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## Employee and Director Accountability to Shareholders: Doing Business for Business Owners

*Andrew B. Cripe*<sup>1</sup>

*When priests are more in word than matter;  
When brewers mar their malt with water;  
When nobles are their tailors' tutors;  
No heretics burned but wenches' suitors; . . .  
Then shall the Realm of Albion  
Come to great confusion.*

William Shakespeare, *King Lear*, Act 3, Scene 2.

### I. INTRODUCTION

After a decade in which many businesses were manipulated for quick stock market gains, too many unscrupulous business managers have largely escaped unscathed, and often times, enriched, from the fallout from their mismanagement and abuse of shareholder confidence. Meanwhile, the investors who placed their hard-earned equity in such failed businesses have begun to feel a burning sensation not unlike that “wenches’ suitors” commonly experience.<sup>2</sup> With confused investors struggling to make sense of financial statements marred by accounting irregularities, the senior officers of certain publicly traded companies must now attest to the accuracy of their financial reporting and accounting practices under oath and the threat of civil and criminal sanctions under the recently enacted Sarbanes-Oxley Act of 2002 (also referred to as the “Act”).<sup>3</sup>

Accountability for financial reporting under the Act is being placed squarely at the top of the corporate chain of command; on the shoul-

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2. WILLIAM SHAKESPEARE, *KING LEAR* act 3, sc. 2.

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 29, 18, 11, and 28 U.S.C.A.); *see also* SEC File No. 4-460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, *available at* <http://www.sec.gov/rules/other/4-460.htm>.

ders of the chief executive and financial officers of the company.<sup>4</sup> No CEO or CFO, however, can have personal knowledge of every aspect of business encompassed in a company's financial reporting and accounting practices. Just as shareholders necessarily rely on information that managers provide, managers rely on information and advice that subordinates provide. This fact has led to a curious phenomenon, whereby managers and directors of failing companies have attempted to explain reporting irregularities by passing blame down the chain of command, in a sort of reverse Nuremberg defense.<sup>5</sup> The Act appears aimed at eliminating this defense by giving senior corporate officers a strong incentive to take steps to ensure that all links in the corporate chain of command are committed to faithfully serving the interests of shareholders.

It is at this point that corporate officers and directors could learn from Shakespeare's tragedy of *King Lear*.<sup>6</sup> Sitting in a royal court more accustomed to self-serving flattery and hyperbole than plain-spoken honesty, the egotistical King Lear invites his three daughters to compete for his affection and their respective shares of his kingdom. The aging King, who is planning for his retirement, proposes splitting his kingdom in thirds, with the best portion going to the daughter who professes the greatest love for the King. Daughters Goneril and Regan profess that their love for their father exceeds their love for all else, husbands included. The third daughter, the virtuous Cordelia, speaks plainly, "I love your Majesty according to my bond, no more, nor less." Dissatisfied with this lack-luster response, Lear implores Cordelia to follow her sisters' example and profess a love that defies limits. Again, Cordelia states that her love is true, but not without limit; she will share her love equally between her father and the man that she may someday marry. An enraged Lear harshly rebukes Cordelia, casting her out of his good graces and fortune: "Thy truth then by thy dower." Lear's misjudgment proves costly, as a dying Lear finds himself penniless and imprisoned at the hands of his loving Goneril and Regan, to whom he has foolishly given his entire kingdom.

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4. See SEC Commissioner Cynthia A. Glassman, Sarbanes-Oxley and the Idea of "Good" Governance, Speech Before the American Society of Corporate Secretaries, Washington, D.C., (Sept. 27, 2002), available at <http://www.sec.gov/news/speech/spch586.htm> (last visited Jan. 25, 2003).

5. See, e.g., Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106. "Practically everyone involved has pointed the finger of blame at others or proclaimed his or her ignorance as a badge of honor." *Id.* at 112-13.

6. WILLIAM SHAKESPEARE, KING LEAR.

The royal court of Shakespeare's King Lear is not entirely unlike the boardrooms, offices and hallways of corporate America today. Individuals often compete and are rewarded according to their ability to promise and report results that defy limits. Promised or reported results and actual results, we are daily reminded, may be entirely different matters. Top executives hoping to avoid a fate similar to that of Shakespeare's King Lear (i.e., financial ruin and imprisonment) should be mindful of the perverse incentives that may reward individuals who, like Goneril and Regan, deliver only self-serving and empty promises. As King Lear learned too late in life, plainspoken honesty should be embraced and rewarded, not punished.

## II. THE EMPLOYEE AND DIRECTOR ACCOUNTABILITY AUDIT

### A. *Background*

In recent years, companies (and their insurers) have faced an increasing number of lawsuits by employees, customers, shareholders and the general public alleging unlawful practices on a company-wide basis. Claims alleging everything from securities fraud<sup>7</sup> to conspiracies to harm the environment and public health have prompted many companies to re-examine their corporate policies and practices. As a result, many companies have wisely adopted 'best practices' policies and instituted regular audit and other compliance programs intended to enforce those policies. Businesses in certain industries subject to close government regulation, such as nuclear power generators and health care providers, have long utilized even more aggressive compliance programs.

'Best practices' policies typically include detailed ethics rules and codes of conduct for individual employees (management included) and directors. However, these written policies and the compliance programs aimed at enforcing those policies, or general notions of "corporate social responsibility," have not necessarily proven sufficient to guard against corporate disaster.<sup>8</sup> In fact, many of the recent highly publicized corporate scandals have involved companies with very detailed ethics policies, codes of conduct, mission statements and mottoes. For example, Enron's very thorough code of conduct alleg-

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7. The year 2002 is on track to be a record year for securities fraud actions. See Sean Higgins, *Shareholder Suits Near A High Despite '95 Reform Legislation*, INVESTOR'S BUS. DAILY, Sept. 10, 2002, at A1.

