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A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

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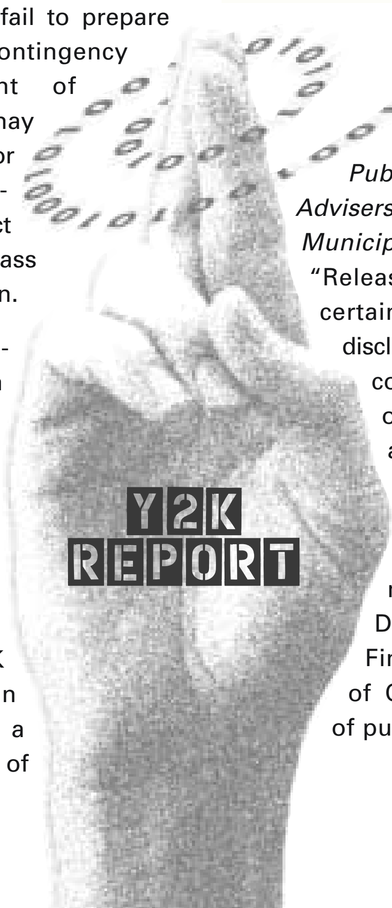
DISCLOSURE ISSUES FOR THE YEAR 2000: TRUTH...OR CONSEQUENCES?

By Jeffrey A. Klafter

With six months left in 1999, more and more institutional investors are asking "Is my portfolio Year 2000 compliant?" Evaluating public companies for their Y2K readiness has become an integral part of the investment process for institutional investors in a market where earnings expectations have become a dominant part of how stock prices are determined. The key to knowing which companies may be adversely affected is by a thorough analysis of their public disclosures. A company's failure to make adequate disclosures concerning its Y2K exposure makes it extremely difficult for an institutional investor to make informed investment decisions. Companies that fail to communicate the stage and costs of their Y2K remediation efforts or fail to prepare and disclose adequate contingency measures in the event of "mission critical" failures may seriously compromise investor confidence, place future earnings in jeopardy, and subject themselves to securities class actions or derivative litigation.

The unprecedented legislative and media attention given to the Y2K issue requires new levels of due diligence on the part of investors. For institutional investors, concern about their investments is further fueled by the inconsistency of current corporate Y2K compliance and disclosure. In January 1998, following a review of the public filings of 1,023 companies, the Securities and Exchange Commission ("SEC") found that only 27 percent of these companies had even completed their assessment of the seriousness of their Year 2000 problems. In an effort to generate more meaningful disclosures, on July 29, 1998, the SEC issued its most recent view on the subject in an interpretive release entitled

> *The unprecedented legislative and media attention given to the Y2K issue requires new levels of due diligence on the part of investors.*



Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers, (the "Release"). The Release requires certain specific Year 2000 issues' disclosures in the annual reports of companies with a fiscal year on or subsequent to June 30, 1998 and in the quarterly reports of companies commencing with quarters ending after August 4, 1998 to be reported, for the most part, in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of public filings.

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Inside Look

We are gratified by the positive reader response to the first issue of the *Advocate* and were especially pleased to hear some of our readers describe the first issue as "highly readable," "above the legal mumbo jumbo," and "right on the mark for issues addressing institutions." Your response and input is much appreciated. We will endeavor to ensure that the *Advocate* will continue to provide you with cutting-edge, relevant information on the legislative, litigation and regulatory fronts regarding securities and corporate governance matters.

In this volume of the *Advocate*, besides our regular columns, you will find articles addressing two critical issues facing institutional investors. The so-called "millennium bug" is something that will affect all of us in some way. In *Disclosure Issues for the Year 2000: Truth...or Consequences*, Jeffrey Klafter explores the potential implications of the Y2K issue on public corporations that institutions may invest in, and discusses what types of disclosures concerning Y2K preparedness these companies are required to make under the law. In our second article, *Accounting Fraud In Public Companies Is More Prevalent Than Ever: Where Is The Audit Committee?*, Lisa Buckser addresses the important role and responsibilities of audit committees in detecting and preventing accounting fraud — which seems to be more pervasive than ever before. We hope that you find these articles interesting and insightful.

As a young and growing publication, we are still learning what issues are most important to you. In this regard, as always, we encourage you to call, write or E-mail us, so that we can tailor the *Advocate* to your needs. We look forward to hearing from you.

Max W. Berger

YEAR 2000 DISCLOSURE ISSUES: TRUTH OR CONSEQUENCES

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To reinforce the need for corporate compliance, on August 3, 1998, SEC Chairman Arthur Levitt sent a letter to executives at more than 9,000 publicly traded companies urging them to focus their attention on disclosures concerning their company's Year 2000 readiness. Two months later, on October 20, 1998, the SEC announced, with great fanfare, its "*first*" enforcement proceedings against thirty-seven broker-dealers for failing to disclose their Year 2000 status on SEC Form BD-Y2K. Since then, the SEC filed additional enforcement proceedings against nine transfer agents.

