CHALLENGES FACING BOARDS OF DIRECTORS: THE ANATOMY OF AN ACCOUNTING CRISIS

Fall, 2013

New York, NY

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DIRECTORS ROUNDTABLE
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A nightmare for Boards of Directors is the simple phrase from their audit firm, "We have a problem." Whether it is a taxation problem, or worse, the revelation that a CEO or CFO may have engaged in "creative" accounting methods, the Board, C-Suite management, and their advisors must take immediate action including identifying wrongdoers and keeping investors and employees supportive so that a severe market reaction does not occur. These distinguished speakers are former officials drawn from the ranks of SEC and DOJ enforcement, crisis management, and D&O insurance. Given the SEC's new demonstrated focus on accounting related issues and "irregularities," they will identify successful strategies for responding to a hypothetical accounting crisis and other key issues.

The Directors Roundtable is a civic group which organizes the preeminent worldwide programming for Directors and their advisors including General Counsel.

DISTINGUISHED SPEAKERS

Kieran Hughes	Vice President of Financial Lines Claims, AIG
Richard Levick	Chairman & CEO, LEVICK
Harvey Kelly	Managing Director, Global Head of Financial Advisory Services, AlixPartners
Christopher Garcia	Litigation Partner, Weil, Gotshal & Manges LLP; former Chief of the Securities & Commodities Fraud Task Force, U.S. Attorneys' Office (SDNY)
Dana Kopper	Managing Director, Lockton Companies, LLC, Directors & Officers' Liability and Governance Risk Management Group
Ellen Odoner	Corporate Partner, Weil, Gotshal & Manges LLP; head of Public Company Advisory Group
Paul Ferrillo (Moderator)	Of Counsel, Weil, Gotshal & Manges LLP

(The biographies of the speakers are presented at the end of this transcript. Further information about the Directors Roundtable can be found at our Website, directorsroundtable.com.)

TRANSCRIPT

JACK FRIEDMAN: I am Jack Friedman, the Chairman of the Directors Roundtable. We have done approximately 800 events globally, as varied as doing a series on corporate governance in Beijing and Shanghai with NASDAQ to the program this morning. We have never charged to attend any event in the 800.

I want to thank all of the panelists for joining us. In particular, I want to thank AIG and their speaker. It's a world leader in D&O, so we are privileged that they are sharing their expertise today. I am going to turn the program over to Paul Ferrillo who will be moderating. Thank you all for coming.

PAUL FERRILLO: Good morning, everyone. My name is Paul Ferrillo, and welcome to Weil, Gotshal.

I spent much of the week trying to figure out how to open such an enormous program like this—probably one of the biggest events we've ever had at Weil. Somebody gave me a good idea, and I thought this would be a good way for our panelists to get our game faces on.

[PLAYS VIDEO OF MAORI HAKA WAR DANCE]

Well, with thanks to my friends from AIG for stealing an idea of theirs, I thought it was a good way to open our presentation today, to talk a little bit about a topic that's been most in the news over the past few months. Certainly, this is a topic that is very well known to any of us who grew up in the early 2000's and it is a topic that, for many of us, is near and dear to our hearts.

Let me open up and introduce our panelists today, who are experts in their fields. We're very fortunate to have my partner, Ellen Odoner, who is head of our Public Company Practice Group. Ellen has a tremendous amount of experience helping companies through accounting irregularities and troubled accounting issues.

My partner, Chris Garcia, comes from the Department of Justice and has an immense amount of experiencing handling and prosecuting accounting irregularities cases.

Harvey Kelly; what can I say about Harvey Kelly? If you ask nine or ten securities litigators, like myself in the field, who would be the first guy you would go to in an accounting crisis, I think nine out of ten would pick Harvey.

The same is true for Richard Levick. Richard is CEO of Levick Strategic Communications Group. Although many accuse me of being a twit, Richard is one person who actually can tweet, and tweet very, very well. Richard is an expert in social media and in crisis management and crisis communications.

