PACIFIC SOUTHWEST
AUDIT COMMITTEE NETWORK
VantagePoint

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Litigation risk and the audit committee

Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based primarily in the Pacific Southwest region of the United States. The network held its tenth meeting on June 12, 2008. *VantagePoint* is a synthesis of insights and comments from that meeting.

Prior to the meeting, members agreed to focus the discussion on litigation risk and the audit committee. In particular, members wanted to discuss:

- **Current trends in corporate litigation**
- **The role of the board and the audit committee in the oversight of litigation risk**
- **The resources available to the audit committee**
- **Directors' personal liability**

Between them, the members of the network participating in the meeting sit on the boards of over 20 large-, mid-, and small-cap public companies. They were:

- Barbara Alexander, Audit Committee Member, Qualcomm
- Frank Biondi, Audit Committee Chair, Amgen
- Richard Dahl, Audit Committee Chair, DineEquity
- Henry DeNero, Audit Committee Chair, Western Digital
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- Diana Laing, Audit Committee Chair, Macerich
- Lou Lavigne, Audit Committee Chair, BMC Software
- Marty Melone, Audit Committee Chair , Countrywide Financial
- Mike Stein, Audit Committee Chair, AIMCO

In order to provide perspective, the group was joined by Jim Sanders, a partner at the law firm McDermott Will & Emery and head of the firm's Los Angeles trial department. Also participating in the meeting from Ernst & Young were:

- Gary Birkenbeuel, Managing Partner, Pacific Southwest Area Assurance and Advisory Business Services
- Rich Corgel, Executive Director, Fraud Investigation and Dispute Services

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:

- **Litigation risks are becoming broader and more global** *(Page 2)*

  Corporations are facing an increasing number of non-employee lawsuits, including class action and derivative suits related to market volatility. As companies expand into emerging markets, they need to be increasingly mindful of their obligations under the Foreign Corrupt Practices Act (FCPA). Furthermore, the Securities and Exchange Commission (SEC) increasingly expects companies to conduct and report on their own investigations.

- **The audit committee plays an important role in litigation oversight** *(Page 3)*

  While the full board must get involved in any legal matters that have the potential for substantial strategic, financially material, or enterprise-wide impact, audit committees often engage in more frequent, detailed litigation reviews and decide how to best prioritize litigation. Members recognize that litigation offers the board significant learning opportunities, but admit they often struggle to extract the lessons learned.

- **Audit committees regularly draw on the expertise of internal and external resources** *(Page 5)*

  The audit committee deals with a wide range of legal matters, but it also has a variety of resources it can turn to for advice and guidance. A strong relationship with the general counsel (GC) is of paramount importance. In addition, some audit committees retain independent counsel to provide advice or confirm the adequacy of oversight procedures. The audit committee should be aware of the inherent tension between the external auditors' need for information and lawyers' sensitivity to issues of attorney-client privilege and should be ready to intervene as necessary.

- **Directors can reduce their personal risk by adhering to a few simple practices** *(Page 7)*

  While members acknowledge that litigation against company directors *"comes with the territory,"* they understandably seek practices that might reduce their personal litigation risk. In particular, members were advised to retain few (if any) official or personal notes from audit committee and board meetings and to limit their use of e-mail and perhaps to cease using it altogether for director-to-director communication.

Litigation risks are becoming broader and more global

The litigious nature of the U.S. business environment is hardly a new problem. Securities lawsuits, labor and employment claims, product liabilities, patent infringement, and environmental issues continue to be concerns for companies. One audit committee chair stated, "We have a system that has set up huge monetary rewards for litigation. You can sit down and try to get rid of everything [that could be a lawsuit], but we are still getting sued." Another articulated the frustration companies feel: "[Many of these lawsuits] are essentially legal extortion."

Members note that employee lawsuits have always been common. However, several members observed that non-employee litigation has been escalating in recent years: *"You used to be sued over employee or class action issues, but recently we have been dealing with more non-employee litigation issues, like product*

liability and environmental responsibility." Furthermore, along with an expanding set of domestic risks, U.S. companies face increased risk of litigation from their international activities.