Despite these efforts, SEC surveys of third quarter 1998 corporate filings found that, even after the Release, half of the companies failed to disclose their Y2K remediation costs, half failed to disclose their contingency plans, and 1,200 public companies failed to make any Y2K disclosures whatsoever. Current disclosures continue to be woefully inadequate.

In January 1999, CalPERS, which began its own comprehensive Y2K compliance plan in the Fall of 1995, sent a letter to 1,600 companies in its United States stock portfolio asking them to disclose how ready their computers are for the Year 2000. CalPERS called on these corporations to fulfill their obligations to investors and comply with the Year 2000 disclosure requirements adopted by the SEC.

Meaningful Disclosures

With the issuance of the Release and subsequent enforcement efforts, the SEC has made it crystal clear that investors are entitled to meaningful disclosures concerning the risks public companies face as we enter the new millennium. There are few exceptions to the strict disclosure requirements.

The Release states that a reporting company must provide Year 2000 disclosures if (i) the company's assessment of its Year 2000 issues is not complete; or (ii) the company determines that the consequences of its Year 2000 issues would have a material effect on the company's business, results of operations, or financial condition, *without taking into account the company's efforts to avoid those consequences*.

SEC surveys of third quarter 1998 corporate filings found that, even after the Release, current disclosures continue to be woefully inadequate.

In addition to conducting a self-assessment, a reporting company must take reasonable steps to verify the Year 2000 readiness of any third party that could cause a material impact on the company. For vendors and suppliers, the SEC defines their relationship with the reporting company as material if there would be a substantial and important effect on the company's business, results of operations, or financial condition if these third parties do not timely become Year 2000 compliant. The SEC has also stated that this analysis should be conducted for significant customers whose Year 2000 readiness could cause a loss of business that might be material to the company. A company also should consider its own potential liability to third parties if its systems are not Year 2000 compliant, such as possible legal actions asserting breach of contract or other claims.

If a reporting company is unable to determine whether a key supplier will be

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ACCOUNTING FRAUD IN PUBLIC COMPANIES IS MORE PREVALENT THAN EVER: *Where is the audit committee?*

By Lisa K. Buckser

Hardly a week goes by without hearing something new about the sorry state of financial reporting. If it's not disclosures by public companies like Cendant Corp., Waste Management, Sunbeam Corp., Fine Host Corporation, or Mercury Finance Co. that they are restating their previously issued financial statements in order to correct material misstatements due to accounting errors and irregularities, then it's SEC Chairman Arthur Levitt bemoaning the "noticeable erosion in the quality of financial reporting." This erosion in the quality of financial reporting has had a very painful effect on institutional investors: since January 1997, disclosures of improper accounting in the companies mentioned above (as well as others) have taken *more than $31 billion* out of the pockets of investors who purchased stock in those companies in reliance on admittedly false financial statements.

The erosion in the quality of financial reporting has had a very painful effect on institutional investors. Disclosures of improper accounting have taken billions out of the pockets of investors who purchased stock in reliance on admittedly false financial statements.

Investors and regulators alike are scrambling for answers to questions like "who is to blame when companies commit accounting fraud?" and "how can we stop the fraud before it starts?" The first question has been answered historically by imposing liability on management and, in cases when audits are not conducted in accordance with generally accepted auditing standards ("GAAS"), on outside auditors. One group that has largely escaped liability for accounting fraud is the same group that can have the biggest impact on the answer to the second question — the audit committee of the board of directors.

Accounting Process Gatekeepers

The audit committee is comprised of members of the board of directors who are appointed by the board at large. It is the gatekeeper of the accounting process in public companies in that it is charged with the responsibility of ensuring that management is carrying out its financial reporting responsibilities with integrity and that the outside auditors are independent and receive the cooperation they need to complete a full and fair audit of a company's financial statements. One complicating factor is that management's integrity is sometimes challenged by the temptation for management to do anything it can to meet analysts' earnings estimates to prevent their company's stock prices from taking a dive when those estimates are missed so that managements' incentive compensation — which is often based on the company's financial results as well as its stock performance — is not adversely affected. Consider the case of Computer Associates whose stock price recently dropped from $57 to $39 when it announced that although its profit had risen 25% in the prior quarter, it would not meet earnings expectations for the current quarter.

Warren Buffett, the most famous investor of them all, noted as much when he recently wrote in his annual letter to the shareholders of Berkshire Hathaway Inc., "[m]any major corporations still

One group that has largely escaped liability for accounting fraud is the the audit committee of the board of directors.

play things straight but a significant and growing number of otherwise high-grade managers — C.E.O.s you would be happy to have as spouses for your children or as trustees under your will — have come to the view that it's O.K. to manipulate earnings to satisfy what they believe are Wall Street's desires."