8. See Milton Moskowitz, *What Has CSR [Corporate Social Responsibility] Really Accomplished? Much of the Movement Has Been a Public Relations Smokescreen*, BUS. ETHICS, May/June & July/Aug. 2002, at 4 ("Looking over the history of corporate social responsibility, I can see it has consisted of 95 percent rhetoric and 5 percent action.").

edly included statements such as, “Relations with the Company’s many publics – customers, stockholders, governments, employees, suppliers, press and bankers — will be conducted in honesty, candor and fairness.”<sup>9</sup> Written ethics policies have, therefore, often served only as “paper tigers,” though they have occasionally been of some use in defending claims of company-wide malfeasance (i.e., by evidencing the company’s objection to certain conduct) and in marketing materials intended to impress “socially conscious” customers and investors.<sup>10</sup>

### B. *The Sarbanes-Oxley Act of 2002*

The Sarbanes-Oxley Act was enacted on July 30, 2002, in response to the failure of many corporations to effectively police and enforce their existing policies and otherwise ensure good corporate governance. The express purpose of the Act is to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”<sup>11</sup> In addition to setting new guidelines for a chief executive officer’s certification of financial statements and for maintaining effective controls and procedures to ensure complete and accurate disclosures to shareholders, the Act contains a number of other provisions intended to address some of the issues that recent corporate scandals have raised, including: (1) the oversight of public accounting firms; (2) conflicts of interests involving securities analysts; (3) prohibitions on loans to insiders; (4) codes of ethics for senior financial officers; (5) rules of professional responsibility for attorneys; (6) new insider trading rules and restrictions; and (7) new “whistle blower” protections for employees of publicly traded companies who provide evidence of fraud.<sup>12</sup>

Significantly, the Sarbanes-Oxley Act does not establish any new “safe harbor” provisions for companies and executives who fail to provide accurate disclosures. To the contrary, the Act creates new potential liabilities for companies and executives alike who fail to be vig-

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9. Enron Code of Ethics (July 2000) (republished by the Illinois Institute of Technology, Center for the Study of Ethics in the Professions), *available at* <http://www.iit.edu/departments/csep/publicWWW/codes/industry.html> (last visited Jan. 25, 2003).

10. As evident in the recent California Supreme Court case of *Kasky v. Nike, Inc.*, 45 P.3d 243 (Cal. 2002), however, investors and customers are becoming increasingly critical of companies that attempt to use their corporate social responsibility for marketing purposes. In *Kasky*, the Court recognized that Nike’s statements about its labor policies, practices, and conditions constituted “commercial speech” that could support a private attorney general action for fraud under the California Business and Professions Code.

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 29, 18, 11 and 28 U.S.C.A.) (noting the statement of legislative purpose).

12. *Id.*

ilant in matters of corporate governance, including the potential for: (1) forfeiture of certain bonuses and profits; (2) debts being deemed nondischargeable if incurred in connection with a violation of securities laws; and (3) criminal punishment.<sup>13</sup>

While the Sarbanes-Oxley Act is broad in its potential scope, it does not represent the significant overhaul of existing securities laws and corporate governance practices many shareholder activists, lawyers, legislators and others have demanded.<sup>14</sup> The Act largely represents an attempt to add some 'new teeth' to aid in the enforcement of existing securities laws. A company that simply sets out to ensure compliance with the Act, therefore, will not necessarily ensure that the problems of the recent past are not repeated.

### C. *Power of Incentives, Denial and Other Unseen Forces*

In a speech at Harvard University, Charles Munger, Vice Chairman of Berkshire Hathaway, identified "24 standard causes of human misjudgment."<sup>15</sup> In his speech, Mr. Munger first commented on the power that incentives have on individual behavior in the business world:

One of my favorite cases about the power of incentives is the Federal Express case. The heart and soul of the integrity of the system is that all the packages have to be shifted rapidly in one central location each night. And the system has no integrity if the whole shift can't be done fast. And Federal Express had one hell of a time getting the thing to work. And they tried moral suasion, they tried everything in the world, and finally somebody got the happy thought that they were paying the night shift by the hour, and that maybe if they paid them by the shift, the system would work better. And lo and behold, that solution worked.<sup>16</sup>

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13. *Id.* (codified as amended at 18 U.S.C.A. § § 1519-20 and 11 U.S.C.A. § 523 (2002)).

14. For example, the Conference Board Commission on Public Trust and Private Enterprise recently released its first recommendations for improved corporate governance, which included: (1) retention and direction of compensation experts by compensation committees - not management; (2) compensation committees setting compensation not by ratcheting up industry averages; (3) uniformly expensing stock options; (4) substantial director and top management stock ownership for extended holding periods; (5) avoiding "special purpose entity" compensation to executives; (6) greater disclosure of equity dilution and employment agreements; (7) shareholder approval of option repricing; and (8) advanced notice of executive stock sales. See Press Release, The Conference Board Commission on Public Trust and Private Enterprise, Corporate Governance: Commission Calls for Major Compensation Reform (Sept. 17, 2002), available at <http://www.conference-board.org> (last visited Jan. 25, 2003).

15. Charlie Munger, Munger On the Psychology of Human Misjudgment, Address at the Harvard University (estimated date June 1995) (transcript available at [www.tilsonfunds.com/mungerpsych.html](http://www.tilsonfunds.com/mungerpsych.html) (last visited Jan. 25, 2003)).

