Director Notes

From Enron To Lehman Brothers

Lessons for Boards From Recent Corporate Governance Failures

by Frederick D. Lipman

In order for boards to fulfill their oversight obligations, the organizations they serve must have robust whistleblower and compliance policies and programs to encourage reporting that can help identify risk exposures, fraud, or other illegal activity. This report identifies common pitfalls in many current whistleblower and compliance programs, and it offers recommendations on how audit committees can strengthen them.

Government investigations, bankruptcy receiver reports, and numerous books provide a rich source of information about the major corporate disasters of the first decade of the twenty-first century. Although the financial implosions, starting with Enron and ending with Lehman Brothers, have significant differences, one common corporate governance theme can be seen: The board, and, in particular, the independent directors, did not have the information required to properly perform their oversight duties, even though such information was known to various members of management.

In almost all the cases, the directors claimed they were misinformed or "duped" by the CEO or CFO.[1] In this respect, these disasters were partly the result of corporate governance failure and, in particular, a failure to establish a robust whistleblower system as an internal control. Those failures also offer evidence that the independent directors of companies that suffer shareholder debacles tend to lose their business reputation and their other directorships.[2]

The audit committee members and other independent directors of these companies relied heavily on the fact that the company was receiving clean audit opinions from its independent auditors and failed to develop other independent sources of information. An investment advisory group formed by the Public Company Accounting Oversight Board ("PCAOB") noted that a number of companies all received unqualified audit opinions within months of their failure. (See "A Sampling of Failed Financial Institutions" on page 3.)

1 Frederick Lipman, *Whistleblowers: Incentives, Disincentives and Protection Strategies*, (Hoboken: John Wiley & Sons, Inc. 2012), pp. 82-83.

2 See Andrea Redmond and Patricia Crisafulli, Comebacks: Powerful Lessons from Leaders Who Endured Setbacks and Recaptured Success on Their Terms (San Francisco: Jossey-Bass, 2010), which details the story of Herbert S. "Pug" Winokur, Jr., former head of the Finance Committee of the Enron Board of Directors, who subsequently lost his directorship with the Harvard Corporation.

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It is clear that corporate governance oversight cannot be effective if the only source of board information is the CEO, CFO, and the independent auditor.

In reaction to Enron, WorldCom, and the other shareholder disasters that took place from 2000 to 2002, Congress enacted the Sarbanes- Oxley Act of 2002 (SOX), which mandated that companies whose stock is traded on national securities exchanges require their audit committees to establish procedures for "the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." This resulted in employee hotlines being established by most public companies. However, these hotlines have not been effective in most cases to induce management personnel to go over the heads of the CEO or CFO and make disclosures to the audit committee.

For example, prior to the collapse of AIG, there were executives who recognized the major risks being undertaken through its derivatives business in credit default swaps, but they had no incentive to reveal these risks to the directors.[3] According to a Michael Lewis article, in mid-2005, an AIG executive named Gene Park was fiddling around at work with his online trading account after reading about this wonderful new stock called New Century Financial with a terrific dividend yield. [4] Park looked at New Century's financial statements and noticed something "frightening."[5] The average homeowner counted on to feed the interest on the "A+" tranche of New Century mortgage-backed collateralized debt obligations ("CDOs") had a credit score of only 598, with a 4.28 percent likelihood of being 60 days or more late on payment.[6] Park subsequently discovered that the AIG Financial Products Division was insuring a substantial portion of the New Century mortgages. He allegedly revealed this information to Al Frost, Joseph Cassano's No. 2 person in the AIG Financial Products Division, and was ultimately blown off by Cassano, the former head of A.I.G.'s Financial Products unit.[7] Had a robust whistleblower system existed at AIG at that time, Park might have used it to advise the AIG audit committee. Instead, the AIG Financial Products Division did not reduce or hedge their existing super-senior tranches of subprime CDOs, although they stopped writing credit default swaps in late 2005/2006.[8]

Why didn't Park use the AIG anonymous employee hotline to report to the AIG audit committee the excess risk being taken by AIG in issuing credit default swaps? One can only speculate that there was no reward for Park to do so, and it is likely he would have had an abbreviated career at AIG had Cassano discovered that Park had gone over his head to the AIG audit committee.