The devastating effect of fraudulent financial reporting on institutional investors cannot be overemphasized. Companies that disclose that they are restating their financial statements in order to correct errors or irregularities in previously issued financial statements often see a significant portion of their market capitalization wiped out within a day or two of such a disclosure. Take Cendant for example. The day after it announced the biggest accounting fraud in history, its stock price dropped from $35 5/8 to $19 1/16 causing the company to lose $14.2 billion — or 47% — of its market capitalization. Moreover, time often does not heal the effect of a financial fraud on a company's stock prices. Although Cendant's market value has recovered somewhat in the last year, as

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YEAR 2000 DISCLOSURE ISSUES: TRUTH OR CONSEQUENCES

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Year 2000 compliant, then it must evaluate its Year 2000 issues on what the SEC has termed a "gross" basis. According to the Release, absent clear evidence of Year 2000 readiness, a company must assume that it will not be Year 2000 compliant and it must also assume that material third parties will not be ready either, unless these third parties have delivered written assurances that they expect to be Year 2000 compliant in time. A company must estimate the financial consequences as if it is not prepared, rather than the amount of money the company has spent, or will spend, to address this issue.

The SEC has made it crystal clear that investors are entitled to meaningful disclosures concerning the risks public companies face as we enter the new millennium.

Given the lack of assurances generally being provided by third parties and the likely catastrophic consequences of failing to become Year 2000 compliant, the SEC has aptly noted in the Release that it expects the Year 2000 issue will likely be material for the vast majority of reporting companies, and that disclosure will, therefore, be required. Moreover, according to Brian Lane, Director, Division of Corporation Finance of the SEC, *the SEC strongly suggests that a company report on the Year 2000 problem, even if it has determined that it is immaterial to their operations.*

Potential Investor Actions For Inadequate Y2K Disclosure

If a public company ignores the unambiguous requirements of the Release and follow-up letter from Chairman Levitt, as well as the groundswell of public attention to the Year 2000 issue, it may expose itself to potential liability and significant damages. If the value of an investment drops due to a Y2K-related failure at a particular company or at a vendor on which the company is dependent, institutional investors would be remiss in their obligations to their own constituents if they failed to investigate whether the company adequately disclosed Y2K information or the Board acted properly in addressing the company's Y2K business and system concerns.

For example, under these circumstances, if a company's stock prices drops as a result of Y2K related problems, an institutional investor may consider filing an action for violations of the federal securities laws if, after an investigation, it is determined that the company failed to include any Year 2000 disclosures in its periodic SEC public filings or offering documents. Indeed, a claim for fraud under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 may exist if the company intentionally or recklessly omitted to state facts necessary to inform investors concerning Y2K related issues. Damages in this case could include recision in the case of an offering of securities, out-of-pocket damages to open market purchasers of the company's securities, disgorgement of insider trading profits, or injunctive relief for proxy violations.

Furthermore, in light of the SEC's mandate on disclosure of Year 2000 contingencies, a company's silence on the issue is no defense and tantamount to a representation that the company's Year 2000 assessment is complete and that Year 2000 issues *will not* have a material effect on the company's business, results of operations, or financial condition. The same would be true if the company baselessly claims that the coming new millennium will not have a material effect on it and then ultimately suffers a material loss as a result.

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The issues are less clear when a company makes limited Year 2000 disclosures. Although shareholders may be injured if a company's Year 2000 problems are of a greater magnitude than disclosed, according to the SEC, many of the required MD&A disclosures concerning Year 2000 problems could be deemed forward looking in nature and therefore, in the case of private actions, would be covered by the statutory safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). Year 2000 disclosures made in connection with IPOs, tender offers, or included in a financial statement prepared in accordance with GAAP, however, are not covered by the safe harbor.

The safe harbor is not an absolute bar to liability and public companies would be well advised to be more forthcoming in their affirmative disclosures rather than in their litany of cautionary statements.

Not all Year 2000 disclosures are forward looking in nature and entitled to protection under the safe harbor. A statement of historical costs of Year 2000 remediation is one example. The concealment of a known ability to remedy a material Year 2000 issue would be another.

Nevertheless, even if the statements are forward looking, for the statutory safe harbor to apply, the forward-looking statements must be identified as forward looking and accompanied by "meaningful cautionary statements." Boilerplate statements will not qualify. Under the Reform Act, the meaningful cautionary statements must identify *important factors* that could cause actual results to differ materially from those in the forward looking statement.

Moreover, even if the statement is forward looking and is accompanied by *meaningful* cautionary language, the safe harbor will not apply if the statement was *knowingly* false when made. Whether knowledge can be alleged and proven will depend on the circumstances. The safe harbor is not an absolute bar to liability and public companies would be well advised to be more forthcoming in their affirmative disclosures rather than in their litany of cautionary statements.