16. *Id.*

As Mr. Munger observed in his speech, there is an inextricable link between the causes of human misjudgment and the economics of a business. Incentives (financial and otherwise), personal bias, psychological denial, the institutional imperative (i.e., following institutional policies and practices no matter how irrational), peer pressure, undue influence, fear, envy and greed may all motivate an individual more strongly than mere mission statements, common sense or a basic sense of right and wrong. One of the longest running and most thorough discussions of this subject is contained in the annual reports, letters to shareholders and owners' manual for Berkshire Hathaway, as well as the other works of Warren Buffett, Chairman of Berkshire Hathaway, and Charles Munger.<sup>17</sup> As Warren Buffett once observed about the unseen forces that cause individuals in a company to engage in destructive lemming-like behavior:

Most managers, have very little incentive to make the intelligent-but-with-some-chance-of-looking-like-an-idiot decision. Their personal gain/loss ratio is all too obvious: if an unconventional decision works out well, they get a pat on the back, if it works out poorly, they get a pink slip. Failing conventionally is the route to go; as a group, lemmings may have a rotten image, but no individual lemming has ever received bad press.<sup>18</sup>

While the complexities of human behavior may never be fully understood, it is clear that behavior will not change simply by virtue of compliance initiatives that ignore the impact of these unseen forces on day-to-day business operations. Just as Cordelia was a rarity in the Court of King Lear, Enron's Sherron Watkins, who signed a letter warning that the company was at risk of "implod[ing] [due to] a wave of accounting scandals,"<sup>19</sup> is a rarity in the corporate world.

#### D. *Accountability Audit Objectives*

To ensure that all individuals in the corporate chain of command work in a manner reasonably calculated to grow a business capable of generating a sustainable return on shareholder equity,<sup>20</sup> companies

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17. In the interest of full disclosure, the author is a shareholder of Berkshire Hathaway. Nothing in this paper, including any references to the writings and works of Warren Buffett and Charles Munger, should be construed as an endorsement of any particular investment decision.

18. BERKSHIRE HATHAWAY INC., SHAREHOLDER LETTERS (1984), available at <http://www.berkshirehathaway.com/letters/1984.html> (last visited Jan. 25, 2003).

19. See Stephen J. Hedges & Melita Marie Garza, *Lawyers' Report Says Probe Was Curtailed*, CHI. TRIB., Jan. 16, 2002, § 1, at 1.

20. For purposes of this paper, a sustainable return on shareholder equity refers to an increase in the intrinsic value of the business as opposed to a momentary spike in share price as a result of market fluctuations or momentum. Intrinsic value can be defined as "the discounted value of cash that can be taken out of a business during its remaining life." BERKSHIRE HATHAWAY INC.,

must look beyond merely defending the type of claims raised in the last lawsuit and beyond vaguely defined compliance initiatives aimed at achieving “corporate social responsibility” or technical compliance with securities laws. Specifically, management should thoroughly review how individual employees (management in particular) and directors are, or are not, held accountable to the shareholders they are supposed to serve, whether through incentives, fear, past behavioral reinforcement or otherwise.

An accountability audit cannot fix a company that lacks a sound business plan or that is lead by an incompetent, apathetic, or self-serving board of directors and/or management team. It is up to the individual investor to avoid these traps. At best, an accountability audit can only help a company to keep unscrupulous individuals in check and people of good intentions from going astray by:

1. Exposing actual or potential conflicts of interest;
2. Evaluating whether conditions within the company and the interests of employees and directors (e.g., compensation, professional advancement or survival, etc.) are aligned with the interests of shareholders (return on equity);
3. Studying past incidents involving or indicating possible questionable or unethical conduct to see whether the root causes of that conduct have been candidly acknowledged and appropriately addressed so that the problem will not be repeated; and
4. Evaluating the sufficiency of existing compliance programs, safeguards and disclosure controls.

Thus, the purpose of the accountability audit is not to replace existing regular financial audits and legal compliance programs, but to enhance them by providing individuals at all levels in the organization, particularly those who are best able to spot problems, with the willingness and ability to bring issues to the attention of those necessary to address them. Toward that end, the audit must identify perverse incentives or conditions within a company that may impact the information provided (or not provided) to management, legal and financial auditors, shareholders and government regulators. The accountability audit should further aid in developing or enhancing an internal “smoke alarm” system, through which individuals in the corporate chain of command *will* alert management, auditors, shareholders or, if necessary, government regulators of potential problems before it is too late.



### E. *Selecting the Auditor*

Just as the integrity of a financial audit largely depends on the integrity and independence of the financial auditor, the quality of an accountability audit will largely depend on the integrity, skill and independence of the person, or persons, charged with performing the audit, whether on a formal or informal basis.<sup>21</sup> A board of directors' audit or disclosure committee, parent or holding company, major shareholder, or some other designated individual or group of individuals with the time, expertise, objectivity, independence, and authority to do the job effectively, could competently perform such an audit internally.

With the caveat that “[t]o the man with a hammer, every problem tends to look pretty much like a nail,”<sup>22</sup> a company conducting an accountability audit could benefit from the assistance of outside legal counsel.<sup>23</sup> First, an accountability audit could be efficiently undertaken in connection with an effort to ensure technical compliance with the many new rules and regulations contained in the Sarbanes-Oxley Act. As demonstrated below, many of the areas of inquiry relevant to an accountability audit would also need to be reviewed and addressed in connection with ensuring compliance under the Act.

Second, an accountability audit would likely raise significant legal issues requiring legal advice beyond those issues arising under the Sarbanes-Oxley Act and other existing securities laws. For example, an obvious source of information for identifying potential accountability issues within an organization would be past, present or threatened lawsuits, regulatory actions and other legal proceedings. As one court wisely observed, “[a]s always when we are required to predict likely human behavior, the bases for that predication must lie in past conduct.”<sup>24</sup> As discussed in greater detail below, an analysis of a company's claims experience may help identify common and problematic themes underlying or causing alleged misconduct—i.e., a particularly overbearing individual, employees failing to openly identify issues for fear of reprisal, compensation plans that reward individuals for achieving easily manipulated targets (e.g., earnings per share), etc.