Major trends in corporate litigation

- **Increased government expectations.** *"One of the trends we've been seeing over the last few years is companies having to conduct their own investigations over allegations of fraud. It seems like something the government has actually started to expect. The SEC can't conduct all investigations internally, so the corporation is now expected to police themselves and report. That has been an upward trend."*
- **Increase in both derivative and class action lawsuits.** NERA Economic Consulting reported that the number of securities class action lawsuits rose significantly in 2007, to 207 from 131 in the previous year.[1] Additionally, the number of settled cases involving derivative actions has increased: "More than 55 percent of cases settled in 2007 were accompanied by the filing of a derivative action, compared with 45 percent in 2006 and 35 percent in 2005."[2] As one meeting participant pointed out, *"We're seeing more derivative litigation because it's easier to get more money involved."*
- **Globalization and the FCPA.** *"The Foreign Corrupt Practices Act is something more and more companies are dealing with."* Added another member, *"Certainly a broader spectrum of litigation can be seen. Litigation is a lot more global than it was five years ago. The propensity to sue is much greater than it used to be. You used to be sued just in the United States, but now you're getting litigation from all over the world. And it's big dollars."*

The audit committee plays an important role in litigation oversight

Both the full board and the audit committee play a part in overseeing litigation risk. While the volume, magnitude, and type of litigation varies widely by industry, members report a similar process for discussing and addressing litigation risk at the board level. Most members reported that the full board reviews litigation risks at least annually, with the list of cases compiled, prioritized, and reported by the GC, with occasional assistance from outside counsel.

Depending on board structure, litigation risk might be addressed across multiple committees. Members agree that it is important to coordinate the committees to ensure the widest possible view of risk. Additionally, members stress the need for better communication across board committees: *"A lot of companies assign litigation to the various committees, and it results in a gray area regarding where the line should be drawn. When you're doing an internal investigation of an allegation [prior to litigation], you can do a whole review and later find out you blew it because everyone was thinking in silos."*

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[1] Stephanie Plancich, 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.

[2] Melissa Klein Aguilar, "Class Action Suits Get Fatter at the Middle," *Compliance Week,* April 8, 2008. Available to subscribers at http://complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=4071.

Litigation triage facilitates effective oversight

Members also agree that certain litigation cases merit more attention than others, and therefore it can be useful to classify lawsuits according to their importance. One member laid out this framework by explaining, *"One thing you can see audit committees doing today is deciding what 'bucket' certain litigation ought to be in. For example, if you're building new homes, you automatically can assume you're going to get sued [by some customers and contractors], and while those lawsuits are important, they shouldn't be taking up all your time – although I know that sometimes that can happen. Class action and derivative lawsuits fall into another bucket and are a different situation and require more attention. Finally, lawsuits that could potentially cost a lot of money or ultimately imperil the company should receive the most attention. I believe marrying these various buckets in a sensible way, so you don't spend a lot of time on the little ones, but rather focus in on the big ones in greater depth, is the most sensible approach."*

While members believe it is important to prioritize litigation, they also point out that the board should not let the threat of being sued interfere with doing good business, which can happen if litigation risk is given higher priority than other considerations. One member commented, *"There is never really a formal board agenda topic about how we avoid litigation risk before it happens. It's a negative topic, and [board members] want to always focus on the positive, proactive topics … When you're discussing an issue, you want to view it first from a business perspective – does it make sense? After that, you want to view it from an ethical perspective, next from a legal, and then from a litigation [avoidance] perspective."*

The audit committee's role is expanding

Members say it is important to distinguish between the responsibilities of the audit committee and the full board: *"When you think about all the sources of litigation – product liability, environmental issues, etc. – I worry that there's a tendency to put it all on the audit committee. Yes, we as an audit committee should be worried about the many different sources of litigation, but I think there's an important distinction between the audit committee's responsibilities and the [full] board's oversight role."*

Still, an increasing amount of responsibility is falling to the audit committee: *"More and more is falling to the audit committee, even if it isn't financial. There seems to be a trend that the audit committee chair is drifting into being more of an all-encompassing role. I'm not demeaning the other committees; I'm just acknowledging that more is falling into the audit committee realm."*