SEC Year 2000 Disclosure Requirements for Financial Statements

In order to limit their own liability because of Y2K problems, institutional investors have a right to know which companies will be prepared for the new millennium, when evaluating every one of the investments in their portfolios. The following list provides a summary of the disclosure information that the SEC has determined that public companies should provide in their financial statements:

- ✔ ***Costs of Modifying Software.*** Costs of modifying software should be charged as expenses as they are incurred.
- ✔ ***Costs of failure to be Year 2000 compliant.*** Operating losses should only be recognized as they are incurred.
- ✔ ***Losses from Breach of Contract.*** Possible losses from claims of breach of contract or warranty due to Year 2000 noncompliance must be disclosed in notes to the financial statements, and must be recognized as a liability if those losses are probable and reasonably estimable.
- ✔ ***Impairment of Assets.*** Certain companies may need to write down capitalized software in accordance with FASB Statement No. 86, Accounting for the Cost of Computer Software to Be Sold, Leased or Otherwise Marketed. Check FASB Statement 86 for guidance.
- ✔ ***Disclosure of Risks and Uncertainties.*** A company must disclose any risk or uncertainty of a reasonable possible change in its estimates in the near term that would be material to the financial statements.

Corporate Governance Issues

Apart from disclosure obligations under the Federal Securities Laws that may give rise to securities fraud class actions, the board of directors of a public company also has an obligation to address its company's Year 2000 issues. As part of the board's fiduciary responsibilities to its shareholders, directors and officers of a corporation may be held liable in a shareholder derivative lawsuit for breaching their fiduciary duties to the corporation if they fail to take adequate actions or fail entirely to address the Year 2000 issues facing their company. A shareholder derivative case is an action brought by a shareholder on behalf of the corporation

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Rochelle Feder Hansen

Institutional Investors Poised For Greater Impact On Corporate Governance Issues. According to the Council of Institutional Investors, institutional investors have submitted or plan to submit significantly more proxy resolutions than they did in prior years. This year's key issue? Binding shareholder proposals that mandate certain board actions. Unlike prior years when only a few mandatory proposals were submitted, this year more than thirty filed or planned to be filed proposals are binding bylaw resolutions. This shift is a direct response to the fact that companies almost always disregard winning results on traditional precatory shareholder proposals.

Quick Implementation Of Recommendations Improving Effectiveness Of Audit Committees Urged By SEC. SEC Chairman Arthur Levitt stated that the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees "deserve quick implementation." He stated that these recommendations give companies and auditors the tools they need to make strong and independent audit committees the rule rather than the exception. Levitt commented that he expected the involvement of institutional investors to help bring about the quick implementation of the recommendations. **See: "Accounting Fraud in Public Companies is More Prevalent Than Ever" by Lisa K. Buckser, beginning on page 3 of this issue.**

FASB Issues Interpretation Of Stock Options Proposal. On March 31, 1999, the Financial Accounting Standards Board released a planned interpretation of key accounting rules on stock compensation issued to employees. The proposed interpretation of APB No. 25 seeks to clarify how APB 25 should be applied in certain situations such as in the event of stock option repricings and awards offered to outside directors. The proposal has drawn criticism from computer industry and other corporate executives. The proposed interpretation has a 90-day comment period. It is expected to be issued in final form by September 30. Copies of the document are available from FASB by calling (800)748-0659 or visiting the board's World Wide Web site at http://www.fasb.org. **See also "The Battle Over Options Repricing: Investors Take the Offensive" by Robert S. Gans, in Volume 1, 1st Quarter 1999, of the *Advocate*.**

Initiative Taken To Improve Mutual Fund Governance. SEC Chairman Levitt announced a major initiative to improve mutual fund governance to better protect and serve shareholders. Four proposals, which form the cornerstone of the initiative, will be addressed through the Commission's rule making and disclosure process to turn them into concrete reforms. The proposals would require: (i) that fund boards have a majority of independent directors; (ii) that independent directors nominate any new independent directors; (iii) that outside counsel for directors be independent from management to ensure that directors get objective and accurate information; and, (iv) that fund shareholders have more specific information on which to judge the independence of their fund directors. Mr. Levitt's remarks can be found at http://www.sec.gov/news/speeches/spch259.htm.

Lead Plaintiffs Should Be Limited In Number. In *In re Baan Co. Securities Litigation,* (C.D.C. Apr. 12, 1999), the United States District Court for the District of Columbia, basing its opinion in part on an *amicus brief* submitted by the SEC, denied an unopposed motion for appointment of a 20-member group to act as lead plaintiffs. Instead, the court found that, based upon the intent of the Private Securities Litigation Reform Act (the "Reform Act"), a small committee will generally be more effective and efficient than a larger aggregated group. It held that, optimally, a lead plaintiff group should include no more than three persons and that five or six would be the upper limit. The court also rejected the notion that only a group with a pre-litigation relationship could serve as lead plaintiff under the provisions of the Reform Act.

FASB Proposal Would Give Investors Better Idea Of Merger Costs. On April 21, 1999, FASB announced that it had tentatively decided to eliminate the "pooling of interests" method of accounting for business combinations. Only "purchase" accounting methodology would be allowed. FASB Chairman Edmund Jenkins said that the board decided that it is hard for investors to make sound decisions about combining companies when two different accounting treatments exist for what is essentially the same transaction. He stated that FASB believes that the purchase method of accounting gives investors a better idea of the initial cost of the transaction and the investment's performance over time than does the pooling of interests method. The elimination of poolings would be effective for business combinations initiated after FASB issues final rules on the subject. Members of the business community and venture capitalists have already voiced opposition to the proposal. FASB expects to issue draft rules in late July and there would be a comment period of 90 to 120 days.