Third, outside counsel would be able to engage in candid and privileged communications with certain individuals, within the corporate

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21. See e.g., Donna Howell, *Integrity Is Among Qualities to Look for in an Outside Auditor*, INVESTOR'S BUS. DAILY, Apr. 3, 2002, at A4.

22. Munger Address, *supra* note 15.

23. See, e.g., Donna Howell, *It's the Law: Attorneys Do More Than Get Firms out of Jams*, INVESTOR'S BUS. DAILY, May 29, 2002, at A4.

24. *Armstrong v. Chicago Park Dist.*, 117 F.R.D. 623, 634 (N.D. Ill. 1987).

client, concerning potential legal issues and solutions. As one court noted, “[b]y allowing confidentiality of the substance of client and lawyer discussions, the privilege is held by clients as a means of encouraging their candor in discussing their circumstances with their chosen legal representatives.”<sup>25</sup> Since the primary purpose of the accountability audit is to encourage candor at all levels, it naturally follows that candor should be encouraged and protected in conducting the audit. The attorney-client privilege would, therefore, be a significant tool in performing an accountability audit. Likewise, the attorney work product doctrine would help protect the unwanted disclosure of sensitive information that the attorney prepares. An accountability audit performed in the absence of these attorney-client protections could potentially create discoverable evidence supporting the claims of potential litigants or government regulators, without yielding the sort of candid information that a company would need to implement effective reforms.

#### F. *Managing the Audit*

In utilizing the services of an auditor/outside counsel in connection with an accountability audit, a company should, at a minimum, consider the following issues:

1. Is the proposed law firm involved in any transactions or other engagements with the company that could impact the firm’s own objectivity or independence?
2. How and by whom will the law firm be paid for its services in connection with the engagement (e.g., fixed or hourly rate; paid by company, insurer or other interested party, etc.)?
3. How and to whom will the results of the audit be reported so that the appropriate corrective action may be taken?

Regarding the first issue, any audit proposal should include a plain statement from the law firm identifying any actual or potential conflicts. For this purpose, the actual or potential conflicts identified should not be limited to only those “conflicts of interest” that meet the definition set forth in the ABA’s model rules of professional responsibility.<sup>26</sup> The lawyer, or law firm, should also identify other transactions or engagements for the *same* client that could impact ob-

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25. *In Re Subpoena Duces Tecum*, 738 F.2d 1367, 1369 (D.C. Cir. 1984); see *Upjohn v. United States*, 449 U.S. 383 (1981).

26. MODEL RULES OF PROF’L CONDUCT R. 1.7 (1987) provides in pertinent part that: “(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client . . . (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer’s responsibilities to another client . . . .”

jectivity and explain how such potential conflicts will be addressed (i.e., by building a “Chinese Wall” around the lawyer(s) involved in the prior engagements). For example, if the law firm in question wrote the company’s stock option or other compensation plan, it would likely be hesitant to suggest that the compensation plan has in any manner motivated behavior that is somehow detrimental to the intrinsic value of the company. Even if the law firm did not determine the compensation formula, it may have close ties to the person who did and may not want to criticize that person and risk jeopardizing future engagements.

Regarding the second issue, an accountability audit should not be used as a ‘gateway’ to a never-ending source of professional fees. Unfortunately, professional advisors such as lawyers, accountants and consultants have typically utilized a ‘cost plus’ contract approach to billing their professional services, whereby inefficiency and a lack of focus can be rewarded at an hourly rate. A fixed rate, hourly rate with a maximum cap, or some other alternative fee arrangement would be preferable to the traditional hourly billing method and would help provide outside counsel with an incentive to carefully define the scope of its involvement in the audit, as opposed to an incentive to audit and collect hourly fees into perpetuity.

One alternative billing method, for example, could involve conducting the accountability audit in connection with the underwriting of a directors’ and officers’ liability insurance policy, fidelity bond coverage, or an extension of credit. The corporation would pay a fixed fee for auditing services that the insurer or lender pre-approves, in exchange for a reduced insurance premium, lower financing charges or less restrictive lender covenants, assuming the corporation implements corrective action in response to areas of concern that the auditor has flagged. The value of the auditor’s services could ultimately be based on the long-term claims experience or default rates of audited versus unaudited companies. If the auditor fails to make a real dent in an insurer’s claims experience or a lender’s default rate, their services would no longer be approved as a basis for obtaining a premium reduction or lowered financing charge.

Third, the audit should anticipate the risk that the recipient of the report might be connected with a negative item in the audit report, and may, therefore, be unwilling to take the necessary corrective action. As a result, it is important that the report’s findings be distributed as broadly as possible without: (1) destroying any attorney-client privilege; or (2) disclosing confidential or proprietary information to

the general public.<sup>27</sup> Thus, it would not be advisable for outside counsel to prepare an audit report for general distribution to the public or shareholders summarizing privileged communications and/or legal advice. Even a short statement to shareholders communicating the law firm's conclusion and advice in connection with the audit, along the lines of, "The law firm of Dewey, Cheatum & Howe has performed an accountability audit of Offshore Partnerships Holding Co. and has found no material areas of concern," could jeopardize the attorney-client privilege as to materials prepared by, or communicated to, outside counsel. Moreover, such a disclosure would also put pressure on outside counsel to issue a 'clean' report that serves a marketing function, or risk jeopardizing future business with the client.

