

Litigation risk and the audit committee

Introduction

On February 19, 2008, members of the Audit Committee Leadership Network (ACLN) met in Los Angeles for the network's 16th stand-alone meeting. During a private session, members discussed the slowing economy, the credit crunch and valuation of financial instruments, and improving risk management. Members also discussed investor perspectives with a representative of the California State Teachers' Retirement System (CalSTRS).¹ For further information about the network, see "About this document," on page 9.

During their discussion on litigation risk, members focused on:

- Trends in litigation risk
- The role of boards and audit committees in overseeing litigation risk
- Reserving and disclosing litigation risk
- Supporting the independence of the general counsel (GC)
- Assessing the external auditor's litigation risk

Members were joined by Jamie Wareham, global chair of litigation at the leading international law firm Paul Hastings. Audit chairs participating in the meeting, who sit on the boards of over 25 large-, mid-, and small-cap public companies between them, included:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Dick Harrington, Audit Committee Chair, Xerox
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Marie Knowles, Audit Committee Chair, McKesson
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Steve West, Audit Committee Chair, Cisco Systems

Members from Ernst & Young participating in the discussion were:

- Tom Flannery, Partner and Director, Audit Committee Communications
- Steve Howe, Americas Managing Partner

ViewPoints 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 before and during meetings are not attributed to individuals or corporations. However, Mr. Wareham has permitted his comments to be attributed.

¹ See Audit Committee Leadership Network, "The investor's perspective: a discussion with CalSTRS," *ViewPoints*, March 14, 2008. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar08_View20.pdf.

Executive summary

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

- **Trends in litigation risk** (*Page 3*)

Mr. Wareham outlined the major trends in litigation, which include an increase in securities class action suits, particularly following the subprime meltdown, an increase in Employee Retirement Income Security Act (ERISA) suits, and the globalization of litigation, with more cases arising from the Foreign Corrupt Practices Act (FCPA) and anti-bribery laws in countries outside the U.S. Mr. Wareham also predicted an increase in cases of intellectual property (IP) litigation.

- **The role of boards and audit committees in overseeing litigation risk** (*Page 4*)

Most members reported that they review litigation risks at the full board meeting, with a written and verbal litigation report most often delivered by the GC. The reports generally cover the most important current cases and potential litigation risks, prioritized by their impact on both reputation and the balance sheet. There is more diversity in the level of involvement in and discussion of litigation risk at audit committee meetings, with the common denominator being a thorough review of the company's reserves and disclosures in the Form 10-K. Mr. Wareham strongly recommended that audit committees also spend some time discussing prospective litigation risk.

- **Reserving and disclosing litigation risk** (*Page 5*)

The challenge for audit committees is to verify whether litigation risk has been appropriately quantified and whether it should be reserved in accordance with FAS No. 5.² It is important that the process the company uses be robust. Members report pulling estimations and judgments from several different sources inside and outside the company including the general counsel, the external auditor, outside counsel, third-party analysts, and reviews of previous experience.

- **Supporting the independence of the general counsel (GC)** (*Page 7*)

Suggestions of ways to support the independence of the GC included getting involved in the hiring decision for the GC, ensuring the legal function does not become too decentralized, holding regular executive sessions and private meetings with the GC. If the audit committee has concerns about the GC's independence, they can bring in outside counsel as a counterbalance.

- **Assessing the external auditor's litigation risk** (*Page 8*)

Audit committees also consider the litigation risk to their external audit firm. Members receive regular reports from their auditors on significant cases against the auditing firm, including threatened and actual litigation. They also tend to get early warning of media coverage of major cases. Some members include a review of litigation risk in their auditors' annual performance review.

² Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 5: Accounting for Contingencies* (Norwalk, CT: Financial Accounting Standards Board, 1975). Available at <http://www.fasb.org/pdf/fas5.pdf>.

Trends in litigation risk

As context for the discussion, members reviewed trends in litigation risk with Mr. Wareham.³ For more detail on the three major trends identified, see the box below.