According to the Lehman Bros. Bankruptcy Examiner Report, Matthew Lee, a senior vice president of Lehman Bros. finance division, was aware of accounting improprieties at Lehman Bros. In May 2008, he sent a letter to Martin Kelly, his superior and the Lehman Bros. controller, about the Repo 105 transactions used by Lehman Bros. to move assets off the balance sheet at quarter-end.[9] There was no response to the letter.

Why didn't Lee use the employee hotline to report the issue directly to the audit committee? Perhaps Lee decided that sending a letter to a superior was risky enough without further jeopardizing his career by going to the audit committee. There is no evidence that Lehman Bros. created any reward for providing legitimate information on the employee hotline. In any event, Lee was laid-off less than a month after sending the letter.[10]

According to *All the Devils Are Here: The Hidden History of the Financial Crisis*, a book by Bethany McLean and Joe Nocera, Merrill Lynch senior executive Jeff Kronthal warned then-CEO Stan O'Neal about the excessive subprime risk being assumed by Merrill Lynch. His warning was ignored and disbelieved by the CEO.

3 Bethany McLean and Joe Nocera, *All The Devils Are Here: The Hidden History of the Financial Crisis* (New York: Portfolio/Penguin 2010), p. 190.

4 Michael Lewis, "The Main Who Crashed the World," in *The Great Hangover: 21 Tales of the New Recession from the Pages of Vanity Fair*, Graydon Carter (ed.) (New York: Harper Perennial 2010), pp. 119-120. See also "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," January 2011, pp. 200-201.

5 Lewis, "The Man Who Crashed the World."

6 Moe Tkacik's Page, "That AIG Story, For Readers Who Are Sick of AIG Already," July 6, 2009, True/Slant (http://trueslant.com/moetkacik/).

7 Lewis, "The Man Who Crashed the World."

8 Cohan,"The Fall of AIG: The Untold Story," *Institutional Investor* Apr.7, 2010, p.6 , (www.institutionalinvestor.com/Popups/PrintArticle.aspx?ArticleID=2460649).

9 Anton R. Valukas, "Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner Report," March 11, 2010, p. 21 (http://lehmanreport.jenner.com).

10 Andrew Clark, "Lehman whistleblower lost his job weeks after raising alarm," March 16, 2010 (www.guardian.co.uk/business/2010/mar/16/lehman-whistleblower-auditors-matthew-lee).

Table 1

A Sampling of Failed Financial Institutions Receiving Unqualified Audit Opinions Within Months of their Failures

Company	Event	Event Date	Investor losses ($ millions)*	Audit firm
Lehman Brothers	Bankruptcy	9/15/2008	31,437.10	Ernst & Young
American International Group	TARP	9/16/2008	155,499.60	PricewaterhouseCoopers
Citigroup	TARP	10/26/2008	212,065.20	KPMG
Fannie Mae	Government takeover	9/6/2008	64.1	Deloitte
Freddie Mac	Government takeover	9/2/2008	41.5	PricewaterhouseCoopers
Washington Mutual	Bankruptcy	9/26/2008	30,558.50	Deloitte
New Century Financial Corp.	Bankruptcy	4/2/2007	2,576.40	KPMG
The Bear Stearns Companies Inc.	Purchased	3/17/2008	20,896.80	Deloitte
Countrywide Financial Corp.	Purchased	1/11/2008	22,776.00	KPMG

* Calculated based on decline in market capitalization from one year prior to the event and the event date. Fannie Mae and Freddie Mac data is from 10/9/07 and 9/12/08.

Why didn't Jeff Kronthal use the anonymous employee hotline to warn the audit committee of this excessive risk? Going over the head of the CEO, even on an anonymous basis, is considered an act of disloyalty to the management team and typically results in some form of retaliation, including being considered a pariah within the company and the industry as a whole.

The final report of the National Commission on the Causes of the Financial and Economic Crisis in the United States notes that Matthew Tannin, a Bear Stearns executive, stated in a diary in his personal e-mail account in 2006, long before the collapse of Bear Stearns, that "a wave of fear set over [him]" when he realized that the Enhanced Fund "was going to subject investors to 'blow up risk'" and "we could not run the leverage as high as I had thought we could."[11] Why didn't Matthew Tannin use the anonymous employee hotline to report his concern to the Bear Stearns audit committee? He probably did not use it for the same reasons stated above (i.e., lack of reward and likelihood of retaliation).