Kieran Hughes and I go a long way back. Kieran is a Vice President in the AIG Financial Lines Claims Group. He handles heavy accounting cases for AIG's Fortune 500 clients.

Dana Kopper has been a Director of Lockton for about 100 years. He understands the D&O areas extremely well.

This has already been an extremely busy year, as far as accounting issues have come. We started the year with HP and Autonomy. Next was Avid Technology in June. After Mary Jo White came in as Chairman of the SEC, she announced a new financial reporting and audit task force group on July 2, 2013, which she termed as an incubator group to develop potential accounting cases and then turn them over for full-blown investigations. In July, we got notice of the IBM Cloud Computing investigation, and more recently, it was noted that in 2012, the SEC received 547 whistleblower claims alleging financial reporting misconduct.

So, this is an issue that is not going away whatsoever. It's an issue that we're going to be dealing with today.

Unlike other panels, this is not a talking heads presentation; we are running this as a full-blown Q&A, full body contact, ask questions, interrupt the speakers. We want you to get as much out of this as we have gotten in preparing and trying to give you a good program.

We're going to jump right into this today. Chris, with that introduction, a few weeks ago, Andrew Ceresney, former Co-Director of Enforcement, said, "I recently read a *New York Times* article with a headline about the SEC bringing the sexy back in referring to our experts to combat accounting fraud." Now, tell me, Chris, is the SEC *really* bringing the sexy back by refocusing itself on accounting irregularities?

CHRISTOPHER GARCIA: Somehow, I think that when Justin Timberlake came up with that song in 2006, he was *not* referring to accounting fraud [LAUGHTER] as being sexy or bringing it back.

Look, I don't know if it's bringing the sexy back to refocus on accounting fraud. I do think, though, your point, Paul—and it's an important one—the focus that the SEC is now placing on identifying instances of potential accounting irregularities for purposes of bringing enforcement actions, is something that we all need to heed and pay close attention to.

I left the government approximately 18 months ago to come here to Weil, and when I left the government, my last court duty was as Chief of the Securities Fraud Unit here in the Southern District of New York. The question that we, in our office, and in conjunction with the SEC, asked with a considerable amount of regularity, was, "Where did all the accounting fraud cases go?"

The statistics bear out what has been a marked decline in accounting fraud enforcement actions over the last many years. They're startling. In 2003, right after Sarbanes-Oxley, the SEC had brought 199 enforcement actions in the area of disclosure issues. In 2012, they brought only

79 actions. In 2006, right before the financial crisis, the SEC had 304 investigations of potential accounting irregularities extant in the Enforcement Division. By 2012, they had just 124 investigations. To people in Enforcement—particularly towards the end of my tenure there—there was a growing skepticism that Sarbanes-Oxley and other remedial efforts that were responsive to the accounting fraud crises of the early 2000's weren't actually all that successful in dampening down the irregularities; there's a concern in Enforcement that, among other things, our attention had been drawn and directed to other matters—matters coming out of the financial crisis—and not enough on potential accounting irregularities. It's worth noting, and Paul, you mentioned this—at the same time, where Enforcement has noted that there's been a dearth in accounting fraud cases, whistleblower complaints have gone through the roof. To put the number that you offered in context, Paul, in all categories of cases where the SEC receives whistleblower complaints, the single largest category is in the area of accounting irregularities, by far.

This past fiscal year, 18.2% of the whistleblower complaints filed with the SEC concerned accounting irregularities. Compare that with some of the other hot topics of the last year or two—they've received only 6.3% of complaints in connection with insider trading, and only 3.8% in the area of FCPA.