"Poison Pills" Harder To Swallow. In the wake of the Delaware Chancery Court's decision last July sustaining a complaint alleging that a "dead hand" provision in a poison pill violated Delaware General Corporation Law (*Carmody v. Toll Brothers, Inc.,* 723 A.2d 1180 (Del. Ch. 1998)), the Teachers Insurance & Annuity Association-College Retirement Equities Fund ("TIAA-CREF") has been actively seeking repeal of these provisions. The fund initially targeted 10 companies. Seven eliminated their "dead-hand" provisions immediately or during the course of discussions with TIAA-CREF and one company is still discussing the issue. Of the two remaining companies, shareholders voted to adopt TIAA-CREF proposals calling for the repeal of the "dead-hand" provisions. Management of one of the companies has said that in light of the vote, it will review the provision at its next board meeting. TIAA-CREF has identified at least 30 other companies that have "dead-hand" provisions that the fund will seek to have rescinded. At its general members' meeting on March 29, 1999, the Council of Institutional Investors also officially went on record as opposing "dead-hand" poison pills.

Year 2000 Legislation Attempts To Restrict Lawsuits. Various legislative proposals have been introduced to govern liability for Y2K computer problems. The "Y2K Fairness in Litigation Act" (S.738) introduced by Senator Christopher Dodd (D-Conn.) and (H.R. 1319) introduced by Rep. Anna Eshoo (D-Calif.), would establish a 90-day waiting period before lawsuits could be filed to allow the prospective defendant an opportunity to remedy the problem, does not place a cap on punitive damages and does not limit personal liability of corporate directors, officers or trustees. Other Year 2000 liability-limiting measures introduced in the 106th Congress include S.96, sponsored by Senator John McCain (R-Ariz.), which is out of committee and is now on the Senate floor. This bill has a cap on damages; provides that all actions (except for personal injury) will be treated as breach of contract claims; and permits defendants to avoid liability beyond their responsibility for plaintiffs' economic loss if they can show that they exercised due diligence and acted with reasonable care to prevent or fix the Y2K problem. The House Judiciary Committee approved "The Year 2000 Readiness and Responsibility Act" (H.R. 775), which caps damages and apportions blame and is the result of the expressed concern that without such a shield from liability, small businesses will spend more time addressing their potential legal worries than fixing their Y2K systems problems. Representative Donald A. Manzullo (R.-Ill.) is also sponsoring a House measure (H.R. 192) that would limit Y2K problem related liability. **See "Disclosure Issues for the Year 2000: Truth…or Consequences" by Jeffrey A. Klafter beginning on page 1 of this issue.**

Web Site Monitors Executive Compensation Abuses. The AFL-CIO launched its updated Executive PayWatch web site which allows users to call up the compensation packages of the CEOs of S&P 500 companies to see what their own pay would be if it had increased at the same rate as the chief executive's. The site also tells users how to calculate CEO pay packages at companies not included in the database and how to look up company performance to see if pay packages are tied to performance. In addition, the site suggests ways in which individuals can help curb the problem of runaway compensation packages. It urges users to express their views to boards of directors, Congress and the SEC and includes sample letters, e-mail messages and shareholder proposals. The site can be accessed at www.paywatch.org.

Second Circuit Clarifies Required State Of Mind For Pleading Securities Fraud Action. In a recent decision, *Stevelman v. Alias Research, Inc.,* (2d Cir. Apr. 5, 1999), the United States Court of Appeals for the Second Circuit held that the strong inference of fraudulent intent necessary to satisfy the pleading requirements for the scienter element of a securities fraud action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 may be satisfied by pleading facts that *either* (i) constitute strong circumstantial evidence of conscious misbehavior or recklessness; or (ii) show that defendants had both motive and opportunity to commit the fraud. The Court found that the allegations of insider trading in combination with the timing of the misrepresentations were probative of motive, which supports a strong inference of fraudulent intent and were sufficient to satisfy the pleading requirements.

Shareholder Lawsuits Under Attack In Japan. The ruling party in Japan, the Liberal Democratic Party ("LDP") will attempt to have the Commercial Code on corporate governance amended to impose restrictions on shareholder litigation. The amendment would enable corporations to adopt resolutions limiting the liability of board members and it would preclude actions by shareholders who acquired shares through irregularities committed by board members. The amendment would also allow corporations to limit the liability of their auditors through special shareholder general meeting resolutions except for situations where there has been criminal conduct or malicious or serious faults committed by board members. Opponents of the amendment are expected to demand that it be tougher on board members and auditors. The text of the draft bill can be accessed on the LDP home page at: www.jimin.or.jp.

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Where is the Audit Committee?

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of the end of January 1999 it was still down $11.2 billion since it announced the restatement. Cendant is not alone. From January 1997 through January 1998, at least $31 billion in market value has been erased as a result of accounting errors and irregularities including, among others, $4.76 billion attributable to Waste Management's restatement, $3.64 billion due to Sunbeam's problems, $2.62 billion as a result of Mercury Finance's fraud and $250.5 million due to Fine Host's accounting fraud.