These cases are examples of situations where significant information was known within the management group but unknown by the audit committee and/or other independent directors. One may speculate that had this vital information been reported to the audit committee, the tremendous losses subsequently incurred by shareholders may have been wholly or partially avoided.

Defects in Current Whistleblower Systems

Although Congress may have contemplated SOX as an active and effective whistleblower program, this goal has not been uniformly realized. Hotlines today are primarily a vehicle for employment discrimination, sexual harassment, and other similar employment related complaints, rather than a pipeline for major fraud, illegality or enterprise risk of interest to the independent directors. The hotlines typically fail to create incentives for executives below the CEO and CFO level to reveal important information directly to the audit committee. Unfortunately, some independent directors are misled by the employment-related complaints on the hotline into believing the hotline is really effective.

There are seven major problems with most current whistleblower systems:

1. The tone at the top tolerates but does not encourage whistleblowers, particularly executive whistleblowers.
2. There is no meaningful reward or recognition for legitimate whistleblowers.
3. The inability to communicate with anonymous whistleblowers results in a failure to fully investigate anonymous information.
4. The system does not guarantee anonymity.
5. The system is not well-advertised.
6. The audit committee uses employee administrators and investigators who are not viewed as independent by whistleblowers and do not have forensic skills.
7. Whistleblowers' motivations and personalities affect the investigation.

11 "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," The Financial Crisis Commission, January 2011 (http://fcic.law.stanford.edu/report).

Many public companies have a "paper" whistleblower system. In such a system, the company has complied with the letter of the SOX requirements and exchange listing rules but has done nothing more. Management tolerates the whistleblower system but does not encourage whistleblowers. Whistleblowers are almost never recognized as employees of the month. As a result, potential whistleblowers (including executive whistleblowers) who face daunting disincentives often refuse to participate in the system.

Concerning the SOX whistleblower statute, the former general counsel of the Securities and Exchange Commission (SEC) has stated:

> *"Not all corporate compliance programs work well. Some—no matter how elaborately conceived and extensively documented—exist only on paper. Some small numbers are shams. I once knew of an ostensibly anonymous employee hotline that actually rang on the desk of the CEO's secretary. I'm not at all sure that Congress intended that a whistleblower at this company would have to avail himself of this hotline before coming to the Commission and getting an award."*[12]

Very few, if any, whistleblower systems provide meaningful rewards or recognition for whistleblowers. Although some employees are driven by their moral compass to do the right thing and do not need rewards, the number of employees who are Mother Teresa is very limited. Given the real possibility that persons disclosing wrongful activity may be terminated, or at least potentially socially ostracized, employees have no reason to assume those risks without a meaningful incentive. Internal whistleblower systems do not have to compete economically with the size of awards available under the whistleblower statutes since there are many disincentives to external employee whistleblowing. However, the lack of any meaningful reward or other recognition for internal whistleblowers reflects an organizational attitude that is not conducive to whistleblowing.

Although the SOX whistleblower system allows for anonymous whistleblowers, that system does not work well because the audit committee or its counsel may need to further question the person whose identity has been hidden. Audit committees tend to provide fewer resources for investigating anonymous complaints.[13] Unfortunately, approximately half of whistleblower calls in 2010 were anonymous, a fact that suggests that many employees fear retaliation.[14]

Moreover, many current whistleblower systems do not guarantee anonymity. Voice recognition techniques can be used to trace hotline calls. Private detectives can use handwriting analysis to trace anonymous letters. Anonymous e-mails can be traced back to the whistleblower's computer. Best practices would provide greater guarantees of anonymity by permitting communication through the whistleblower's personal counsel (at the company's expense if the information is legitimate) and allowing the whistleblower to form an entity to further hide his or her identity.