Three major trends in litigation risk

- **Securities class action suits.** NERA Economic Consulting reported that the number of securities class action lawsuits rose significantly in 2007, to 207 from 131 in the previous year.⁴ Mr. Wareham noted that the subprime meltdown could represent trillion-dollar losses, with potential knock-on effects such as transaction failures and *“substantive plaintiff’s firms going after non-financial companies.”* He added, *“Anything funded by off-balance-sheet [vehicles] will be under question.”*
- **ERISA suits.** A January 2008 study on workplace class action lawsuits reported that the volume of wage-and-hour lawsuits continues to rise exponentially, that employment discrimination class action theories continue to evolve, and that ERISA class action settlements outpace other kinds of settlements.⁵ Mr. Wareham commented, *“Every time the stock declines, you’ll see ERISA litigation. ERISA damages are more definable, but they are growing faster. The increase there is outstripping other areas. A lot of people are not getting state-of-the-art advice on ERISA investments ... If you dot the i’s and cross the t’s, you can eliminate the risk.”*
- **Globalization of litigation.** Mr. Wareham said, *“The global nature of large enterprises is being matched by attacks on those businesses globally. We have cases with Korea and the European Union going after companies. It is difficult to cauterize a risk in the U.S.”* Mr. Wareham also reminded members that often cases that are civil law issues in the United States are criminal law cases in other countries, particularly in Europe. In addition, he mentioned that, *“the FCPA and foreign bribery is an issue that will impact everyone. The authorities are staffing up in Europe.”*

Despite these trends, there is some positive news for public companies. Court cases such as *Dura Pharmaceuticals v. Broudo*⁶ and *Tellabs v. Makor* have raised the bar for plaintiffs in securities class action lawsuits, and the U.S. Class Action Fairness Act of 2005 expanded federal jurisdiction over many class action suits in an effort to reduce abuse by attorneys.

³ James D. Wareham is the Global Chair of Paul Hastings’ litigation department and in that capacity supervises 300 litigators. He has served as lead counsel on behalf of multinational public companies, boards of directors, and senior executives in the defense of securities class actions, whistleblower cases, government investigations, corporate criminal internal investigations, and complex civil litigation matters.

⁴ Stephanie Planchich, Brian Saxton, and Svetlana Starykh, *Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High* (New York: NERA Economic Consulting, 2007). Available at http://www.nera.com/publication.asp?p_ID=3364.

⁵ Seyfarth Shaw LLP, “Fourth Annual Workplace Class Action Litigation Report From Seyfarth Shaw Notes Significant Growth in High Stakes Litigation at State Court Levels,” press release, January 14, 2008. Available at http://www.seyfarth.com/index.cfm/fuseaction/news_pub.news_pub_detail/object_id/2a69ffe5-df15-475f-a78a-da0661200731/FourthAnnualWorkplaceClassActionLitigationReportFromSeyfarthShawNotesSignificantGrowthinHighStakesLitigationatStateCourtLevels.cfm. A free CD-rom of the report is available from Seyfarth Shaw upon request.

⁶ The U.S. Supreme Court found in favor of Dura Pharmaceuticals, which was represented by Paul Hastings.

The role of boards and audit committees in overseeing litigation risk

Both the full board and the audit committee play a part in overseeing litigation risk. Most members reported that they reviewed litigation at the full board level, with a written and verbal litigation report most often delivered by the GC. It is usually *“the principal litigation [that] is discussed at the board meeting. A significant case may also have an outside counsel present.”*

However, one member commented that in one company, *“it’s all done at the audit committee level. We’re pushing to get it up to board level rather than as just a piece of the audit committee report, but there is some resistance by management to doing this [because] management likes to manage the clock.”*

Mr. Wareham noted, *“In some of the big [accounting scandals] ... [management] used discussion with the audit committee chair as a proxy for broader discussion. I worry [in situations] where the CEO isn’t interested in a full vetting of litigation. The CEO can use the audit chair as a protection for management, [and] that puts the audit committee and the chair at risk.”* On the other hand, one member countered, *“The responsibility lies with the audit chair. A lot of things start with me, but I can put it in the briefing book, or put it on the audit committee or board agenda. That’s very much my job.”*

Board oversight

While the volume, magnitude, and type of litigation is highly variable based on industry and company specifics, the process by which litigation risk is discussed and addressed at the board level appears to be fairly consistent. The decision to discuss issues at the board meeting comes from the audit chair or the GC. Two types of litigation risk are discussed at board level – potential litigation risks and current litigation:

- **Potential litigation risks.** One member said, *“I can request it, or legal can independently decide to raise a litigation risk to the board. The only ones reported have reputation and big balance sheet impact.”* Some members feel that all risk is litigation risk and therefore deserving of board time: *“To me it’s not litigation, it’s ERM [enterprise risk management].”* Another member advised, *“If [a litigation risk] is to be listed in the 10-Q or 10-K, then it should be discussed at the full board.”*
- **Current litigation.** One member said, *“It’s hard to keep track of what’s new and different, as litigation moves slowly. You need to get the full board to pay attention to significant legal milestones.”* Another member agreed: *“If it’s a situation where we are trying to settle, we have outside counsel come in and update the whole board.”*