So from an Enforcement standpoint, they're getting these whistleblower complaints that suggest that maybe there are accounting irregularities. They have a decline in enforcement actions and certainly how they are focused. Then they stand up the Financial Reporting Audit Task Force, which I know we're going to get into in a little bit. We've seen this playbook from the SEC in the last several years. In 2010, they stood up a number of specialized units, including the Market Abuse Unit, to investigate insider trading. When they stood up that unit, it touted and

heralded the use of new analytical computer tools that would help them identify insider trading. In the 2½ years and the aftermath of that, we've seen one of the most significant assaults on insider trading probably in the history of our country, in the enforcement of securities laws.

We should all pay attention to the next couple of years, in what I think will likely be a robust enforcement regime.

PAUL FERRILLO: Harvey, same question to you; you spend a lot of time in Washington. Do you see an uptick and a new emphasis or focus on accounting cases?

HARVEY KELLY: Yes, it's an interesting question, because statistics like that would make you think that I've been sitting around doing nothing, myself, for the last several years. That certainly has not been the case. I am one who subscribes to the theory that Sarbanes-Oxley did not cure all, and I'm sure some people's eyes would bug out if they saw some of the things that I see happening in this day and age, whether it's the e-mails people write or the flagrant accounting abuse. But it really goes beyond the flat-out fraudulent accounting. The areas of aggressive practices to get transactions into a quarter, to improve the profitability for a particular time period and so forth, it really goes to those areas on the fringes. In the last several years they have gotten less attention, perhaps, than they would have in the heyday. Without a doubt, I can tell you I've been to the SEC, in various SEC offices, over the last several months for lots of different clients, and there's no question that they are taking this topic very seriously. There's no question that they are employing other technology tools that they're developing, that they hope will help them to detect fraud. They're taking whistleblower complaints very seriously. It's become fashionable, quite frankly, to fire off a letter to the SEC if you're an upset or disgruntled employee, whether or not there's merit to those matters. There is certainly an uptick in attention given to those.

PAUL FERRILLO: Let me change the topic just a little bit, both to Chris and to Harvey. From 2005 to 2008, it was very typical for securities litigators to settle with the SEC on a "no admissions basis," meaning *mea culpa*, but we didn't do anything wrong. We'll pay you a fine and let's all move on with our lives so our shareholders don't kill us even further.

Chris, with the advent of the recent announcements in *Harbinger* and *SAC Capital*, is this the brave new world of SEC enforcement activity, where companies who are involved in major high-profile situations are going to be asked essentially to admit fault?

CHRISTOPHER GARCIA: I don't think that "no admissions" is gone; I think it's still here, and I take the SEC at their word that there will be plenty of circumstances where companies will be able to settle on such a basis. But they are going to be less than there were in the past. In the easy cases, the SEC will demand admissions where there's some criminal elocution of conduct. That, frankly, just makes sense; but that's not most cases. Most cases don't involve some kind of criminal case. *Falcone* is a good example of that. If there are people who aren't familiar, Phil Falcone is a hedge fund manager of Harbinger Capital, and he settled a case with the SEC where he was forced to admit his conduct. There, the SEC said it was in the public interest to require the admission of guilt because of the egregiousness of the conduct. In this case, there was no parallel "no admissions" case. The conduct was pretty egregious, at least as alleged, and as admitted by Mr. Falcone, in that, among other things, he borrowed $113 million out of his own fund to pay tax liabilities, while at the same time, refusing others' redemption rights who were investors in the fund.

It's here to stay, and to the extent to which people admit their conduct, like Phil Falcone, in those contexts, it makes it more likely that the government will be successful in extracting admissions in the future. Certainly it changes the negotiation dynamics. The SEC is very, very

serious about this. I was struck by comments made by Matt Martens, who was the head of the Trial Unit at the SEC before recently departing for Latham & Watkins, in which he said on a panel, “We have this new policy of no admit and deny, and I hear people on the defense bar say, ‘That’s not such a big deal, because if we make an admission, then we’ll be able to negotiate our way out of unfavorable parts of the resolution, like we’ll reduce the amount of money that the company has to pay, or we’ll be able to get out of the monitorship.’” Mr. Marten said, “Frankly, we’re not looking at it that way. You start with the admission, and if we want the admission, we get the admission. That’s independent from negotiating any other aspects of the potential form of resolution.”