Hotline service providers advertise their ability to ask further questions to the anonymous whistleblower. Although this service is useful, it is not a good substitute for direct communication between the whistleblower's lawyer and the audit committee's attorney away from the intervention of the hotline service provider. Hotline providers do not normally have the forensic skills necessary to ask follow-up questions. Sophisticated executive whistleblowers know that the information they reveal to the hotline, including their company position, is not protected from discovery by the attorney-client privilege. Moreover, executive whistleblowers, concerned about being blackballed and anxious about maintaining anonymity, will not necessarily be comfortable with an ongoing detailed dialogue with a hotline service provider selected by management and possibly even providing summaries of the conversation to management personnel. Yet, without this detail it is difficult for the audit committee to conduct a thorough investigation.

12 David M. Becker, Esq., General Counsel, "Speech by SEC Staff: Remarks at the Practicing Law Institute's Ninth Annual Institute on Securities Regulation in Europe," U.S. Securities and Exchange Commission, January 25, 2011.

13 James E. Hunton and Jacob M. Rose, "Effects of Anonymous Whistle-Blowing and Perceived Reputation Threats on Investigations of Whistle-Blowing Allegations by Audit Committee Members" *Journal of Management Studies,* 48, no. 1, 2011, pp. 75-98.

14 "2011 Corporate Governance and Compliance Hotline Benchmarking Report" The Network, Inc., August 23, 2011 (tnwinc.com/files/2011TNWbenchmarkingreport.pdf?webSyncID=feeb1011-cfd5-46f5-9002-b82b755566a9&sessionGUID=839c7949-4019-6a43-b5c5-2ebd95e8aea9); Deloitte Forensic Center, "Whistleblowing and the New Race to Report: The Impact of the Dodd-Frank Act and 2010's Changes to U .S. Federal Sentencing Guidelines," 2010 (www.deloitte.com/view/en_US/us/Services/Financial-Advisory-Services/Forensic-Center/fb02b4b17deaa210VgnVCM2000001b56f00aRCRD.htm).

Many companies do not adequately communicate the whistleblower system except in a policy contained in an SEC filing or on their websites. As a result, average employees may not realize that the company even has an anonymous whistleblower system. A survey by the Institute of Internal Auditors indicates that employee familiarity with the organization's hotline is a key factor in encouraging its use.[15]

The administration and investigation of whistleblower complaints are typically performed initially by the internal auditor, director of compliance, human resources (HR) head, or general counsel. All of these individuals are company employees whose compensation is determined by management (with the possible exception of the internal auditor).

Potential whistleblowers do not have confidence in the independence or impartiality of those employees who would administer or investigate their complaints. Moreover, many of these individuals are not skilled forensic investigators.

An example of why whistleblower systems do not work can be found in the Enron case. Sherron Watkins sent a letter to Kenneth Lay, Enron's chairman, stating, in part, that "I am incredibly nervous that we will implode in a wave of accounting scandals." Kenneth Lay then turned the matter over to inside counsel to administer and investigate Watkins' complaint, rather than using completely independent counsel for that purpose. Inside counsel then employed Enron's regular outside counsel, which received substantial legal fees from Enron, to perform the investigation. At the end of a very limited investigation, the regular outside law firm gave Enron a report that, in general, found no substance to Watkins' complaint. A separate investigation completed shortly after Enron's bankruptcy by an independent board committee, using completely independent counsel, found significant substance to Watkins' complaint.

Whether a particular company's hotline is effective can only be determined through employee surveys and exit interviews that are directed primarily at the executive group. Independent directors should consider conducting such surveys anonymously using third party service providers.

Elements of a Robust Whistleblower Policy

If audit committees and independent directors want to receive information from executives below the CEO or CFO level in order to fulfill their oversight obligations, they must establish a robust whistleblower system and an effective compliance program.

