SOUTHEAST
AUDIT COMMITTEE NETWORK
VantagePoint

June 2, 2008 TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

Litigation risk and the audit committee

Introduction

The Southeast Audit Committee Network held its tenth meeting on May 6, 2008, to discuss the audit committee's role in addressing litigation risk. This document is a synthesis of insights and comments from that discussion. In a private session, members also shared best practices regarding committee notes, concurrent committee meetings, and dealing with current market conditions, the consequences of the credit crisis, and the potential adoption in the United States of International Financial Reporting Standards (IFRS).

During the discussion on litigation risk, members focused on the following topics:

- **Current trends in corporate litigation**
- **The role of the board and the audit committee**
- **Legal advice and resources for the audit committee**
- **Litigation and the external auditor**

Collectively, members of the network in attendance at the May meeting sit on the boards of more than two dozen large-, mid-, and small-cap public companies. Audit committee chairs attending were:

- Eddie Adair, Tech Data
- Denny Beresford, Kimberly-Clark and Legg Mason
- Renée Hornbaker, Eastman Chemical Company
- Doug Ivester, SunTrust Banks
- Andy McKenna, AutoZone
- Tom Presby, World Fuel Services, Invesco, and Tiffany & Company
- Jim Robbins, DSW
- Erik van der Kaay, RF Micro Devices
- Bunny Winter, Wellesley College
- Edwina Woodbury, R. H. Donnelley

In order to provide perspective, the group was joined by J. Kelley, the head of the Corporate Practice Group at the law firm King & Spalding. Also participating in the meeting from Ernst & Young were:

- Edwin Bennett, Southeast Area AABS Managing Partner
- Tom Hough, Vice Chairman and Southeast Area Managing Partner

VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Members' remarks appear in italicized quotes.

Executive summary

Members focused on four themes related to litigation risk and the audit committee:

- **Current trends in corporate litigation** *(Page 3)*

  Corporate America faces increases in a number of types of litigation, including class action suits related to market volatility, lawsuits resulting from the subprime securities crisis and the credit crunch, Foreign Corrupt Practices Act (FCPA) investigations, and intellectual property (IP) lawsuits. The news is not all bad, however. Litigation over financial restatements decreased in the past year, and two recent legal decisions (one against Bill Lerach, the other for JDS Uniphase) have proved heartening to corporate directors.

- **The role of the board and the audit committee** *(Page 4)*

  While the audit committee will often be the first line of oversight of litigation, the full board quickly gets involved in any legal matters that have the potential for substantial strategic, material, or enterprise-wide impact or which might lead to a footnote in the financial statements. Members agreed that they need to look at potential future litigation risks and not simply address issues that have already arisen, but were aware of how hard that is to do. Members believe that the reserving process is fundamentally a task for management in concert with the external auditor, with the audit committee providing oversight.

- **Legal advice and resources for the audit committee** *(Page 6)*

  The audit committee deals with a wide range of legal matters, but they also have a variety of resources and people to turn to for advice and guidance. Some audit committees retain independent counsel, using a different law firm from that retained by the full board. Members did not agree about whether it was helpful to the audit committee to have at least one member who is a practicing or retired lawyer, noting that directors need to provide business judgment, not legal expertise. Members also explored the relationship between the committee and the GC and action they can take to ensure the GC is free of undue management influence.

- **Litigation and the external auditor** *(Page 7)*

  The audit committee must balance the need of the external auditor for full and complete information about the company with the need of management and board directors to speak privately and confidentially about the company's approach to particular litigation. Members noted that they do not withhold information from the external auditor, and they proposed ways to meet all parties' needs, such as by working through outside counsel. Members also acknowledged wanting to be kept abreast of the external auditor's litigation issues.

Current trends in corporate litigation

The litigious nature of the U.S. business environment has deep roots: within 35 years of the Pilgrims' landing at Plymouth Rock, plaintiffs were actively filing lawsuits related to business transactions in the towns and villages at the eastern end of what later became known as Long Island, NY.[1] In an overview of current corporate litigation trends, J. Kelley highlighted:

- **More class action lawsuits related to increasing market volatility.** *"Volatility typically equals more cases, and the increased volatility we're seeing means things will step up. So far [this year], 75 class action suits have been filed, the highest number since the 1995 (Private Securities Litigation Reform Act)."*
- **More subprime-related lawsuits.** *"Subprime issues are driving an enormous quantity of litigation,"* J. Kelley noted. While companies have already had a rollercoaster ride in dealing with financial issues as a direct result of the credit crisis, *"the second shoe still hasn't fallen."*
- **Lawsuits deriving from an increase in FCPA investigations.** J. Kelley reported that *"[FCPA cases,] mostly with the U.S. Department of Justice, doubled in 2006."* Another trend was *"international actions, [with the Department of Justice] teaming up with foreign countries"* to launch investigations.
- **More IP lawsuits.** IP lawsuits have become *"an exploding area between companies,"* with a number of boards dealing with litigation both as plaintiffs and as defendants.