That’s pretty bold talk. When you couple that with what Andrew Ceresney, who is now Co-Chief of Enforcement, said in a speech which you referred to earlier, “We realize at the SEC that the import of taking this position, that we’re going to extract admissions, is that we may have to go to trial more, because companies may take us to trial. We’re okay with that, because we feel real confident in our trial abilities. For example, look at the recent victory in the *Tor* trial in the Southern District of New York.” This is pretty bold talk. They’re really serious about it, and when you see the people involved at the SEC—whether it’s Mary Jo White or Andy Ceresney or others—these are all people who mean what they say when they say it. It’s here, and it’s something to be dealt with.

HARVEY KELLY: Yes, I don’t think there’s any question that they’re serious about it. Corporate America struggles with that when faced with those types of situations. A board of directors and the senior management of a company struggles to understand what are the implications of that. We’ve already restated our financial statements; we’ve already told the world we got it wrong, for whatever reason or another. What is the next consequence of

admitting there was fraudulent behavior vs. not? There could be all kinds of business consequences to that including stock market implications, obviously. Or maybe it's not that big of a deal, ultimately; maybe people are more afraid of the consequence than what the real consequence would be if they do make that admission. The jury's still out on that a little bit, as to how bad of a thing it really is to make that admission, when every other relevant fact is out there anyway. In terms of dealing with the government, certainly, I have been involved in situations where the talk of late is tougher, perhaps, on that particular topic than it had been in the past. Likewise, by the same token, companies get their dander up and don't feel like that admission is necessary in light of all the other disclosures that have already been made to the public. There may well be more litigation that's the consequence. Whether that's a good thing or a bad thing, time will tell.

PAUL FERRILLO: Ellen, let's change this up a little bit and look at it from a corporate perspective now. If this is the new paradox of more accounting investigations and a different enforcement regime, what should public companies be thinking about now, if they discover an accounting problem?

ELLEN ODONER: One of the things that public companies are thinking about is how to prevent accounting problems in the first place. There's a lot more emphasis on compliance, and on internal audit, getting to the bottom of possible control weaknesses or control deficiencies that could blossom into weaknesses. There's a lot more focus on trying to encourage people in the company who have a concern to come forward to the company, rather than to go to the SEC. Certain facets of the whistleblower program encourage employees to go to the company first, although they don't have to. So there's a lot on the preventative side that's happening right now.

PAUL FERRILLO: Ellen, in the past few weeks, I have read more and more about the reinvention and the reconstitution of the whole audit committee function, with respect to accounting irregularities and accounting issues. In terms of noting this perhaps increased government involvement, are you considering, or would it be your advice more likely now than ever, that audit committees *must* be running internal investigations relating to accounting problems and accounting issues, because of the need to have credibility with the government if things pan out and if there is a problem.

ELLEN ODONER: Not all accounting problems turn out to be the certifiable crises that really are the subject matter of our program today, and one of the first steps is to try to get a handle on whatever the facts are as they exist when the problem surfaces. You can have large errors that you may be able to, in a principled way, conclude are not material. On the other hand, you can have small ones that are absolutely devastating. One initial job of the company's counsel when a problem like this surfaces, is to try to figure out whether it needs to go to the audit committee immediately or whether the company has some time to look into the problem. If a problem seems to implicate integrity at the senior management level or in the accounting function that's one of the red flags where you need to jump to the audit committee almost immediately. If the situation is in a subsidiary in Brazil, where it's not clear that anyone in the home office knew about it or benefitted from it, there is more time for the company to look into it on its own. On the other hand, the audit committee should always be apprised of what's going on, what management has found, and should always have the option, and always does have the option, of taking control of the situation itself. The legal backdrop for this is Section 10A of the Exchange Act, which essentially tells the auditors that if there is a possibility of an illegal act—and that's not defined, so it's looked at quite broadly—the auditor has the responsibility to be

comfortable that senior management and the audit committee are handling the situation appropriately—getting to the bottom of it, and remediating it. If the auditor is *not* satisfied, that's the situation in which it gives what's called a "10A letter" to the board, and the board has to give it to the SEC.