In order to address these concerns, the findings and advice of outside counsel in connection with an accountability audit should, at a minimum, be distributed to all top members of the management team, including the company's CEO, CFO and general counsel, as well as the company's board of directors.<sup>28</sup> Since outside counsel may uncover accountability issues that involve management and directors acting in collusion (or at least, directors acquiescing to management abuses), the report of outside counsel should also be distributed to other interested parties pursuant to a 'joint interest' confidentiality agreement. If the threat of civil and criminal penalties is not enough to motivate management to take the appropriate corrective action, these interested parties could exert an additional and independent pressure to bring about a change in management. Such interested third parties could include parent companies, acquiring companies, certain major shareholders, lending institutions or insurers. Indeed, major shareholders, lending institutions, and insurers would have a strong incentive to see an effective accountability audit performed, as they are the ones who usually pay the price for corporate mismanagement. The renowned business scholar, Benjamin Graham, once noted "[i]t can be stated as a rule with very few exceptions that poor managements are not changed by action of the 'public stockholders,' but

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27. Section 307 of the Sarbanes-Oxley Act provides for the creation of new rules of professional responsibility for attorneys, including rules: (1) "requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty . . . by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company"; and (2) requiring the attorney to report the evidence to the board of directors or an appropriate committee thereof if appropriate remedial action is not taken by the chief legal or executive officers. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified as amended at 15 U.S.C.A. § 7245 (2002)).

28. *Id.*

only by the assertion of control by an individual or compact group.”<sup>29</sup> Thus, the auditor should, at the outset of the audit, identify and involve any individual or compact group that could assert the necessary control to change management, if the audit reveals management to be an area of concern. An auditor should be reluctant to render its services in the absence of such an interested third party, as doing so may tarnish the reputation of the auditor without bringing about needed change in the company being audited.

Finally, a company should, through its disclosure committee and/or with the assistance of counsel, prepare a “risk factor” disclosure identifying potential accountability issues. For example, if employee compensation is based in large part on some form of stock ownership plan, the report should candidly explain the correlation that may exist between the company’s stock price and individual employee performance (i.e., depressed stock prices may cause low morale, increased employee turnover, or poor employee performance). However, care should be taken to avoid creating documentation that would destroy any attorney-client privilege, or simply benefit potential litigants, as opposed to providing shareholders with material information. A candid and up-to-date “risk factor” disclosure should aid in the defense of claims from plaintiffs who may assert that they have been misled by a company’s forward-looking statements (i.e., expected performance, goals, etc.).

### G. *Areas of Inquiry*

The accountability audit must be narrowly tailored if it is to be effective. Moreover, it should not be redundant with existing compliance programs and/or regular financial audits. The accountability audit should, therefore, not involve the review of every piece of paper that the company has ever created. Nevertheless, the auditor should be thorough and consider reviewing information pertaining to the following general areas of inquiry for a specified period of time (i.e., three years):

1. Corporate Governance
  - Major corporate governance documents (i.e., articles of incorporation, by-laws, minute books, etc.);

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29. BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* 270 (4th rev. ed. 1973); *see also* BENJAMIN GRAHAM & DAVID L. DODD, *SECURITIES ANALYSIS* 513-14 (1934) (“In such matters the most impressive and creditable moves are those made by a group of substantial stockholders, having an important stake of their own to protect and impelled thereby to act in the interests of shareholders generally.”).

- Identity of all affiliated divisions, entities, partnerships, ventures, etc.;
  - Description of business purpose, business plan, expansion plans, along with any significant changes in the business purpose or plan;
  - Identity of major competitors;
  - Description of any significant earnings or accounting re-statement along with the basis for the restatement; and
  - Description of any significant “one time” charges or write-offs along with the basis for the charge or write-off.
2. Key Employee and Director Information
- List of all directors, officers, senior management and key employees along with an organizational chart illustrating the Company’s management structure;
  - For each of the foregoing individuals, the following:
    - title(s);
    - length of service;
    - department or place of employment;
    - direct supervisors and direct reports;
    - copy of C.V. and/or employment application;
    - salary, fee, or benefit arrangements;
    - copy of any employment or director contract or agreement;
    - statement of how and by whom person was referred and/or selected;
    - describe training received or available in connection with position;
    - describe duties and responsibilities; provide performance reviews; and summary of individual stock holdings in company.
3. Compensation and Benefit Plans
- All employee benefit or compensation plans;
  - Reports of any compensation committee;
  - Schedule showing cost of employee benefit or compensation plans;
  - Actuarial or financial report for all plans; and
  - Accounting of incurred and expected costs associated with any stock option plan.
4. Employee Hiring and Termination Analysis
- Identity of all (or a random sampling of all) employees hired and/or terminated (whether voluntarily or involuntarily) by title, department and direct supervisor;

- Brief description of circumstances of terminations (i.e., “fired – excessive absences;” “quit – new employment opportunity,” etc.); and
  - Copies of all (or a random sampling of all) exit interview notes, letters of resignation, termination notices.
5. Company Handbook and Policies
    - Employment policies, handbooks, training manuals, rules of conduct, contracts, and at-will employment acknowledgements;
    - Standard disciplinary procedures; and
    - Collective bargaining agreements, if any.
  6. Major Lender or Financing Agreements
    - Copies of all material financing agreements, including any financing covenants (i.e., maintaining minimum book value, etc.); and
    - Identity of any actual or technical defaults, loan workouts or major debt restructuring, with respect to any financing agreements.
  7. Claims, Litigation and Regulatory Proceedings
    - Claims made or threatened against any insurance or bond coverage;
    - Past, present and/or threatened lawsuits, settlement agreements, or binding court orders;
    - Government Investigations (i.e., EPA, OSHA, SEC, IRS, etc.); and
    - Private party investigations (i.e., NASD, ISO, etc.).
  8. Major Vendor and Customer Information
    - Identity of major vendors and customers (i.e., with contracts exceeding specified amount deemed material), including the terms of any agreements or understandings, length of relationship, and identity of any individuals or companies who either own or control said vendor or customer; and
    - Description of vendor or customer disputes, defaults or breaches of contract.
  9. Dealings With Outside Auditors and zAdvisors
    - Identify outside legal, financial or accounting auditors, including a description of nature and scope of all engagements; and
    - Copies of correspondence with financial and legal auditors.
  10. Dealings With Investment Banks and Analysts

