

How Founders and Private Companies Can Mitigate Risks of a Government Investigation

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Government investigations can be costly. A simple subpoena for documents could entail collecting hundreds of thousands of documents from your email servers and personal devices, hiring attorneys to review and produce documents, and sitting for hours of interviews with government investigators. And if that investigation uncovers evidence of violations, the consequences could include significant penalties for a company and its principals.

Private companies are not immune from these risks. The anti-fraud provisions of federal securities laws apply to private companies, and the US Securities and Exchange Commission (SEC) has not shied away from pursuing private companies (as well as their officers and directors) for alleged fraud. The US Department of Justice (DOJ) also closely scrutinizes startups and their founders. And because of the relatively long statute of limitations for securities fraud (five years for SEC civil enforcement and six years for DOJ criminal prosecution), statements made to investors in a company's early stages could trigger a government investigation years down the road. Moreover, the mere existence of an investigation – not to mention the company's response and the investigation's outcome – is highly relevant in due diligence when companies raise capital or pursue an exit. That means that officers and directors of startups should be mindful of what they say to investors and the public about their companies' products and financial performance. Here are some ways to mitigate the risks of a government investigation for founders and private companies.

1. Use tenses carefully: Now versus later

Understandably, investors want to know what the company plans to achieve in the future. When communicating with investors, it is helpful to distinguish between what the company **has** and **does** today versus what it **expects** or **aims to do** tomorrow. Try to avoid ambiguous phrasing that implies current capabilities when you are describing roadmap items.

2. Double check the numbers in written materials

Make sure that any numbers you provide in pitch decks, press releases or other written materials are accurate and can be substantiated with supporting documents. If you include pro forma or illustrative figures, consider labeling them as such and keeping them separate from actual results. When announcing a financing round, be accurate about (i) the total round size targeted, (ii) the amount already closed and (iii) any remaining capacity for subsequent closings. Remember that statements about the company's users, traffic or revenue are not just for marketing purposes – they could be treated as representations to investors, and any material inaccuracies could potentially lead to a securities fraud investigation.

3. Caveat forward-looking statements appropriately

When making forward-looking statements (such as those about expectations, goals and projections), it is best to clearly identify them as such and accompany them with appropriate cautionary language. For example, instead of saying, "We will reach \$50 million in revenue next year," consider, "We expect to reach \$50 million in revenue next year, although risks and uncertainties could cause actual results to differ from our projection." Better yet – identify the assumptions underlying your forward-looking statements and the risks that could lead to deviation from the goal.

4. Build projections in good faith

Financial projections should be prepared in good faith and grounded in defensible methodology and supporting data. Where feasible, consider offering investors access to the underlying model or a summary of key assumptions so they can understand the basis for the forecast. Apply the same discipline to any option-value estimates shared with prospective hires by using reasonable, supportable exit valuation ranges and other assumptions.

5. Provide accurate financial records to investors and the board

Consider engaging experienced accounting professionals early on to help maintain accurate records of the company's financials. When communicating to investors about the company's financials, make sure the information you provide

aligns with the company's stated accounting policies. If the provided financials are unaudited, you might consider noting that. Officers should provide regular updates to the board about the company's financials. If material adjustments are required, explain them promptly to the board as well as to investors, who may otherwise rely on the inaccurate numbers.

6. Accurately describe third-party relationships

It is helpful to be precise when describing your relationships with customers, partners and other investors. Distinguish signed agreements from verbal interest, and avoid exaggerating the nature of the relationship. You may want to share a proposed description with the relevant third party for review. It is always a good idea to obtain consent from the third party before using its logos or attributing quotes.

7. Use raised funds as represented

While money is fungible, you may want to monitor what you tell investors about the use of proceeds and how the company actually spends them to help ensure accuracy. Where appropriate, consider informing investors of compensation paid to founders and high-level employees. Aim to maintain clear records tying expenditures to the stated purposes. If your plans change, document the rationale and update the board in a timely manner. Where appropriate, inform investors of the change of plan.

8. Where practicable, provide transparency into company performance

Consider setting a reasonable cadence for updates to investors, highlighting both progress and risks. It is helpful to provide visibility into key performance indicators and deviations from the plan (though avoid divulging proprietary or sensitive information about the business). Transparency strengthens credibility and instills investor confidence.

9. Enable effective board oversight

Having a well-functioning board is important to assure investors that your company is operating effectively. To help ensure the board can carry out its oversight role, officers should provide accurate and timely information to the board. In addition, consider sending important, time-sensitive updates to the board in real time, rather than waiting for the next board meeting.

10. Be careful with statements about the use of AI

It is important not to overstate the company's use of cutting-edge technology, such as artificial intelligence (AI). Both the SEC and DOJ have pursued companies and their principals who allegedly misled investors about the use of AI technology (known as AI-washing). Consider reviewing your representations about your company's AI capabilities, especially statements used in fundraising activities.

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