Members generally agree that the audit committee can add the most value by establishing the process whereby litigation risk is addressed. One member suggested, *"The place [where] the audit committee ought to start is to make sure they understand how the company addresses the questions raised by litigation risk and make sure the company has a process in place. The audit committee then delegates the oversight of risk to management or the entire board … but it starts with the audit committee."* Another member agreed: *"The full board prefers to discuss [key risk issues], so if you spend time in the audit committee [identifying] a framework and defining the 'buckets,' you have a better approach."*

Audit committees can use litigation to increase focus on risks and ethics

Members agree that boards can and should use the threat of litigation (or actual litigation) as a chance to understand and resolve systemic issues within the company. Unfortunately, boards and audit committees rarely do so. As one member noted, *"Boards aren't great about lessons learned in a lot of things. It's not something boards push on, and if they do, management doesn't usually want to listen."*

Still, members agree that *"how the company learns from litigation is important,"* and therefore the audit committee should call it to the board's attention: *"If you have a series of employee suits, you have to ask, 'Why?' If you have a matter in a company that gets to the point where the Justice Department needs to do an investigation, you need to be doing your own investigation. I think in cases where you're talking about the integrity of individuals or the [ethical] environment of the company, what's being done from an investigative standpoint by the [audit] committee is very important."*

Members recognize the value of a more proactive approach to litigation risk and discussed several specific ways in which audit committees can work to reduce that risk:

- **Ensure there is adequate training.** *"I think this whole issue of FCPA tells us that you need to make sure our training process is actually training people about what the practices are supposed to be. The real question is about how people are trained. What tools is the company using in all these locations across the world?"* Another member agreed: *"I think you have to train proactively. I had reviews done at all my companies after [a particular case hit another company] even if this company wasn't in the limelight."*
- **Anticipate potential litigation.** *"I think you need to be really attuned and keep your ears open. If there's an increase in activity around FCPA in the industry, let's talk about it now. You need to pay attention to what's expected of an organization, not just the litigation you're already dealing with. In some types of business, there are a wide range of laws the company has to be in compliance with, and the audit committee needs to know if [the company] could potentially have problems. [Audit committees] need to make sure the company is being proactive."*
- **Focus on prevention.** *"How much time you spend on prevention is also important. I think it's the obligation of the audit committee to make sure the report to the board doesn't just gloss over the issue. It's the obligation of the committee to make sure the board is aware of all of it. I think it's very important how much time you're spending on proactive things because once it gets to the point of litigation, there's no going back. There's no sense of humor with [litigants]."*

Audit committees regularly draw on the expertise of internal and external resources

Members report that they look to many different parties to help assess litigation risk. Understandably, audit committees rely heavily on the GC for expertise and guidance on litigation risk. The information that the GC provides – including an assessment of likely and possible damages – is the foundation upon which accounting judgments are made for litigation reserves.

Members agree that their interaction with the GC has expanded and that the GC's scope of responsibility *"has increased immeasurably over the past several years. I would argue that I deal with the GC more than*

the internal auditor. I think this is because the GC's scope of influence has become so much greater in this post-Enron environment." Another member added, *"The GC is a very present figure. They've practically taken over the [10-]K's and [10-]Q's."*

Advice from GCs for audit committees seeking to deepen the relationship with their GC[3]

- **Build trust.** "This is the single [most important] driver of an effective working relationship between the board and the general counsel." GCs say they can build this trust over time by consistently providing impartial opinions on board matters. The board and audit committee must trust that their GC will speak up if he or she has a differing opinion to other executives.
- **Be clear on expectations.** "To get the most out of [me], [my audit committee chair] is very clear about what he needs from me, and he lets me know when he doesn't like something."
- **Hold private sessions regularly.** "When you're at the board table, sometimes it's hard to be candid if your boss [the CEO] is [also] at the table."
- **Ensure a dialogue exists outside of formal meetings.** The ability to pick up the phone and ask a question or have an open conversation greatly increases the effectiveness of this relationship.
- **Use the GC as an early-warning system.** "Audit committees are usually looking in the rearview [mirror]." The GC can help the audit committee be more proactive, particularly around risks.
- **Ensure the GC has sufficient technical knowledge.** "I've seen GCs falter because they haven't educated themselves on technical things like accounting."