The devastating effect of fraudulent financial reporting on institutional investors cannot be overemphasized. Companies that disclose that they are restating their financial statements in order to correct errors or irregularities in previously issued financial statements often see a significant portion of their market capitalization wiped out within a day or two of such a disclosure.

In light of the ramifications of accounting fraud on unwitting investors, it is crucial that the audit committee do everything in its power to prevent the falsification of financial results so that institutional investors can safely rely on the publicly issued financial statements that often play a large role in the decision of whether to buy, sell or hold a security. Indeed, a report issued by the National Commission on Fraudulent Financial Reporting (the "NCFFR Report") in 1987 recognized that a *key factor* in reducing the incidence of fraudulent financial reporting was the "establishment of an informed, vigilant and effective audit committee to oversee the company's financial reporting process."

Unfortunately, even though audit committees have been described as playing a role "critical to the integrity of the company's financial reporting," all too often audit committees have not lived up to that billing. This was brought home by the results of a study described in the NCFFR Report which showed that 69 percent of the companies involved in SEC enforcement cases for fraudulent financial reporting between 1981 and 1986 had audit committees. This can be explained by the fact that many members of audit committees have no financial background whatsoever and, those that do, have failed to devote the time or energy necessary to fulfill their mandate. Despite this, audit committees have rarely been held accountable for rampant accounting fraud at the companies on whose boards they sit. In fact, shareholders who look to the audit committee for answers after a massive accounting fraud has been disclosed are often met with the attitude "what do you want us to do, we're only outside directors?"

One example of this was recently seen in the *In re Physician Computer Network Securities Litigation* pending in the District of New Jersey. In that case, in which the State of Wisconsin Investment Board ("SWIB") serves as lead plaintiff, the company's financial statements for more than two years were phony as a result of accounting "irregularities" (which are defined by generally accepted accounting principles as intentional acts) relating to revenue and expenses.

In addition to suing the company, the officers responsible for the fraud, and the chairman and majority shareholder of the company, SWIB also named as defendants the two people who served on the company's audit committee. In their motion to dismiss the claims against them, the audit committee defendants expressed outrage over being sued, claimed that they had no involvement whatsoever in the company's accounting functions and maintained that they could not be held responsible for the massive accounting fraud at the company since they spent only one day a year in service to the audit committee. In other words, their defense was the counter-intuitive proposition that since they had done nothing to fulfill their mandate to ensure that management was carrying out its financial reporting responsibilities with integrity, they could not be held liable for the fraud that was committed while they looked the other way.

Ending Cavalier Attitudes

The Physician Computer audit committee's cavalier attitude is not an isolated one, and with good reason — more often than not, audit committees have been given a free pass when it comes to the litigation of accounting fraud claims. It is no wonder, then, that audit committees have not approached their duties with the degree of responsibility that such a crucial job requires. This, in turn, has allowed many companies to falsify their financial statements that would not have otherwise been able to do so. The question then becomes, what can institutional investors do about this serious problem.

There are two answers. The first is for institutions to insist that the duties and responsibilities of audit committees be defined more clearly. The second is to work to develop a system to incentivize audit committee members to fulfill those duties by holding them legally responsible if they do not. The New York Stock Exchange ("NYSE") and the NASD have already begun the process of defining these duties by appointing a Blue Ribbon Committee (the "Committee") to present recommendations on improving the effectiveness of audit committees. The Committee came out with their recommendations to the NYSE and the NASD earlier this year, most of which are directed at companies with a market capitalization above $200 million. The recommendations, while helpful, are merely proposals and do not require the NYSE or the NASD — or their member firms — to take any actions with respect to audit committees.

In light of the ramifications of accounting fraud on unwitting investors, it is crucial that the audit committee do everything in its power to prevent the falsification of financial results.

While the Committee's recommendations are a good starting point for bringing about improvements of audit committee responsibilities, institutional investor activism in this area is, undoubtedly, equally important to affecting a positive change.

In its recommendations, the Committee found that although the audit committee, financial management and outside auditors must work together to support responsible financial disclosure and active and participatory oversight, the audit committee *"must be 'first among equals' in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process."* Further, in order to ensure that audit committees stay free from the pressures to inject fraud into the financial reporting process that management may feel, the Committee's first two recommendations are aimed at strengthening the independence of the audit committee. First, the Committee recommended that audit committees be comprised *solely* of independent directors. Second, members of the audit committee be considered independent only "if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation." These independence-related recommendations are significant because several recent studies have produced a correlation between audit committee independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud.

Quarterly Quote

"In recent years, probity has eroded. Many major corporations still play things straight, but a significant and growing number of otherwise high-grade managers — CEOs you would be happy to have as spouses for your children or trustees under your will — have come to the view that it's okay to manipulate earnings to satisfy what they believe are Wall Street's desires. Indeed, many CEOs think this kind of manipulation is not only okay, but actually their duty."