- Identity of all analysts providing coverage and copies of analyst reports;
  - Copies of communications with analysts and policy concerning such communications; and
  - Description of all transactions or engagements with investment banking firms.
11. Disclosures To Shareholders and Public
- Description of existing disclosure controls and action plan, including any disclosure guidelines, timetables, chart identifying individual(s) responsible for particular portions of filings;
  - Public filings with SEC;
  - Press releases;
  - Shareholder information request and response policy;
  - Reports or correspondence generated by any disclosure committee or individual charged with preparing disclosures; and
  - Copies of any earnings conference call scripts or transcripts.
12. Compliance Program(s) Information
- Description of any compliance programs, initiatives and parties responsible for implementation (i.e., safety inspector, HR department, general counsel, outside consultant, etc.); and
  - Copies of any recent complaints, concerns or comments or investigative files relating to such complaints, concerns or comments.
13. Relationships and Transactions With Related Persons
- Description or copies of all oral or written arrangements not already identified between the Company and (1) any current or former shareholder, director, officer, senior management or employee; or (2) any officer or employee of any government or governmental department, agency, or entity owned or controlled by any such officer or employee; (3) and any auditor, accountant, lawyer or other professional advisor or any firm associated with such advisor; or (4) any family member of any officer, director or key employee of the Company or any business owned or controlled by such family member;
  - Details of any loan or transfer of assets between the Company and any of its shareholders, directors, officers or key employees;



- Description of any direct or indirect interest of any director, officer or key employee that competes with, conducts business with, conducts business similar to or has any present (or contemplated) arrangement or agreement with (whether as a customer or supplier) the Company;
- List of any directors, officers or other key employees who have an interest in the company (including stock or stock options) or any assets of the company; and
- Insider trading history, along with any pre-clearance trade requests.

#### H. *Audit Methodology*

In examining the foregoing information, the auditor should not attempt to impose a predetermined formula (i.e., specific compensation packages, compliance programs, etc.) as to what will and will not serve the best interests of shareholders, though certain basic recommendations should be applicable to most companies (e.g., requiring advance notice of executive stock sales, accurately accounting for any equity dilution, etc.). For example, while an “independent” board of directors may help keep management honest,<sup>30</sup> it may also be so independent as to not have any vested interest in the company. In some circumstances, a very “dependent” board of directors, comprised of major shareholders who are also key officers of the company, may be a superior means of achieving accountability to shareholders as they “eat their own cooking,”<sup>31</sup> so long as potential areas for officer/director abuse are adequately addressed (i.e., determination of compensation). As another example, some have suggested that simply tying employee compensation to a company stock ownership plan might produce better results for shareholders. However, as Home Depot CEO, Bob Nardelli, recently acknowledged, such a plan is not entirely foolproof, particularly when the general markets bring stock prices down—“[s]ervice directly relates to morale, and morale in our company is directly related to stock price.”<sup>32</sup>

Rather than trying to impose a particular dogma or set of protocols, therefore, the auditor should strive to view the facts as they apply to the particular company, withholding any conclusions in advance of a thorough examination of those facts. In so doing, the auditor should engage in a two-fold exercise: (1) studying known incidents involving or indicating possible questionable or unethical conduct (i.e., lawsuits,

30. See, e.g., Sonnenfeld, *supra* note 5, at 106-13.

31. See BERKSHIRE HATHAWAY INC., *supra* note 20, at 2.

32. *IBD's Top 10*, INVESTOR'S BUS. DAILY, Sept. 9, 2002, at A1.

claims, regulatory actions, earning restatements, “one time” charges or accounting write-offs, loan defaults, etc.) to determine whether the incidents and attending circumstances have been candidly acknowledged and appropriately addressed; and (2) studying existing conditions (conflicts of interests, compensation packages, disclosure controls, etc.) to identify “areas of concern” where as of yet unknown incidents may have a likelihood of occurring, or continuing to occur undetected, in the absence of closer scrutiny. Engaging in this two-fold exercise requires that the auditor view facts from the perspective of the individual employees and directors involved in the day-to-day operations of the company to determine how, or if, perverse incentives or other unseen forces are at work in motivating human misjudgment. Sir Arthur Conan Doyle’s famous detective, Sherlock Holmes, best represents this approach:<sup>33</sup>

You know my methods in such cases, Watson: I put myself in the man’s place, and having first gauged the man’s intelligence, I try to imagine how I should myself have proceeded under the same circumstances.<sup>34</sup>

You’ll get results, Inspector, by always putting yourself in the other fellow’s place, and thinking what you would do yourself. It takes some imagination, but it pays.<sup>35</sup>

With this methodology in mind, consider how an accountability audit might address accountability issues at work in the companies involved in the following scenarios:

*Example 1:*

A computer hardware company “books” tentative third quarter orders as firm orders in the second quarter causing unnecessary overtime and production costs as employees scramble to produce the hardware tentatively ordered for the third quarter before the end of the second quarter only to later disassemble the hardware when the tentative orders are cancelled in the third quarter.

The acceleration of tentative orders as firm orders and similar quarterly sales or revenue boosting slights of hand of varying degrees are, unfortunately, all too common occurrences. Companies seeking to boost quarterly sales figures through such practices, however, put themselves in a precarious position. When, for example, tentative orders booked as firm orders in a prior quarter are cancelled, the cancellations will offset actual firm orders in the current quarter. Thus,

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33. See John Price, Ph.D., *Sherlock Holmes and the Science of Investing*, (Sept. 2000), available at <http://www.Sherlockinvesting.com> for a detailed discussion of the application of Sherlock Holmes’ investigative methodology in analyzing a company (last visited Jan. 25, 2003).