Audit committees may choose to retain independent counsel

In an effort to ensure independence, some audit chairs turn to outside counsel for a fresh view on litigation issues and other matters the audit committee must consider. Members point out that Sarbanes-Oxley gives audit committees the authority to engage counsel at their discretion, and without the approval of management: "Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties."[4]

Members have differing views regarding the ultimate value of obtaining external legal expertise. In the meeting, members discussed three particular advantages:

- **Independence.** *"The GC often has an increasing influence on board activity, and therefore having external counsel can provide [an independent perspective]."* Added another member, *"In stock options [backdating] cases, you want to find a law firm that had absolutely no relationship with the company. In those cases, having external counsel is sometimes a necessity to ensure independence."*

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[3] Ernst & Young and Tapestry Networks, "The general counsel's perspective," *InSights,* February 6, 2008, 7. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_InSights_Feb08.pdf.

[4] Sarbanes-Oxley Act, Section 301, amendments to Section 10A of the Securities Exchange Act of 1934, no. 5 ("Authority to Engage Advisers"). The full text of the Sarbanes-Oxley Act is available for download at http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.

- **Specific expertise.** *"We find it useful to have an independent lawyer on retainer. We call on him four to five times a year with [specific] questions."*
- **Process assurance.** *"I know an audit chair who always keeps an outside counsel … just to have the lawyer say, 'You've done your job.' He just wants to know his audit committee has done its duties. It serves merely as a belt and suspenders. It's a little extreme, but it's a comfort factor."*

Despite these benefits, members said outside legal expertise had at least two disadvantages:

- **Impaired decision making.** Members generally agree that while legal considerations should inform decision making, they should not drive board or committee business decisions. In addition, members wondered how to reconcile outside legal advice when it differs from the general counsel's. *"I think it can be [unhelpful] … it stifles the committee's [decision-making process]."*
- **Expense.** *"If you trust the GC, you don't need to hire an outside attorney. Why would you? You're just spending your company's money unnecessarily."*

While members agree that in some cases it can be appropriate to include independent counsel in audit committee meetings, most agree that *"post-Enron, the average general counsel is much more professional than they were a few years ago."* Moreover, most members would agree with the member who said, *"To conclude that in the ordinary course of litigation, you need another layer of protection concerns me. What is that saying about the environment that we need that kind of protection? It nags at me."*

The audit committee can help auditors and counsel balance their respective needs

The audit committee deals with the external auditor on a number of issues related to litigation risk. Estimating exposure to loss is one such issue; it is a complicated process that requires work from the CFO, finance staff, general counsel and external auditor and frequently also involves internal audit and outside counsel before it reaches the audit committee for approval.

Ultimately, each company must make its own decisions on estimated litigation exposures, and provide supporting facts and information to the auditors in the course of the audit. However, management is sometimes uncomfortable sharing relevant information with auditors for fear of giving up the attorney-client privilege that protects the company's sensitive information. It's a delicate balancing act that may require the audit committee chair to act as a go-between. One member commented prior to the meeting, *"I know sometimes there can be a tug-of-war between the company, lawyers, and the audit committee in terms of what information [the external auditor] can get their hands on."* Another member pointed out, *"The external auditor has to do their job and has to know what's going on … You have to be open with them – you can't hide behind attorney-client privilege if it's something that would be important to the financial statements."*

Directors can reduce their liability risk by adhering to a few simple practices

In January 2005, the former board members of Enron Corporation agreed to pay a total of $13 million out of their own pockets to settle securities class action lawsuits stemming from one of the largest corporate

governance scandals in U.S. history.[5] While this is obviously an extreme case, members of the PSW ACN were interested in discussing ways in which they could reduce their personal liability and exposure to litigation. Unfortunately, some litigation is unavoidable: *"[Companies] can always get sued. If the directors are doing their duty – paying attention, reading the materials, and asking questions – yes, there's risk, but provided you're doing your job, I think you've got a good case. The rest kind of just comes with the deal."*