It's not all bad news for companies and their board directors, however. J. Kelley also mentioned two areas in which positive results have been obtained:

- **A decline in litigation from financial restatements.** *"Restatement litigation is down."* Of approximately 1,300 restatements last year, only 25 legal cases resulted.
- **Decisions limiting shareholder lawsuits.** In February, Bill Lerach was found guilty of paying people to act as plaintiffs in class action suits against corporations. The *Economist* noted that Lerach was "sentenced to two years in jail, fined $250,000 (on top of $7.75m he had already agreed to repay), and barred forever from practising law."[2] Lerach pioneered the practice of shareholder class action lawsuits; he "earned a fortune by suing firms, typically after a fall in their share prices, which he would allege was due to wrongful behaviour by managers. Whether shareholders benefited from this was unclear, as it was their own money that was paid out to them – minus the legal fees, of course."[3]

  Three months earlier, there was a rare win for the corporate side when the Supreme Court found in favor of plaintiff JDS Uniphase in a suit brought by Connecticut Retirement Plans and Trust Funds. The suit had claimed that "the company – whose stock was one of the most popular during the dotcom era – and the executives unduly cost shareholders $18 billion by overstating the company's financial

[1] George DeWan, "1650s East Hampton: A Litigious Society," *Newsday.com,* 2008. Available at http://www.newsday.com/community/guide/lihistory/ny-hs319b,0,6827510.story

[2] "Lerach and ruin," *Economist,* February 14, 2008. Available at http://www.economist.com/business/displaystory.cfm?story_id=10696014.

[3] Ibid.

health before the stock plummeted."[4] A negative finding for the company could have been disastrous: the company reported in its November 2007 10-Q filing that "Although the complaint does not specify the precise amount of damages sought, Plaintiffs have stated in recent court filings that they intend to seek a verdict of more than $20 billion in alleged damages. […] In the event of a final, non-appealable and enforceable judgment against the Company that is in an amount commensurate with the Plaintiffs' maximum theory of damages, it would not have sufficient assets to pay such a judgment."[5] The Supreme Court ruled that shareholders "must have 'cogent and compelling facts' to prove a company intentionally misled investors, and therefore committed fraud,"[6] which was not the situation in this case.

Cases like the suit against JDS Uniphase are a prime example of why the board and the audit committee must be diligent in the oversight of litigation risks and keenly aware of the legal advice, resources, and options available to them.

The role of the board and the audit committee

How boards handle oversight of litigation risk varies, with one member noting that *"no matter if you're facing two million lawsuits or ten, it's company specific rather than any one best practice"* across all boards. Often, *"the audit committee does the routine heavy lifting, [as it is] the first line for financial statements. What's been accrued for, disclosures, footnotes, etc."*

Depending on board structure, litigation risk might be addressed across multiple committees and best handled in a joint meeting. One member's company holds *"joint audit committee and risk committee meetings annually."* This allows the committee members to *"address a series of topics from a list the general counsel creates."* At the same time, they can bring in *"subject matter experts internally to cover topics, and occasionally outside counsel and experts"* to provide their perspective and opinion.

When litigation is the purview solely of the audit committee, audit chairs often make it a standing item on every meeting agenda, even if the discussion is only for five minutes. The topic for discussion is frequently decided ahead of time, when *"the general counsel calls the audit committee chair to discuss what should be on the committee meeting agenda."* Afterwards, the audit committee chair will often *"advise the full board on the discussion"* during the committee report to the board.

Audit chairs are quick to identify what should be addressed at the full board: *"Significant, enterprise-wide issues impacting on the company go to the full board,"* one remarked, and added that this included *"anything that would cause a footnote [in financial reports]."* Additionally, audit chairs remarked that anything involving *"reputational issues or [that] would lead to bad publicity"* should be addressed at the full board. One member made clear that *"you need to make sure the full board isn't blindsided"* by an issue.