34. SIR ARTHUR CONAN DOYLE, *THE MUSGRAVE*.

35. SIR ARTHUR CONAN DOYLE, *THE ADVENTURES OF THE RETIRED COLOURMAN*.

management might be later tempted/forced to take even greater liberties with reported facts (i.e., allocating costs to capital improvements as allegedly occurred at WorldCom). While engaging in this foolish conduct, the company and its shareholders sacrifice needless labor and overhead expenses to produce and disassemble goods without any return on shareholder equity.

While the practice of accelerating orders may not be obvious to financial auditors relying on information that management provides, it most likely is obvious to the employees who are putting goods together one week only to take them apart the next. Thus, while the practice is known to some, it would probably not be made known to the accountability auditor at the outset of the audit, unless a lawsuit, regulatory action or earnings restatement has called it out into the open. Nevertheless, the accountability audit should be able to highlight such potential conduct as an “area of concern” based on the conditions in existence within the company. Toward that end, the auditor must put himself or herself in the shoes of the employees or directors and consider some of the possible forces at work:

1. Management is compensated, in part, based on easily manipulated objectives, such as “firm orders;”
2. Employees are not saying anything because the risk of getting fired or otherwise retaliated against is greater than any potential benefit to sticking their neck out;
3. The company has no effective mechanism in place for employees to question the practice;
4. The integrity of the mechanisms in place for correcting such practices are compromised (i.e., outside auditors will not challenge “close business questions” for fear of jeopardizing lucrative consulting projects or other engagements, the general counsel answers to the person(s) who initiated the practice, etc.); and
5. The board of directors is comprised of individuals with no vested interest in the company or who simply view themselves as honorary figureheads engaged in a prestigious resume building exercise.

Moreover, through further investigation, the accountability auditor might be able to do more than simply identify manipulation of “firm orders” as an “area of concern.” As noted above, a significant part of the auditor’s job should be to examine the adequacy of internal controls and compliance programs. Aside from simply speculating as to possible weaknesses in those controls based on known facts (i.e., the only internal control is the company’s general counsel), the auditor

should engage in random sampling, in the form of interviews with randomly selected employees in each of a company's major departments. If these employees are provided with a sufficient assurance of confidentiality and are asked the right kinds of questions, they may happily volunteer the fact that they do not understand why the company builds goods only to tear them apart again. Again, though, the auditor's primary job should not be to spot problems, but to spot conditions that may motivate the occurrence or reoccurrence of problems or prevent the discovery of problems. In this scenario, the need for an enhanced reporting mechanism for employees (i.e., a confidential or even anonymous hotline directly to a parent company, major shareholder, insurer, board of directors' audit or disclosure committee, etc.) should be relatively easy to spot and correcting that deficiency might well be enough to bring the practice to light and to an end.

Consider another example:

*Example 2:*

The quality control department of a machine tool manufacturing facility reports installation and production defects on a monthly basis. The reports exclude defects that the department does not deem to be "installation" or "production" related. Thus, if goods are damaged during shipping (by a third party shipping company), they are not reported as an "installation defect," notwithstanding the fact that the goods were not defective when produced and do not show up in the "production defect" records. No record is kept of "shipping related defects." The quality department only reports "production" and "installation" defects. All other defective goods are simply reported as "returned by customer" and are not addressed at all by quality control.

Again, there could be many possible reasons for why this practice occurs, in addition to some of those noted above:

1. A change in practice to include a more complete reporting of defects would make it appear that the quality department is somehow to blame for there, in fact, being more defects;
2. The quality department is compensated based, in part, on reported defects; and
3. The president of the machine tool manufacturer's brother owns the shipping company that transports the goods.

Using facts known from the audit, the auditor may not detect the actual questionable practice (unless it is revealed through random sampling interviews). However, the auditor would likely have sufficient information to spot "areas of concern," including the manner in which defects are reported, or the shipping contract is administered, in light of the president's conflict of interest (i.e., his brother's ownership

of the shipping company), the method of compensation in the quality department and/or a general lack of candor in internal communications.

Finally, consider the following example involving an incident indicating questionable conduct that would likely be made known to the accountability auditor at the outset of the audit (i.e., through disclosure of a regulatory action):

*Example 3:*

A distributor of dialysis equipment learns that it has received a shipment of defective dialyzers. Nevertheless, the company's president decides to sell the dialyzers to the general public. The company's internal compliance officer, its general counsel, is unable to dissuade the president from this course of action. The general counsel informs the FDA of the possible distribution of defective product. The FDA imposes severe penalties.

Here, the auditor need not speculate as to possible conduct that could occur in connection with an "area of concern." The incident has already occurred—the imposition of FDA sanctions. The auditor must, therefore, consider whether the incident has been candidly addressed and corrected so that it will not happen again. Toward that end, the auditor must consider the possible causes:

1. Exceptional external pressure from the supplier of the dialyzers (i.e., dependence on a single distributor); and
2. The general counsel had no other person or person(s) to turn to within the company regarding his concerns.

In this scenario, the importance of the auditor's integrity, independence and reporting procedure is clear. For example, if the auditor were to report only to the president of the company, the audit report could potentially be of little or no use if the auditor determined that the underlying problem involved questioning the judgment or integrity of the president.<sup>36</sup> If the auditor were courageous or foolish enough to raise such a question, the report would likely only result in the termination of any future relationship with the auditor.