Audit committee oversight

There is a great deal of variation among members as to the level of involvement in and discussion of litigation risk at audit committee meetings, with the common denominator being a thorough review of the company’s reserves and disclosures in the Form 10-K. One member said, *“We review a table of all reserves, and changes in them, every quarter.”* Other members described a more frequent audit committee review process: *“We get a litigation book, quarterly, covering significant pieces of litigation, with descriptions and*

activities. The legal group reports on significant cases outstanding at any point in time. We have a standing agenda item to review litigation and a standing review of FAS 5 at every meeting.”⁷

Regardless of how often the audit committee discusses litigation risk, one member said the fidelity to a robust process is critical: *“In interviews with outside lawyers, it is amazing the level of detail they get into in terms of the flow of information, control processes, what you did about it, how it was discussed at the board and audit committee ... You have to be able to answer that it did come to the committee, we did discuss it, and we thought about it.”*

Some members object to being sent an overly detailed litigation report by management: *“I really worry when I’m given a big, thick litigation book. If I get a book [and] I’m expected to pull out what’s important and what’s not, that worries me. I prefer [management] to have to inform me.”* Mr. Wareham shared another concern about such litigation reports: *“I’ve prepared those books, and it’s problematic as the company’s biggest risks are often not in the books. The books focus on pending filings and litigation. The more interesting discussion is to see what else is going on in the industry and discuss that.”*

Mr. Wareham said that audit committees tend to be *“fixed on events that have already occurred.”* He strongly recommended that audit committees spend some time on prospective litigation risk. Given the complexity of transaction risks, regulatory risks, and compliance risks, he advised audit committee chairs to *“make sure you are given a primer on the law that applies in each situation”* as the need arises.

Reserving and disclosing litigation risk

As audit committees are aware, enterprise risk management entails effective identification of risks, quantitative and qualitative analyses of these risks, and early disclosure of what could be material to the company’s financial results. Litigation risk, however, presents a unique challenge for the audit committee due to the complexity involved in quantifying the risk, the disclosure restrictions that often accompany a lawsuit, and the impact of revealing to a plaintiff the company’s perception of the likelihood and size of loss. Accruing for and disclosing litigation risk is regulated by FAS No. 5.

Quantifying litigation risk

The audit committee must ensure that the process for making decisions regarding individual reserve items (and amounts to be reserved) is a rigorous one, with input from the necessary experts. Members described a process of pulling estimations and judgments from several different valuable sources and triangulating them – that is, extracting the salient information, looking for common assessments, and ultimately coming to a judgment. Mr. Wareham commented, *“Everyone wants to be ‘expertized.’ to show you relied on the experts.”*

Audit chairs make their judgments based on information from amongst others:

- **The general counsel.** The information that the GC brings – the analysis and quantification of the likelihood of litigation risk – is the foundation upon which accounting judgments are made for accruals.

⁷ FAS No. 5: Accounting for Contingencies, published by the Financial Accounting Standards Board (FASB).

If the data from the GC is incorrect, the accounting judgments will be too. For further information on the role of the GC, see pages 7-8.

- **The external auditor.** A member said, *“We also quiz the outside auditor to see how they came to their judgment. What did they do to get comfortable?”* However, the auditors have their own issues: *“The legal letters [from outside counsel] to audit firms [rarely] reach a conclusion, so we have to talk to internal and external counsel to get a consensus around the range of loss.”*
- **Outside counsel.** One member said, *“On the big ones, we get outside counsel and a written opinion updated for our FAS No. 5 discussion.”*
- **Third-party analytics.** For some members, quantifying litigation risk is a more analytical exercise: *“I get outside quantitative analysis. I get a couple of different firms to look at the issues.”*
- **Reviews of previous experience.** In the interests of learning from experience, one member suggested that the audit committee review the reserves after the close of a case or settlement: *“When settlements are made, I ask, ‘How close are we? Are we doing a good job?’ If there is a big delta, we do a review to find out why and see if systems and controls are off.”*