Warren E. Buffett
1998 Report to Shareholders of Berkshire Hathaway Inc.

Making The Audit Committee More Effective

The Committee's remaining recommendations are aimed at making the audit committee more effective. To avoid the appointment of directors to the audit committee as a reward for "making it" in corporate America, the Committee recommended that companies have an audit committee comprised of a minimum of three directors, each of whom is financially literate or becomes financially literate within a reasonable period of time, and that at least one member of the audit committee have accounting or related financial management expertise. This recommendation is very much an indictment of the current composition of audit committees since it recognizes the fact that many members of audit committees today have no ability to read or understand the most basic financial statements — a thought that has sent chills down the spines of many investors.

In an effort to keep audit committees more informed about the manner in

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which management is handling the financial reporting process, the Committee recommends that GAAS require that a company's outside auditor discuss with the audit committee the auditor's judgment about the *quality,* not just the acceptability, of the company's accounting principles as applied in its financial reporting. One of the items that the outside auditor should discuss with the audit committee is the degree of aggressiveness of the company's accounting principles. Obviously, the more aggressive that management is in its accounting practices, the more the audit committee should step up their oversight to ensure that management does not cross over the line between what is acceptable and what is illegal.

Shareholders — especially institutional investors — can be instrumental in stemming the "erosion in the quality of financial reporting" by aggressively prosecuting cases against audit committees who fail to fulfill their responsibilities.

Another significant recommendation would have outside auditors conduct an Interim Financial Review prior to the company's filing of its quarterly Form 10-Q and then discuss with the audit committee, or at least its chairman, and a representative of financial management, its findings, including significant adjustments, management judgments and accounting estimates, significant accounting policies, and disagreements with management. This recommendation is aimed at curbing the all too frequent occurrence of a company issuing false financial statements for three quarters and then restating those financial statements at the end of the year when the outside auditors conduct their annual audits. As the Committee noted, "increased involvement by the outside auditors and the audit committee in the interim financial reporting process should result in more accurate interim reporting." Since investment decisions are made year-round and not just after audited financial statements are issued, investors will be able to take more comfort in the reliability of quarterly financial statements.

Conclusion

Although the foregoing guidelines for audit committees are an excellent start in turning the corner towards more reliable financial reporting, the NYSE and the NASD are under no obligation to adopt the recommendations and even if they do, any new NYSE and NASD rules that are promulgated as a result of the recommendations may not be implemented for quite some time. To address these pitfalls, institutional investors can and should take a more active rule in strengthening the audit committee. Lobbying management and getting shareholder proposals aimed at strengthening the audit committee included in proxy statements may put pressure on management to do the right thing *now* without waiting for the lengthy regulatory process which may legally require them to do so in the future.

The Blue Ribbon Committee's recommendations should prove useful; however, the real impetus for change needs to come from institutional investors. Courts must be convinced that the case law that has developed which tends to exonerate audit committees from even the most mammoth cases of accounting fraud is outdated since it does not distinguish the special responsibilities that members of the audit committee have to protect the integrity of the financial reporting process from the responsibilities of the board of directors at large.

When audit committee members are finally held responsible for failing to prevent management from cooking the books, they will realize they can no longer get away with their lack of involvement in the financial reporting process.

Shareholders—especially institutional investors—can be instrumental in stemming the "erosion in the quality of financial reporting" by aggressively prosecuting cases against audit committees who fail to fulfill their responsibilities. Once the tide begins to turn and audit committee members are finally held responsible for failing to take reasonable steps to prevent management from cooking the books, audit committee members will realize they can no longer get away with their complete lack of involvement in the financial reporting process. This will result in a marked difference in the way that audit committees approach their responsibilities—and, most importantly, in the quality and reliability of publicly reported financial statements.

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Q Can a smaller institutional investor play a major role in the prosecution of a securities class action under the Private Securities Litigation Reform Act?

A Under the Reform Act, any institutional investor — without regard to the size of its net assets — may play a significant role in the prosecution of private securities class actions. All private securities litigation is prosecuted under the direction of a "lead plaintiff." The designation of lead plaintiff status is awarded by the Court to the member or members of the purported class that the Court determines to be most capable of adequately representing the interests of class members (referred to under the Reform Act as the "most adequate plaintiff"). In making that determination, the Court must adopt a rebuttable presumption that the most adequate plaintiff is the person or group of persons that the court determines has, among other things, the largest financial interest in the relief sought by the class. Courts have determined that this criterion — the largest financial interest — is satisfied by the person or persons who suffered the largest loss as a result of the alleged securities laws violations.

Institutional investors need not have billions of dollars of net assets in order to be appointed lead plaintiff, and thereby supervise the prosecution of a private securities class action. A smaller institutional investor often will have suffered substantial losses as a result of securities purchased at artificially inflated prices. Those losses alone may represent the largest financial interest in the relief sought by the class, and, therefore, will result in the appointment of lead plaintiff. Even if those losses do not represent the largest loss suffered by a member of the class, the smaller institution may still be a lead plaintiff by joining with other institutions that have suffered losses. Indeed, it is common for institutional investors, notwithstanding their size, to join together to prosecute securities class actions.