Audit committees should, and mostly do, move heaven and earth to avoid getting a 10A letter, and act responsibly in these situations. I would say, in some cases, you need the audit committee to take absolute charge and hire people like Harvey and the other advisors here to do a strictly independent investigation. There are also cases where, at least at the outset, it's appropriate to keep it in the company's hands, although you may, as facts develop, decide that the company should turn it over to the audit committee.

PAUL FERRILLO: Thank you. Speaking of other advisors, Richard, times have changed since Enron and WorldCom, where media like the *Wall Street Journal* and the *New York Times* control the message. Given what you've heard today, and given what you know to be the case from other crises over the past six to twelve months, how on Earth is a company supposed to manage a big accounting mess today, in this present media environment where you have old media and new media? Where is a company supposed to turn to, and how on Earth is it supposed to manage such a crisis with so many avenues of information out there?

RICHARD LEVICK: Paul, thanks so much; I have a couple of thoughts here. First, the good news—to the extent that it is—is that on the day the story breaks—you mentioned Enron; I've never heard of Enron, but I'm just imagining—[LAUGHTER]—you take an Enron-like matter and you look forward to today. The morning the story breaks is not much different than it was ten or twelve years ago. The real change—and I'm only speaking now, not of the rest of your clients or your brands; I'm speaking about accounting matters—will tend to be broken by

the FTE, the *Wall Street Journal*, the *New York Times*, CNBC. What changes is, one, later in the day is that a Twitter, because of hash tags, is connected to all those stories. It's going to overwhelm social media. For the most part, our companies don't need to worry about other social media—Facebook or YouTube—on accounting matters, they tend not to be used. I will give more on those later.

The real issue, though, is what do we do? How do we go in the Wayback Machine? It's not so much what happens on the day of. It's so great to be here and to be invited by Weil on the dual anniversaries; today, of course, is the 23rd anniversary of the World Wide Web, and I'm sure all of you are familiar with Al Gore's invention! [LAUGHTER] But it's also the 44th year since Woodstock, and I have to say, it's so good to see all of you again! [LAUGHTER] Obviously, if you remember it clearly, we were not there. But when you pulled out that triple album—and I'm sure a lot of you were probably playing it this morning on your way in—you pull out the album, and on the second day, there is Grace Slick, you know, Jefferson Airplane. I figure if Paul can play the All Blacks [New Zealand rugby team], I can talk about Grace Slick and Jefferson Airplane! Some of you are trying to pretend, as you're looking at me, "I have no idea who the Jefferson Airplane is." I don't believe you.

But what happens is on the second day of Woodstock, the album begins, and she says, "Good morning, people—welcome to the revolution!" Well, we are in a revolution every bit as significant as the agricultural and industrial revolutions that have preceded it. But we are trying to pretend that it is a technology revolution, not an information revolution, and therefore, we'll give it to some twenty-something and let them deal with the issues. In order to be able to deal with accounting fraud or FCPA matters or any other regulatory or crisis issue, what is it that we're doing during our peacetime?

Let me ask you: How many of your clients, or for those of you who are on boards, have someone who reports or sits on the board—reports directly to or who sits on the board—who deals specifically and exclusively with social and digital media? How is it that only the Silicon Valley firms have that? What about enterprise risk management? How have we changed and inverted ERM so that what we're looking at 24/7 is are the rising stories on hashtags? What the plaintiffs' bar or regulators are starting to do—do we look at that all the time? NGOs, unions *and* regulators have to communicate, and they have to communicate publicly. Are we tracking that? Enterprise risk management is not. There are any number of other things that we can look at in terms of how we've not changed. I think back to buggy whips, which we're doing robustly 15 years after the introduction of the automobile. I'm afraid we're still in love with the buggy whip rather than thinking about this change. What were all of you doing? What were your companies doing on May 2, 2012? Is it okay if we spend the rest of the time this morning just talking about May 2, 2012?