In one company, prior to the audit committee meeting, the CFO brings together all parties providing information so that they can reach agreement on how to account for each piece of litigation. One member described how difficult it can be to get clear answers from people: *“I ask the external auditor and outside counsel, ‘Is this your best judgment? Is it your opinion that we are adequately reserved or appropriately measuring the risk?’ It gets into a battle. The outsiders don’t want to give an opinion, and the insiders want it as we don’t have time to go through the [litigation] book.”* Mr. Wareham confirmed outside counsel’s reluctance to say too much: *“Audit committee chairs would be appalled [by] how little I say ... I don’t give numbers. I’m not going to give a prediction.”*

Regarding the degree of responsibility the audit committee has for ensuring litigation risk has been appropriately quantified, one member stated, *“It’s not necessarily the audit committee’s job to be comfortable with the number. It’s more about oversight of the process and hoping that everyone has done their best.”* Another member was more concerned about, *“whether or not to reserve for litigation.”*

Disclosing litigation risk to the investing public

FAS No. 5 states that if the requirements for accrual for a loss contingency are met, disclosure of the nature of the accrual is necessary, and in some cases the amount accrued may be required to ensure the financial statements are not misleading. If no accrual is made for a loss contingency, disclosure of the contingency is made if there is a “reasonable possibility” that a loss may have occurred or may occur. The challenge for audit committees continues to be how to balance the disclosure of this information with the potential for reaction amongst adversaries. One audit chair, speaking before the meeting, said, *“We don’t like to disclose [our reserves] because that encourages lawyers, but we have to, so we try to be conservative.”*

Disclosing information to the external auditor

Another disclosure issue that has garnered attention from the legal and auditing professions is “when auditors request access to records reflecting counsel’s efforts and advice. In providing auditors with access to

privileged information, companies risk waiving the privileges and being forced to turn the information over to litigation adversaries.”⁸ In 1975, the two professions agreed to a “treaty” that struck a balance by “limiting the range of acceptable disclosures that lawyers may make to auditors with the client’s informed consent,” which defined the scope of what auditors can request.⁹

The debate has resurfaced, with observers pointing to auditors’ post-Enron-related efforts to step up their review of detailed and protected work-product-related information. One audit chair said, *“What I’ve seen is that it goes through the lawyers. The company tells its’ GC, who talks to the outside counsel, who talks to the auditor’s lawyers. It does not maintain privilege, but they have to break down the walls to get it.”* Mr. Wareham added, *“When [the auditors] are really concerned, I tell clients to go to the [auditors’] office and read the memoranda to them.”*

Members differ on how the audit chair should handle the issue. One member was adamant: *“This is not a fight for the audit committee to be involved in. I’ve never gotten in the middle of it.”* Other members have tried to help the parties involved reach a resolution by:

- **Acting as an honest broker.** One audit chair said, *“I’m being placed in a position to ensure the right parties are looking at [the issue] internally and at the external auditor to get to reasonable resolution. The external auditor wants to know what the audit committee knows.”*
- **Acting as a conduit.** Several members said the external auditors are excluded from detailed discussion of litigation: *“We have the external auditor there for the full litigation report, but the nitty-gritty particulars are in the executive session without the auditor present.”* Audit chairs then act as a conduit for communication to the auditor, either verbally or in writing: *“We promised the external auditor in writing [that a particular issue] was immaterial and wouldn’t impact the overall audit.”*

Supporting the independence of the general counsel (GC)

Audit committee chairs rely heavily on the GC for expertise and guidance on litigation risk. Before the meeting, one member expressed concern about overreliance on the GC: *“We take our lead almost entirely from the GC, on his assessment of [the] financial outcome. It is always an interesting discussion, and it is one that always troubled me that this is the way we do it.”*

A particular challenge for the GC is the need to remain independent while serving as a member of the management team and reporting to the CEO. This reporting structure could impair the GC’s ability to be candid about litigation risk at board or audit committee meetings. A GC interviewed for a recent issue of *InSights* stated, “When you’re at the board table, sometimes it’s hard to be candid if your boss [the CEO] is

⁸ David M. Brodsky, Pamela S. Palmer, and Robert J. Malioneck, *The Auditor’s Need For The Client’s Detailed Information vs. The Client’s Need to Preserve the Attorney-Client Privilege and Work Product Protection: The Debate, The Problems and Proposed Solution* (Los Angeles: Latham & Watkins LLP, 2004), 1. Available at <http://www.abanet.org/buslaw/attorneyclient/publichearing20050211/testimony/brodsky2.pdf>.