---

[4] Stephen Taub, "JDS Uniphase Wins Rare Securities Trial," *CFO.com,* November 28, 2007. Available at http://www.cfo.com/article.cfm/10204868/c_10203909?f=todayinfinance_next.

[5] Quotation from JDS Uniphase's SEC 10-Q filing, available online at http://www.sec.gov/Archives/edgar/data/912093/000119312507238473/d10q.htm.

[6] Stephen Taub, "JDS Uniphase Wins Rare Securities Trial."

Be forward looking and identify new risks

J. Kelley remarked that *"boards look in the rearview mirror, [but they] need to be more forward looking. [They need to address] industry risks and strategic risks. In looking back on litigation, they need to ask, 'what were we doing six months ago that caused this problem?'"*

One member felt it was important to *"match your risks with your strategy. Look at the strategic plan and the key assumptions; identify the related risks and disclose them."* A number of members saw the value of such an approach, but also agreed with J. Kelley's warning that *"you can't have hundreds of pages of meaningless risks."*

Businesses are always changing and evolving, and the risk management process has to continuously identify new litigation scenarios that might arise. To address this challenge, one member got management involved in the process by *"driving heat mapping[7] using internal audit and our external resources. We engaged management to identify risks and quantify them. At first, we had to drag them kicking and screaming, but when they get it, they get it."* Another member noted, *"I've seen that start, and then people get distracted."* To keep risk management off the back burner, one director recommended, *"Don't create a list of 300 [risks], but a list of 15 to act on. Half of risk management is better than none."*

Reserving is a management function overseen by the audit committee

Members clearly view handling legal reserves as a management function that in many ways is *"no different than [handling] any other form of reserves."* J. Kelley agreed: *"The key word is oversight,"* he told the group. At the same time, a number of members indicated they had *"never seen the audit committee challenge the numbers,"* and others commented that *"it's hard to challenge [management's] judgments."* However, members are clear that reserves shouldn't be moving around without good reason. *"If it moves quarter to quarter, you have to ask why,"* one member said. Others were open to the idea of *"the audit committee asking outside counsel to discuss litigation and the reserve [with management]"* and providing their perspective to the committee.

Audit committee chairs need to be clear about which litigation requires reserves and how much to reserve. The external auditor can play a role in the process. *"Don't minimize the role of the external auditor,"* one member advised. Being truly independent, the auditor can *"challenge the assumptions"* in the reserving process. At the same time, many members lamented that accounting rules were unclear around how to reserve for legal fees, *"which can be more than the loss itself."* One member commented that he felt *"there is a gap in GAAP. A piece of the reserves is the future litigation costs, and that diverges in practice by industry. FASB hasn't figured that out."*

[7] Heat maps "translate raw, complex … data into visual maps by presenting live, colorful pictures that dynamically change in real time." For an example, please see http://quotes.nasdaq.com/screening/heatmaps.stm.

Legal advice and resources for the audit committee

The audit committee must deal with a wide range of legal matters, but they also have a variety of resources and people to turn to for advice and guidance. Internally, the audit committee has frequent interactions with the general counsel and may have a member with a legal background on the committee. Externally, a number of audit committees are identifying and/or retaining outside counsel for the audit committee itself. Each source of advice has benefits and drawbacks, and the audit chair needs to understand what is available and who to turn to when.

Strengthening the relationship with the general counsel

Most audit committee chairs have experience working with general counsel, but many feel they don't have a strong relationship with the GC, or even that they can trust the GC fully. *"You run the risk of getting advice in shades of gray,"* one member said. Another agreed and remarked that *"it depends on the GC. I have confidence in some, but not in others. Remember, they are part of management, and good management wants to manage everything, including the board and audit committee."*

The fact that the GC reports directly to the CEO is part of the concern for many audit committee chairs. J. Kelley pointed out that the GC is *"a steward of the corporation and a partner to the CEO. That's the tension you feel. Good GCs acknowledge that tension and try to put it aside. In practice, it's a good idea to have the audit committee question the GC without the CEO present."* He went on to say that even if audit committees meet with the GC alone, the committee should realize that the GC will likely have met with the CEO beforehand and discussed the topics to be covered by the audit committee.