PAUL FERRILLO: Well, let me think about that. No! [LAUGHTER]

RICHARD LEVICK: So, on May 1, Google announces it's changing its analytics, as it often does regarding what goes to the top of the search engines. Except on May 1, for the first time, they announce that the spoken word—not just the written word—was going to rise to the top of Google, aka video. So let me ask you this question: If on May 1, you heard that all newspapers were still being published, but none were being delivered; if you heard that all T.V. was going to continue to broadcast, but no homes were going to receive it; don't you think you'd have a board meeting and say, "Maybe we need to look at our spend and our communications strategy here, because no messages are being received."

So on May 1, Google says, "Video is taking over." How many of your companies decided, "We need to change our brand approach—how we use our peace talk." Because when Ellen talks about the regulatory changes, one of the things that we know is, it's very difficult to put the toothpaste back in the tube! If we build trust, if we build a relationship ahead of time, it's so much easier to control the blogs, to control the Twitter conversation. It's never going to be easier than now. So it's not, Paul, in the end, what happens the morning of, so much, as what we do before.

PAUL FERRILLO: Thank you, Richard. You actually hit on my next question, which is one for both you and for Ellen. In my world, every day a stock is trading on potentially faulty financial information; it could mean millions, if not billions, of securities fraud damages. Richard, where does a person, and Ellen, where does a person like Richard fit in to the construct of the crisis management of a company, where a poorly-worded press release or an ill-timed disclosure could mean life or death for a company? Sometimes there must be tension between company disclosure counsel and strategic communications counsel; how do we get it right?

ELLEN ODONER: There can be some constructive tension, but I think all to a good end. One of the key issues when you have an accounting crisis is that it is terrible for the company, its employees, its customers, *and* for the capital markets, if the company has to go dark, it can't be releasing information to the market that at least is unaffected by the investigation. Let's say there is an investigation ongoing, or the discovery of a potentially very serious problem. The company has to make the appropriate disclosures about the problem at the appropriate time, which we'll talk about later, but in addition, it has to keep operating. That's one of the places where, Richard, your skill set is very helpful in shaping the disclosures about what *is* going right with the company, as opposed to where the company is in a disclosure hiatus.

RICHARD LEVICK: Obviously, there is some tension from time to time. A few thoughts: One is that Ellen and I first met on the rugby pitch, so we're used to dealing with some level of tension. In terms of dealing with these issues—you said we could use the Socratic method—how many of your legal and communications professionals have relationships already? Close, trusting relationships? How many of you have brand who get digital? The only folks in your clients' companies who understand digital—they're working on the ascendancy of the brand—have relationships. When I'm talking about a revolution, and an information revolution, I'm talking about changing the way we think. We have to think very differently. There's a lot more transparency and a lot more openness.

I always find it fascinating that during Arab Spring, so much of us, our hearts were aflutter about how wonderful—democracy is breaking out in the Middle East, where I spend a lot of time, and then Jasmine Summer. Then Occupy Wall Street, and we all said, "Call the police," because we like this democracy thing just as long as it's not here! [LAUGHTER]

We know that things are going to be transparent; we know that we need to think differently and we need to have relationships and build that trust. Heretofore, work has existed for 60 years where we had silos; we had IR, we had GR, we had inside legal, we had outside legal counsel; you had corporate communications, you had brand, you had maybe outside crisis communications. We didn't have relationships. We *have* to have relationships now. That trust is so terrifically important.