This last example also highlights a significant problem in many existing internal compliance programs. When compliance is left entirely to the general counsel of a company, that individual will be under a tremendous pressure to acquiesce to questionable practices. In fact, the foregoing example is similar to, but not intended to be representa-

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36. See BENJAMIN GRAHAM & DAVID L. DODD, *supra* note 29, at 510. "All stockholders seem to take for granted that their management is capable. Yet in selecting stocks, great emphasis is laid on the question whether the company enjoys efficient management . . . Should not this mean also that the stockholders of any company should be open-minded on the question whether its management is efficient or the reverse?" *Id.*

tive of, the facts in the case of *Balla v. Gambro, Inc.*<sup>37</sup> In *Balla*, the in-house attorney was fired after reporting the alleged distribution of defective products to the FDA.<sup>38</sup> Following his discharge, the in-house attorney filed a claim for retaliatory discharge, alleging that his termination was in violation of public policy (i.e., motivated by his reporting the intent to distribute a dangerous product to the general public).<sup>39</sup> The Illinois Supreme Court, however, ruled that the in-house attorney could not assert a legally valid “whistle blower” claim.<sup>40</sup> The Court reasoned that the in-house attorney should not be afforded the legal protection of a “whistle blower” claim, as he was already bound to “do the right thing” under the rules of professional conduct for attorneys.<sup>41</sup> Moreover, the Court was reluctant to grant extra legal protection to in-house attorneys who report possible violations to government regulators in violation of their ethical responsibility to maintain client confidences.<sup>42</sup> Thus, in-house attorneys in Illinois and similar jurisdictions face an extraordinary pressure to say yes or turn a blind eye to questionable practices—if they do not, they may lose their jobs without recourse. Conversely, it is unusual for an in-house attorney to be called to task for approving of, or acquiescing to, a questionable corporate practice, as the practice may go undiscovered or the in-house attorney may effectively protect himself from professional sanctions through internal documentation. Thus, the in-house attorney’s “personal gain/loss ratio” may often weigh in favor of approving of, or acquiescing to, questionable corporate conduct.

The areas of inquiry suggested above may reveal many more potential questionable practices and conditions than the foregoing three examples are able to demonstrate, such as: (1) Are officers and directors actively involved or vested in the company, such that they will suffer consequences (i.e., loss of wealth) for squandering shareholder equity?; (2) Are managers sacrificing shareholder equity to satisfy “managerial wish lists”<sup>43</sup> (i.e., foolish expansion plans that are only calculated to increase the *right* of executives to higher salaries, power, prestige, etc.)?; (3) Is executive compensation fully disclosed and in line with executive performance and overall employee compensa-

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37. 584 N.E.2d 104 (Ill. 1991).

38. *Id.* at 106.

39. *Id.*

40. *Id.* at 111-13.

41. *Balla*, 584 N.E.2d at 109.

42. *Id.*

43. BERKSHIRE HATHAWAY INC., *supra* note 20, at 5.

tion?<sup>44</sup>; (4) Are employees able to report issues anonymously or without fear of reprisal?; (5) Are employees motivated by a desire to serve the long term interests of the business by a strong internal promotion policy and/or a well constructed compensation plan?; or, alternatively, (6) Is employee morale and loyalty sacrificed to ineffective compensation plans and/or high employee turnover?; (7) Is a particular individual or group of individuals asserting personal goals above the goals of the company (i.e., return on shareholder equity)?; (8) Are extraordinary conditions testing the limits of human integrity (i.e., dependence on a single customer or vendor or a high debt load with substantial lender covenants)?; (9) Is the company making efforts to promote reasonable shareholder expectations in its disclosures?; (10) Is shareholder equity being surreptitiously diluted through stock option grants or issues made without any reciprocal capital gain?; and (11) Are known failures (lawsuits, insurance claims, earning restatements) significant and recurring, or are they candidly addressed and resolved?

As Sherlock Holmes observed, the investigator's job requires some imagination, "but it pays."<sup>45</sup> Likewise, the accountability auditor's job should "pay" in the long run for companies seeking to restore investor confidence and investor capital to the equity markets. While the short run calculus might seem counter-intuitive (as unearthing fundamental problems in a company is usually not popular with investors), companies and top executives should bear in mind two things: (1) harsh civil and criminal consequences under the Sarbanes-Oxley Act may be brought to bear on companies and executives who do not take decisive action to clean house; and (2) "[i]n the short run the stock market is a voting machine, but in the long run it's a weighing machine."<sup>46</sup> Eventually, a company should expect that its presently unidentified problems will weigh down the company's long-term prospects and its ability to generate a sustainable return on shareholder equity.

### III. CONCLUSION

Ultimately, intelligent investors, with the aid of government regulators, must protect themselves from unscrupulous businesses and man-

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44. In 1934, Graham and Dodd offered the following observation, which is as timely today as it was then: "In recent years the question of excessive compensation to management has excited considerable attention, and the public understands fairly well that here is a field where the officers' views do not necessarily represent the highest wisdom." BENJAMIN GRAHAM & DAVID L. DODD, *supra* note 29, at 512.

45. SIR ARTHUR CONAN DOYLE, *supra* note 35.

46. BERKSHIRE HATHAWAY INC., SHAREHOLDER LETTERS (1987), available at <http://www.berkshirehathaway.com/letters/1987.html> (Chairman Warren E. Buffet quoting Benjamin Graham in Buffet's Letter to Shareholders dated Feb. 29, 1988) (last visited Jan. 25, 2003).

agers by carefully selecting their investments based on sound business principles. In so doing, each individual investor should, to the extent possible, conduct his or her own informal accountability audit of a company by considering such basic questions as: (1) How are employees, executives and directors rewarded/compensated for producing a return on equity?; (2) What consequences are suffered by employees, executives and directors for squandering equity?; (3) What is management saying or not saying about past mistakes and misjudgments so that those mistakes and misjudgments will not be repeated?; and (4) What are the long term objectives of the individuals charged with managing the business? Finally, investors should consider whether management is actively considering these same issues or whether management indulges and rewards self-serving puffery (e.g., King Lear's Court) in lieu of plainspoken honesty. A formal accountability audit is only one way that a company can demonstrate to its shareholders that it is considering these important issues.