Carefully consider personal document retention practices

Members believe thoughtful document retention practices can reduce their personal exposure to litigation and generally agreed that there is little benefit in retaining official or personal notes and materials. One member quipped, *"The line I always remember is that the prize for taking the best notes is giving the longest deposition. I know people who have been deposed for doodling in the margins because [the prosecutor tried to imply] they weren't paying attention."*

Among the different approaches adopted by members:

- **Keep only enough notes to refresh the memory.** *"I keep my board book for about a year. I don't take a lot of notes at the meeting, but I hold on to the agenda because my personal view is that that's probably not going to help [the plaintiffs] if I ever get subpoenaed. You're only required to testify to what you know, and if you don't have really thorough notes, you're not likely to remember the entire conversation."*
- **Destroy all notes and materials.** *"Quite frankly, I destroy all my material. I just looked through my file, and I accidentally took something from my last board meeting, and I just finished shredding it."*
- **Return all materials to the company.** *"I never write anything down, and I never destroy a document I receive. If I'm deposed, I can say I've never destroyed a document. Occasionally I'll ship it back to the company. If they lose it, it's not [my responsibility]."*

Minute-keeping practices vary widely

Members say there is no clear best practice in minute keeping, and they described two distinct schools of thought. Some corporate counsel advise board and committees to keep only cursory minutes, listing discussion topics with minimal detail in order to avoid misinterpretation or second-guessing by plaintiffs. Other committees include much more descriptive information in their minutes, on the assumption that this will support directors' claims that they exercised appropriate duty of care. As one member said, *"[My company] keeps particularly thorough notes, and I think that's been helpful because the board can show whatever court it needs to that the board was doing its job."* Given that case law has not clearly favored one approach over the other, members concurred that either was acceptable. Ultimately, members agreed, *"the culture of the board should dictate [the format of the minutes]. There has to be good documentation, and the board has to ultimately come to a conclusion about how much you say. Otherwise you're always going to have people arguing about the structure [of minutes]."*

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[5] Ben White, "Former Directors Agree To Settle Class Actions," *Washington Post,* January 8, 2005, E1. Available at http://www.washingtonpost.com/ac2/wp-dyn/A57696-2005Jan7?language=printer .

E-mail is forever

Members believe inappropriate or careless use of technology may increase directors' personal liability: *"The biggest problem is e-mail. It's not retention; it's creation. I don't think people are always mindful about quickly blasting off e-mails. Every once in a while, a compensation committee member will say in an e-mail, 'I'm getting sick of these big executive compensation packages,' and I pick up the phone and say, 'Don't ever do that!' People whine, and they chat over e-mail, and taken out of context [those e-mails] can be very damaging."*

Indeed, as one member shared prior to the meeting, *"Once I had the privilege of being subpoenaed by the SEC, and when I showed up, they handed me a bunch of e-mails I had written two, three, four years ago in the course of my daily job. It can be a little disheartening. As a result of that, I tend not to send e-mails if it's something that I think is at all sensitive. I will either pick up the phone and call somebody, or if they're in my own office I'll go stand in their doorway. There deserves to be a lot of caution around this."*

Ultimately, members agreed that *"you should never write an e-mail message to another director."* Although members acknowledge that e-mail continues to be *"the biggest risk area overall,"* they also agree with the audit committee chair who pointed out, *"I think we are more cognizant of it, but we still occasionally fall in the trap. I think everybody's making an effort to be better."*

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. While companies understandably seek to minimize litigation, experienced audit committee chairs view litigation oversight as an opportunity to identify weakness in operating practices or controls. In fact, *"audit committees get a lot smarter because of litigation."*

Audit committees might reflect on key lessons from litigation. What patterns are emerging? Does litigation highlight new risks related to shifting markets, products, suppliers, or processes? Are management controls and practices keeping pace with increased complexity? What are the possible consequences for companies operating in emerging markets? As one member noted, *"You have to be proactive. If you're just sitting on your hands, you're taking a hell of a chance."*

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