In order to mitigate this, member suggested two approaches:

- **Direct questions in a private meeting.** One member said audit chairs should explicitly ask the GC, *"What are we not hearing that we need to hear?"* They should also ask if there are any topics the CEO suggested not bringing up. This can best be done in a private one-to-one discussion with the GC, a practice many audit committee chairs are taking up.
- **Executive sessions at the audit committee meeting.** Another member said, *"We have an executive session for one hour at each meeting."* Another reported holding *"four meetings of 15 minutes each, one each with the internal auditor, external auditor, and CFO. The fourth rotates: someone within an operating unit, the general counsel, the controller."*

The value of having a lawyer on the audit committee

Members were divided on the benefits of having a lawyer sit on the audit committee:

- **A legal expert can add real value.** One member noted, *"We have a practicing lawyer on the committee. They provide an additional resource and a second opinion. They're a tremendous resource."* A member whose board has two former lawyers on it said, *"They're a great resource; they know what questions to ask, and they're a great asset to the committee."* One audit chair valued having *"counsel from counsel who wasn't outside counsel."*

- **Legal expertise can be hired instead.** Other members felt that any legal advice required by the committee should come from inside or outside counsel. One member commented, *"We had [a lawyer on the board]. He retired, and we didn't fill the spot with another lawyer. We didn't feel it was a compelling need."* J. Kelley recommended directors ask themselves, *"Are you getting a lawyer to be a lawyer, or a lawyer to be a director?"* Another member agreed and said that a lawyer on the committee should be there to provide business judgment: *"You can't rely on them for legal opinion."*

Independent counsel for the audit committee

Among members attending the meeting, two said that their audit committees retain legal counsel for themselves, separate from the counsel for the full board. One member said, *"[I] insist on … separate counsel [for my audit committees], not associated with the company. I'm concerned about an event when the audit committee is pressed to respond, time is critical, and we can't spend 45 days to screen counsel. [When we have an issue,] we need a response within 24 hours."*

Another member said, *"We have outside counsel who attends the audit committee meetings, [a practice that] started during [an investigation of backdating]. It's very useful to have them advise us."* Recognizing that it is not retaining but identifying independent counsel that is the time-consuming process, one member reported going through that process so the committee would have counsel if the need arose. The member said the audit committee wanted to *"make sure we knew someone who had no conflicts. We told them that before they become conflicted [by taking on work for the company], to give us a call."*

Litigation and the external auditor

Members discussed two aspects of litigation and the external auditor: tensions surrounding attorney-client privilege and audit firms' own litigation risks.

Attorney-client privilege

Audit committee chairs face a unique challenge in sharing litigation information with their external auditor. The auditor is not protected by client-attorney privilege and therefore, if called upon to testify, must disclose any information they have. At the same time, without that information, the auditor may not be able to fulfill their responsibilities to the company and provide an opinion on the company's financial statements.

Members reported that they erred on the side of providing all the information requested by the auditor. Not doing so, they said, would create more problems than it would solve: *"I would be concerned about withholding information from the external auditor,"* one member said. *"The auditor needs enough information to be able to do their jobs."* Additionally, members felt that it was *"the job of the audit committee chair to ensure the comfort of the external auditor and that they have all the information they need."*

Members indicated that they often use outside counsel as a channel to provide information to the external auditor. *"The outside counsel and the external auditor meet. The external auditor isn't in meetings between the outside counsel and the audit committee."* That way, the conversation between outside

counsel and the audit committee is protected under attorney-client privilege, and the external auditor receives the necessary information from a reliable source.

J. Kelley remarked that *"there needs to be a balance between privacy for the audit committee and what the external auditor needs. The general counsel, outside counsel, and the external auditor need to find a balance."* Members agreed, and one remarked that *"the audit committee always has the right to meet alone"* and suggested that these meetings shouldn't create concern: *"Private sessions shouldn't raise red flags."* In particular, the external auditor should not be alarmed if the audit committee holds private sessions. As one member remarked, *"It has to do with tone at the top, and the relationship [between the company and] the external auditor. Good tone at the top, [and] a good relationship, and there's no issue with private meetings."*

Addressing the auditor's own litigation risks

Whether in the form of an annual review or on a more frequent, as-needed, basis, audit committee chairs expressed their preference that their audit partner *"make sure we're never surprised"* by litigation facing the audit firm. A member who values being informed said, *"[I] like to know I can rely on that continuing."*

Conclusion

Given the increasing volatility in the financial markets and the staggering sums now sought by plaintiffs, audit committees must be more committed than ever to diligent oversight and planning for litigation risks to ensure the company's future well-being. The audit committee has abundant internal and external resources available to it and must make sure it makes good use of outside and general counsel, external auditors, and others in its work.

About this document

The Southeast Audit Committee Network is a select group of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.