On the Gulf oil spill, my favorite moment in the first three days of that was when lead counsel said, "Here is my legal thinking on what we need to do next." Then, with the client in the room and with crisis communications, the phrase he would use was, "Tell me how I'm stupid. Tell me how what I'm suggesting from a legal point of view may actually have more

exposure from a market share point of view, from a long-term business development point of view." It was a *discussion*. We have to have that trust and relationship, to be able to have that discussion. Understand, there will be some losses, but what is it that's most important that we want to cross the "go" line with?

PAUL FERRILLO: Harvey, let me ask you a question. You're the silent partner in the accounting irregularities construct, especially for those, perhaps, in the audience who haven't gone through one of these before. Tell me, where do you and your team fit in this mess? How quickly do *you* get notified of an accounting problem, and how quickly do you get up and running if an audit committee says, "We need you in here."

HARVEY KELLY: Well, I've been married 25 years, and that's a minor miracle, because my wife learned long ago that no dinner is sacred, no vacation is sacred, because the answer to that question is, within the hour or by morning or whatever it is. Once these things hit, it is an absolute necessity for the professionals—in my case, the forensic accountants—to show up on the scene right away. There is no other answer to that. Any call that says, "Well, this isn't really a priority; we don't think there's much here; we know you're busy—if you can rearrange your schedule next week or two weeks from now, that'll be fine"—that's never fine, quite frankly. It's really important to get on the ground immediately, even if it turns out, in the end, to be much ado about nothing. You've got to preserve the documents; you've got to talk to people before they start changing their stories or start catching up on their regretting too much. That's really very, very important. To my way of thinking, when I get that phone call—regardless of what time of day it is—my cell phone number is on my business card for a reason, and I'm not one of those guys that's allowed to shut it off at nighttime when I go to bed. Wherever in the

world it is, we've got to deploy immediately. That's the life I've chosen to live, and all of my colleagues that work with me.

RICHARD LEVICK: Ellen and Chris and I can't shut off our cell phones, either, by the way.

HARVEY KELLY: I'm well aware of that! That's the next call I make! [LAUGHTER]

PAUL FERRILLO: Question?

[AUDIENCE MEMBER:] I serve on the corporate governance committee at the New York Society of Security Analysts. One of my colleagues had experience with Enron. It had band box perfect, you name, and now you call it check the box, but everything about Enron connected to the power structure, White House, perfect corporate governance. The problem was when they were transitioning the company away from a utility into being an energy trading company, and this is just after the passage of the Commodity Futures Modernization Act, so they could trade derivatives. The problem with the correcting markets after the dot-com bubble and the telecom bubble burst, is when you're shadowing by way of fair value markets. Energy derivatives are clearer with the Chicago Mercantile Exchange, and you didn't have a regulated contract. My question is, with the discretionary power of management we've got fair value now in U.S. GAAP. That's the commitment that all these people who I've debated with for years about the problems with fair value vs. accrual-basis accounting where revenues are realized as cash in the reporting cycle. You folks who are experts on the lines where—at that point, we could say that that's what the fair value was, and Enron's problem was a correcting market blew out the values that they were saying they could claim on the books. You have Level 3 assets, now, on the books. You don't even use trading for these, to come up with a value. The fair

value issues, now, are how do you value where you've got blatant fraud versus there's a line here. It's a tough line.

[LAUGHTER]

PAUL FERRILLO: It is!

[LAUGHTER]

PAUL FERRILLO: Thank you! I'm joking, of course.

[AUDIENCE MEMBER]: All this fair value now that—it's kind of blowing out, where you had more responsible accounting. Enron was part of that! I'm not giving them a pass; I'm just saying, now—I mean, is there a way to dress it up? I'm not looking to defend real fraudsters; I just want clear accounting.

PAUL FERRILLO: The 600-pound elephant in the room—and, by the way, we couldn't fit him in the room today, because we had too many people—is actually the public accounting firm that's involved here, and it's the silent partner with Harvey and with Ellen, if there is an accounting investigation or if there is an issue around fair value accounting.

