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Offense Trumps Defense in Avoiding Shareholder Lawsuits

By Harvey Kibel

A cynical observer might say there are two kinds of boards today: those that have been sued by shareholders, and those that will be sued by shareholders. An overstatement? Perhaps. But with shareholder lawsuits a real (and continually growing) possibility, directors are in a unique position to defend against such lawsuits—not in a court of law, but in the boardroom before they ever take place.

Research has shown most shareholder lawsuits are brought for simple reasons: 1) drop in share price, 2) restatement of earnings, or 3) some combination of the two. While they can't directly influence the stock price, directors *can* influence the profitability (or lack thereof) that's behind it.

A Good (And Profitable) Offense

From the director's perspective, profitability is best achieved by focusing on the core issues that directly affect the value of the business. These issues can be divided into four main categories: people, structure, information, and conflicts of interest:

1. People

Key executives. Obtaining and reviewing the résumés of key executives may sound obvious, but it is the board that is ultimately responsible for ensuring that executives are qualified.

CEO and outside board members. A methodology needs to be developed for evaluating the performance of the CEO. Naturally, this cannot be done unless the CEO has clearly articulated and quantified his or her goals and objectives.

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Current and prospective directors. Complete background investigations should be conducted on these individuals. Qualifications are very important for these positions. For example, the head of the audit committee must have an extensive background in both accounting and finance.

Outside experts. Under Sarbanes-Oxley, the board can hire outside experts if it questions any of the information it receives from management and/or the auditors. The authority to engage outside experts without the approval of the CEO is a new right and should be handled judiciously.

2. Structure

Committee composition. Audit and compensation committees should be composed of only outside directors.

Internal auditing. The audit committee should hire, compensate, review, and, if necessary, fire the internal auditor. The internal auditor should only work on projects assigned by the audit committee.

Meetings with the outside auditors. The audit committee must put pressure on the outside auditors to review and approve the internal controls of the company. If there are problems, they should be identified along with the necessary corrective action. The outside auditors' report should be in writing.

Mergers and acquisitions. The second largest source of shareholder lawsuits (after a drop in share price) is related to M&A problems. To avoid these problems, outside directors should form a separate ad hoc committee to track the progress of any proposed merger.

Unusual accounting entries and adjustments. These are often a red flag, particularly if they lead to the dreaded restatement of earnings mentioned previously. The chief financial officer, internal auditor, and outside auditor should approve any suspect entries.

Stock options. Ideally, the compensation committee should be making stock option recommendations to the whole board and guarding against excessive grants to the top executives. Further, controls need to be put in place to prevent insider trading, and executives and board members need to know that these controls will be strictly enforced.

3. Information

Profit and loss deterioration. Directors should always compare every major category of expense as a percent of sales. They should then test to see how these percentages have migrated over time. Even if the company is currently profitable, this could easily change in the future if key competitors are more efficient.

Balance sheet deterioration. Key ratios such as debt to equity, current assets to current liabilities, and inventory turnover need to be tracked from period to period. If there are unusual increases in capital expenditures and/or leasehold improvements, determine whether the company is capitalizing items that should have been expensed in order to increase profits. If the inventory turnover is low and there is slow-moving inventory, there may be inadequate reserves for write-downs.

Off-balance-sheet investments and partnerships. One word: Enron. While it is possible to operate and manage these entities appropriately, the best approach is simply to avoid creating them in the first place. Leaving any portion of the business in an uncontrolled state keeps the door wide open to fraud and abuse.

Joint ventures and strategic alliances. Strategic ventures and alliances shouldn't be "locked in" for unlimited periods, and they should always provide an easy exit if the deal doesn't work out. Most importantly, it's the directors' job to make sure these arrangements are not encumbered with significant and potentially costly guarantees.

Money. Once cash is in short supply, it becomes hard to get adequate credit from vendors and banks. At that point, the domino effect begins to take hold, and there is risk of a downward spiral to oblivion and shareholder lawsuits.

Earnings forecasts. Outside directors need to get comfortable with the adequacy of all major reserves. If they aren't, the earnings and multiple reductions that will invariably follow in later periods can lead to a dive in the stock price.

4. Conflicts of Interest

Key accounting members previously employed by the outside auditors. It is very convenient to hire financial personnel from the ranks of the outside auditors. The company already had a chance to work closely with the candidate, and can more easily assess competence level. But despite the convenience, the appearance of conflict simply isn't worth it.

Director Summary: With shareholder lawsuits on the rise, directors need to learn ways to proactively defend against them. Be diligent regarding personnel, company structure, the availability and transparency of information, and avoiding conflicts of interest, both real and perceived.

Know how and when to seek access to information that is not readily available.

Internal auditor employed by the outside auditors. The inherent nature of an internal auditor's role is that he/she may have to be a "whistle blower" at some point, making his or her independence especially important. The career path of the internal auditor must not be aimed back into the organization—a direction that can compromise his or her objectivity.

Rotation of outside auditors. The law requires that audit partners be changed at some point, but this doesn't go far enough. Auditing firms receive significant fees from the company and understandably do not want to lose the account. Once both the outside auditors and executives understand that the auditing work will be transferred to another firm down the road, the auditors can concentrate on the audit rather than on incubating a cozy relationship with the client company.

Outside auditors engaging in activities outside the scope of their true function. Consultants can be very valuable tools. However, when consultants are part of the outside auditors' organization, it creates an immediate conflict of interest. Outside directors can and should insist that consultants are not part of the auditors' organization.

Getting too cozy with Wall Street. Typically, management will make promises and predictions, Wall Street firms will communicate those to their clients, and the scene is then set to meet this expectation—regardless of how much of it is based in reality. Management needs to work forward from reality to promise, not the other way around.

Outside Directors: Place and Purpose

Outside directors should serve as investigators and caretakers—while they may not be expected to manage the company, they can certainly be expected to ask questions. If they are dissatisfied with the answers they receive, they can and should be expected to consult either the internal auditor or outside professionals. With profitability as their guide and goal, directors will find themselves better equipped, better informed, and the company better insulated from the possibility of shareholder lawsuits. ■

Harvey Kibel is co-founder of Kibel Green, Inc., which specializes in saving distressed companies. He received the National Award of Excellence from the President of the United States for the many contributions his books have made toward the economy.