An effective compliance program requires the following elements:

- Independent directors must be in charge and must be given the resources to fulfill their responsibilities.
- The whistleblower system for accounting, auditing, and enterprise risk complaints must be independently administered. This means that employees of the company (such as HR, internal audit or inside counsel) should not initially receive such hotline complaints, as is the current practice, but rather complaints should initially go directly to the audit committee chair or his or her designee (such as completely independent counsel or other ombudsman). This will assure the whistleblower that more serious complaints will be independently handled by persons not beholden to management. Routine employee complaints, such as employment discrimination, sexual harassment, and similar complaints, should be referred back to HR for investigation. Alternatively, a separate hotline can be developed solely for nonemployment related complaints, with HR continuing to receive employment-related complaints on its own hotline.
- Whistleblower complaints (other than for routine employment discrimination, sexual harassment, and similar complaints) should be investigated by completely independent counsel (or other ombudsman) reporting directly to the independent directors. Employees of the company should not be used to investigate nonemployment complaints in order to encourage executive whistleblowers to use the system.
- There should be no presumption that anonymous complaints are less deserving of investigation.
- Absolute protection of whistleblowers' identity is essential. Whistleblowers (i.e., individuals who are reporting issues other than the routine employment complaints described above) should be permitted to use their own personal counsel and to form entities in order to protect their identity. This protection of identity is designed to encourage executives to use the whistleblower system.

15 Mary B. Curtis, "Whistleblower Mechanisms: A Study of the Perceptions of 'Users' and 'Responders,'" Dallas Chapter of the Institute of Internal Auditors, April 2006.

- The motivations and personality of the whistleblower are not relevant to the truth of the allegations. Whistleblowers with difficult personalities or who have obviously ulterior motives may receive short shrift in any investigation, even though their complaints may be valid. SEC officials made this mistake in ignoring Harry Markopolos' revelations about Bernie Madoff approximately 10 years before his Ponzi scheme was revealed.[16]
- Periodically assess the effectiveness of any employee hotline and provide employee compliance training.
- Independent counsel should report to the whistleblower or his or her attorney the status and results of the investigation and the organization should provide annual reports to all employees as to actions taken.
- Legitimate employee whistleblowers should receive meaningful monetary rewards.
- The whistleblower policy must be communicated effectively.
- Milder sanctions should be considered for whistleblowers involved in illegal group activity.
- Retaliation claims should be independently investigated.
- The director of corporate compliance (if any) should report to the independent directors and become their eyes and ears within the organization.
- The tone at the top of the organization must support an ethical, law-abiding culture. The tone at the top should be established not only by the CEO and CFO, but also by the audit committee chair.

A key factor in employee willingness to use hotlines is the communication of the results of investigations of hotline tips and the actions taken.[17] Many companies do not adequately communicate this information to the whistleblower.

16 "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme–Public Version," U.S. Securities and Exchange Commission, Office of Investigations, Report No. OIG-509, August 2009, p. 250 (www.sec.gov/news/studies/2009/oig-509.pdf). See also Harry Markopolos, *No One Would Listen* (Hoboken, NJ: John Wiley & Sons, 2010).

17 Ibid.

Conclusion and Action Items

In summary, most current SOX whistleblower systems are not sufficiently robust to attract potential internal whistleblowers, particularly executive whistleblowers. Internal compliance systems do not have to compete monetarily with available statutory awards since most potential internal whistleblowers prefer not to suffer the disincentives of going public with their information, including waiting many years for any bounties from litigation. However, it is necessary for the SOX whistleblower systems to provide sufficient incentives to potential internal whistleblowers to induce them to provide to the audit committee the information necessary to correct law violations and to reveal significant risk exposures.

The following are recommended action items for audit committees:

- Audit committees should reexamine their whistleblower and compliance policies to make certain that they encourage reporting of major enterprise risk exposures, fraud, and other illegal activity.
- Accounting, auditing, or enterprise risk complaints should be sent by the hotline service directly to the audit committee chair or his or her designee (such as completely independent counsel or other ombudsman). Completely independent counsel refers to a law firm selected by the audit committee that does not receive any significant legal fees from management.
- Whistleblower complaints or retaliation complaints from whistleblowers (excluding routine employment-related complaints) should be investigated by completely independent counsel who has forensic capabilities, preferably from a law enforcement background.
- Employees (particularly executives) should be permitted to hide their identity by using their personal attorney, forming an entity, or a combination of both, with the company reimbursing the costs incurred if the information is legitimate.
- Meaningful rewards should be created for employee whistleblowers if the information is legitimate. A meaningful reward might include an amount equal to the yearly compensation of the employee or a percentage of the savings of the company. However, the audit committee would retain complete discretion of the amount of the reward.

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