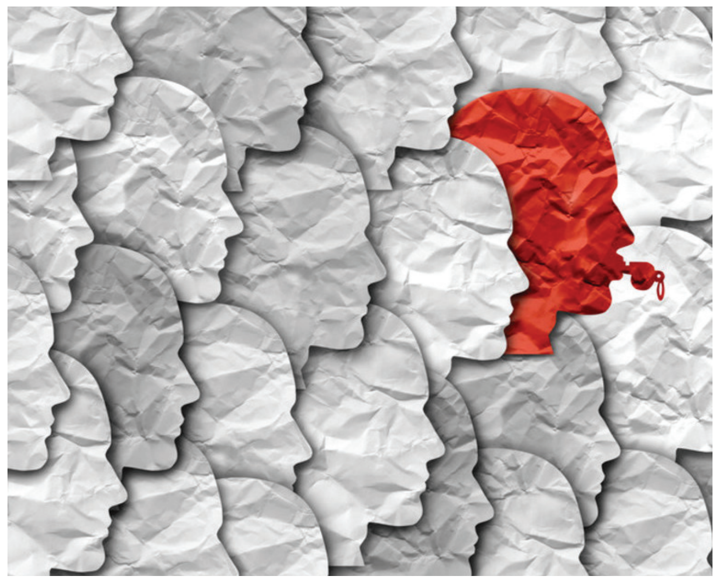
In 2024, the U.S. Department of Justice announced a new whistleblower award program to incentivize disclosures of "corporate crime." Three years earlier, Congress created a whistleblower award program for disclosing violations of anti-money laundering requirements and U.S. economic sanctions. Those newer programs are modeled on templates created by the SEC and CFTC, which implemented whistleblower protocols over a decade ago. The Trump Administration's decision to shrink enforcement staffs may render the government more reliant on whistleblower tips than ever before.

In-house counsel can reduce the likelihood that employees will blow the whistle to the government by implementing an effective internal reporting program. If companies offer credible and effective reporting programs, most employees will disclose perceived problems internally, rather than to the government. To create such programs, companies must encourage reporting, offer a transparent process, and prohibit retaliation. They must also efficiently investigate the reports they receive and identify appropriate responses.



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Effective internal reporting programs do far more than prevent external whistleblowers. They result in fewer lawsuits, smaller legal bills, and even greater profitability.

Benefits of Internal Reporting

Let's start with the business case for internal reporting. Many regard internal whistleblowers as a sign of dysfunction. But research by Professors Stephen Stubben and Kyle Welch shows that is wrong. In a *Harvard Business Review* article entitled, "Whistleblowers Are a Sign of Healthy Companies," Professors Stubben and Welch explain that a greater number of internal reports correlates with fewer lawsuits, smaller settlements, and higher profitability. The reason is simple. All companies have problems. Internal reports are a qualitative tool for identifying—and promptly addressing—problems that may not appear in hard data. Companies that encourage reporting become aware of problems earlier, when they are more manageable. Those that do not allow problems to fester and grow.

Internal reporting programs also mitigate the risk that employees might blow the whistle to regulators or other external entities. Most employees prefer to report internally rather than externally. The SEC found that, in 2021, more than 75% of whistleblower award recipients who were current or former employees of the reported companies initially raised their concerns within the company before reporting to the SEC. The federal government also encourages would-be whistleblowers to first report internally. Reporting internally is one factor that can support a higher whistleblower award.

How to Implement Effective Internal Reporting

Effective internal reporting programs have several key characteristics. First, companies must encourage reporting. Such encouragement takes many different forms. Leadership should tell employees to speak up if they have concerns and train them on how to do so. Effective internal reporting programs also offer multiple channels for reporting, such as through supervisors, compliance or HR departments, board designees, and anonymous hotlines. Multiple channels ensure that employees know their complaint will not be received by the person they accuse of misconduct.

Second, companies must help employees understand what happens after they make a report. Outlining the procedural steps a company takes to investigate internal reports shows employees that their reports will be taken seriously. It also helps employees remain patient after they make an internal report, especially if the company continues to communicate during each phase of the investigation. Companies should be careful, however, not to share privileged information or otherwise collaborate with the whistleblower in a way that could jeopardize the investigation.

Third, where possible, companies should explain the outcome of their investigations. Nothing chills internal reporting faster than a belief that reports simply fall into a void, never to be seen again. Explanations need not be detailed, especially when investigations involve sensitive personal information or result in referrals to government enforcers. But simply communicating that an employee's complaint is still under review and has resulted in further action can increase confidence in the reliability of the reporting program.

Finally, effective reporting programs prohibit retaliation. Retaliation can take many forms. Most obviously, companies should forbid adverse employment consequences because of an internal report. But other forms of retaliation can be informal, such as ostracization. Companies should thus make a point to check in periodically with employees to discuss their experience after reporting.

Efficiently Investigating Internal Reports

Internal reports alone are only half the equation. Companies must also have a strategy for investigating reports. Internal investigations have two goals: identifying what happened and determining an appropriate response that corrects system failures, remedies past harms, disciplines any wrongdoers, and mitigates future risk.

Identifying what happened may sound simple, but the reality is often complicated, particularly given resource constraints. The first step is choosing an investigator who has relevant expertise and lacks any conflicts of interest. When an internal report alleges violations of law, the investigator should be an attorney. Next, the investigator must gather relevant documents, ranging from company policies and work product to email, instant messages, and phone records. The investigator often then needs to interview employees to better understand the written record. The facts uncovered are seldom as clear as the investigator may wish, but the investigator must nonetheless make credibility determinations and draw conclusions about what likely occurred. Without such conclusions, the company has no foundation for future action.

Where an internal report of misconduct is substantiated, the company must consider several different types of action. First, the company must determine how to discipline anyone found to have engaged in wrongdoing. Second, the company must consider whether it should remedy any harms the misconduct caused. For example, wrongdoers may have misled business partners or promoted accomplices over more qualified employees. Third, the company must correct any system failures that permitted the problem to occur. Detecting such failures often requires a “root cause” analysis that identifies not just the problem’s proximate cause but also deeper issues that could lead to recurrence. Finally, the company must determine how to mitigate future risks associated with the problem. Where wrongdoing resulted in potential legal violations, the company should consider whether to disclose those violations to the government. Such disclosures are never easy, but they reduce the risk the company would face if the government learned of the conduct from another source.

Conclusion

An effective internal reporting program alerts a company to problems it faces and generates plans for confronting them. Detecting and addressing problems at an early stage reduces the resources they consume. It also allows companies to remain focused on their businesses. That benefit explains why internal reporting increases profitability.

Importantly, the benefits of internal reporting do not depend on the merits of the underlying reports. Many internal reports will be unfounded because no information source is always reliable. But an unfounded report still has value, because the problem it identifies is not the alleged misconduct, but the report itself. Such reports reflect miscommunications or misunderstandings. If mishandled or ignored, they can result in external whistleblower complaints and government investigations. Thoroughly addressing unfounded reports thus saves company resources. And if frustrated employees still try to blow the whistle to government, the company will have already identified its defense. Either way, the company is better informed and prepared.

Caleb Hayes-Deats *is a partner at MoloLamken LLP, where he represents companies and individuals in government investigations. Previously, he served as an Assistant U.S. Attorney in the Southern District of New York.*