Q What recourse does an aggrieved shareholder have when corporate officers or directors breach their fiduciary duty to the company and the shareholders?

A When a shareholder becomes aware of malfeasance by a company's officers or directors, that shareholder has recourse, even if the federal securities laws are not implicated. If directors or officers breach their fiduciary duties, breach their duty of loyalty or waste corporate assets, a shareholder may commence a derivative action against the wrongdoers.

A derivative action differs from a direct action (that is, for example, a securities class action) in which the lead plaintiffs seek monetary relief for themselves and the class they represent. In a derivative action, the plaintiff acts on behalf of the corporation itself. A derivative plaintiff may seek monetary relief for the corporation as a result of damages caused by breaches of fiduciary duty by the corporation's officers or directors. For example, if a corporation's violations of federal laws result in fines and lost revenue to the corporation, the derivative plaintiff may seek to have the wrongdoers — those officers and directors responsible for the violations — reimburse the corporation for those losses. The derivative plaintiff also may seek to implement changes in corporate governance to reduce the likelihood that such malfeasance will recur.

In the Columbia/HCA case, eleven institutional investors — the New York State Common Retirement Fund, CalPERS, the New York State Teachers' Retirement System, The New York City Public Employees Retirement System (consisting of the five major NYC retirement systems), the Los Angeles County Employees Retirement Association, the D.C. Retirement Board, the Service Employees International Union National Industry Pension Fund, the State of Connecticut Public Employees' Retirement System, the Minnesota State Board of Investment, the Teachers' Retirement System of Louisiana, and the City of Philadelphia Board of Pensions and Retirement — joined together to prosecute a derivative case against the officers and directors of Columbia/HCA as a result of the largest health care fraud in U.S. history. Those institutions seek reimbursement for Columbia/HCA as a result of any fines or penalties imposed as a result of the health care violations, as well as significant improvements to Columbia/HCA's corporate governance plan and its health care compliance system.

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itself seeking monetary relief for the corporation as a result of damages caused by breaches of fiduciary duty by its officers or directors.

In the seminal decision of *Aronson v. Lewis,* (1984), the Supreme Court of Delaware recognized that shareholder derivative suits play an indispensable role in corporate governance. Where a board's actions or conscious decision not to act with respect to a company's Year 2000 readiness is challenged, a court will evaluate a derivative claim under the *Aronson* decision. In these circumstances, in *Aronson,* the Supreme Court of Delaware held that a shareholder may proceed with a derivative action if it alleges particularized facts supporting a reasonable doubt *either:* (i) that the directors are disinterested and independent, *or* (ii) that the challenged actions were "the product of a valid exercise of business judgment."

Directors and officers may be held liable in a shareholder derivative lawsuit if they fail to address Year 2000 issues.

Under the business judgment rule, director liability is predicated upon concepts of gross negligence. If a board's actions or decisions not to act are so inadequate that the corporation suffers a significant Y2K-related failure, shareholders may be able to allege gross negligence or even recklessness on the part of a company's board of directors. Given the SEC's strong pronouncements on the obligation of every public company to become Year 2000 compliant, the failure of a "mission critical" operation due to a Year 2000 related failure, could present the facts necessary to meet this difficult standard.

Where a board of directors fails entirely to address the Year 2000 issues facing a company, the odds of a successful derivative lawsuit are greatly enhanced. A court will evaluate a derivative claim for liability issues under different principles than those where the directors affirmatively make a business decision. In this situation, because no business decision is at issue, the directors are not entitled to the protections of the business judgment rule.

Indeed, in *Graham v. Allis-Chalmers Mfg. Co.,* (1963), a case addressing board inaction, the Delaware Supreme Court held that the protections of the business judgment rule will not be afforded to directors who knowingly or recklessly ignore, or fail to investigate, obvious signs of wrongdoing in breach of their fiduciary duties. In addition, in a case alleging that the board abdicated its responsibility, it has been held that "ordinary negligence" is the appropriate standard for director liability. Accordingly, where a board fails entirely to address Year 2000 issues, under *Graham* — reckless refusal to open their eyes in the face of one of the most daunting problems ever to face corporate America — would likely amount to knowing or reckless conduct and a breach of fiduciary duty to the corporation.

Conclusion

As the SEC has repeatedly noted, the Year 2000 disclosures of most public companies have been woefully inadequate. Now that the SEC has mandated disclosures concerning Year 2000 readiness, we should begin to see the extent to which public companies are addressing the coming new millennium. These new disclosures may give investors comfort that the company has given its Year 2000 issues a top priority, but they may also indicate that a company's efforts are too little and too late to prevent enforcement proceedings by the SEC and actions by investors. The extent to which liability will arise for violations of the federal securities laws or for a failure to comply with fiduciary duties imposed by State law, due to what many believe will be inevitable losses caused by the Y2K problem, will significantly depend on the nature of the disclosures made by public companies in the next several months and board involvement in the remediation efforts.

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