⁹ David M. Brodsky, testimony of on behalf of the Corporate Counsel Consortium before the American Bar Association Task Force on the Attorney-Client Privilege, February 11, 2005, 6–7. Available at <http://www.abanet.org/buslaw/attorneyclient/publichearing20050211/testimony/brodsky.pdf>.

[also] at the table.”¹⁰ Mr. Wareham agreed, telling members, *“I don’t care what the GC thinks their role is; what I care about is what the CEO thinks the GC’s job is ... The pressures exerted on GCs by CEOs are often dire. It is hard to give bad news when it will impact your own compensation.”*

Members suggested several ways in which the audit committee chair could support the GC’s independence:

- **Get involved in the hiring decision.** Several members described the GC’s role as somewhat analogous to the CFO’s, but whereas audit chairs are typically involved in the selection of a new CFO, this is not always true for the GC role. One member said, *“I demanded sign-off on the new GC and wanted to interview them and do the due diligence.”*
- **Keep an eye on the structure of the legal function.** Another member said, *“At [one scandal-hit company], the big problem was an ineffective GC function. There was no focal point because there were three different people in the role, reporting to different parts of the business ... In today’s world, too much decentralization and devolvement in the GC’s role would cause directors to speak up.”*
- **Hold executive sessions and private meetings with the GC.** Most GCs interviewed for *InSights* view private sessions with the audit committee as an essential mechanism for discussing issues, building trust, and ensuring the GC has weighed in on important considerations. One member commented, *“I have a good conversation with the GC on a routine basis, at least quarterly, and the GC comes to the pre-audit committee breakfast with the external auditor and without the CFO.”*

If the audit committee has concerns about the GC’s independence, they can bring in outside counsel as a counterbalance. One member had experienced outside counsel attending the audit committee and found that this added considerable value to the discussion: *“It was very comforting, but it would feel very difficult to suggest this at [my current company],”* as it would be seen as a sign of mistrust in management. However, another member said, *“We chose not to do that because we were comfortable with our GC and thought it would impair the business judgment of audit committee members. Our concern was [that] we would always defer to the outside lawyer ... when there was a decision [to be made].”*

Assessing the external auditor’s litigation risk

Audit committees do not have to deal only with their company’s litigation risk. They also consider the litigation risk to their external audit firm. Audit committee members report a great deal of sensitivity around the issue of auditor liability risk. One audit chair commented, *“My sense is that it’s very important that we keep the four [accounting firms] we’ve got. Most people at Arthur Andersen were fine people, and [they are] now at the other Big Four firms. There was a stampede from Arthur Andersen that was unfair, and none of us wants to see that [happen again].”*

Last year Jim Turley, global chairman and CEO of Ernst & Young, told the U.S. Treasury Advisory Committee on the Auditing Profession, “The unlimited, uninsured, and potentially catastrophic top-side liability risk facing firms in the U.S. threatens the long-term sustainability of private sector auditing of public

¹⁰ Ernst & Young and Tapestry Networks, “The general counsel’s perspective,” *InSights*, February 5, 2008. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_InSights_Feb08.pdf.

companies.”¹¹ Audit committee chairs want to understand the liability risks audit firms face. Some members ask their auditor to report on significant cases against the auditing firm, including threatened and actual litigation. One member described a fairly common approach: *“I get a report from my external auditor every time I meet with them. It’s a conversation about ongoing litigation. Any time they have public news [regarding a case], they call me. I am pretty satisfied with that.”*

Another member reported a more elaborate process: *“We made it a formal part of our annual assessment of our external auditor’s performance. We get a peer review report. We get the PCAOB report and focus on companies in our industry. They also give a report on existing litigation or warning of news reports.”*

Conclusion

Audit chairs often draw a distinction between business matters, which are the important strategic issues on which audit committee should be spending their time, and legal matters, which seem to represent the very compliance-oriented activities they feel add the least value. The reality is somewhat different. As one audit chair commented, there is no enterprise-wide risk that is not also a litigation risk, and there are few litigation risks that do not also pose a reputational threat to the company. For audit committee chairs, the primary concern should perhaps be to protect the independence of the GC on whom they so heavily rely. That is both good business and prudent risk management.

About this document

The 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 environment.

ViewPoints 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 *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* 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.

The views expressed in this document represent those of the Audit Committee Leadership Network and Mr. James D. Wareham. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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¹¹ Jim Turley, testimony before the United States Treasury Advisory Committee on the Auditing Profession, December 3, 2007. Available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf>.