Harvey and Ellen, I'll ask you both the question: If there is such an issue raised, and it's raised up to the audit committee, how do you propose, or how do you tell audit committees to deal with the public auditors? The same ones from whom you need to get audited financial statements.

HARVEY KELLY: Okay—I guess I drew the short straw. I'll start. The answer is, without a doubt, the auditors are an important constituency in this process. The question—without getting into the specifics of the particular company—is right. The issue of whether it's fair value or some other accounting principle, very often we're in grey areas. There's matters of judgment, and certainly, somebody might look at that and say, "Where's the—there's not much

judgment there; that's flat-out wrong." But an equally-informed person may look at that, and well-intentioned, and say, "Well, actually, I think that really *is* a matter of judgment."

Those kinds of questions are very important; they're important to the message that it gets out to the marketplace. Gathering those facts quickly and interacting with the auditors and how they may react to the situation is important. We talked about 10A earlier, and the auditor's obligation to report up. Make no mistake about it: While sometimes auditors can, no doubt, be frustrating to deal with, and maybe they're even talking about something that the company is quite sure is an issue that has been vetted with that accounting firm year-in, year-out, the reality is, they've got a lot of power in the process. They've got the magic pen that you need to sign that opinion at the end of the day. They, themselves, are under a lot of pressure. To be fair, the SEC has sent, and other regulators have sent not-so-subtle messages back to them that there is some concern about how they have historically reacted in these situations. Have they allowed the company to go too far along in dealing with the issue internally? Have they, themselves, as the audit team, appropriately shown the correct sensitivity to the situation? If you'll allow me just 20 seconds to read a partial quote from the now former, but at the time, the Chief Accountant in the Enforcement Division of the SEC, that he delivered to the AICPA (the society for the accountants and the CPAs). He was talking about different cases that the SEC was taking against the various accounting firms, and concerns particularly as it related to some of the issues in China and how the financial reporting questions were being raised. He said, "These cases raise questions in my mind as to whether the auditors fully understand what it takes to fulfill their 10A obligations. However, a series of things need to occur before an auditor is required to report to the SEC, and there are two primary areas where things could break down and could result in investor harm, and these involve the quality of the investigation and how the auditor

monitors and responds to potential issues. The decision of an issuer or audit committee to use internal office of general counsel and internal audit, for example, to conduct internal investigations could impact results. Similarly, if an audit engagement team decides to handle an issue on its own without providing a notification to their risk function or national office, it could likewise impact the result." He was sending a pretty clear message to the auditors: You guys need to be the tough guys in these situations; you need to put pressure on your clients as thoroughly and as objectively as possible, and look into these situations.

We just have to be appreciative that that message is being sent to them.

ELLEN ODONER: I think in the ten years since Enron, you really have one of the creatures of Sarbanes-Oxley, which is the PCAOB, coming into the forefront and basically telling the auditors that they have to be extremely careful, extremely responsible, and I think the phrase they use is "exercise professional skepticism." What that means in terms of working your way out of an accounting problem is that essentially, the inside counsel, the outside counsel, and the independent forensic investigators, have to work with the accounting firm and make sure that the accounting firm is comfortable with the thoroughness and the freedom from bias of that investigation. You don't want to expend months of effort and get to the end of the line and have the accounting firm say, "We didn't look into the right things," or "We didn't like your search terms," or "You didn't interview five people that we think are key." So it's really a collaborative effort at the end of the day, if you're trying to get to the smoothest possible result.

[AUDIENCE MEMBER:] The question I have is from the other side of the table. I'm not the accountant; I'm not the lawyer; I'm the company. I have an accountant. My auditors say to me, "I have to report you to the SEC because of this, this and this." So where am *I* at that point? Did I call up Richard? And say, "Help! Help! I'm under fire here!" No! I have the

auditor saying, "We're withdrawing from the company because we caused this, this and this." Now, why did it happen? The question is why did it happen? Because the auditor that I particularly had on one board that I was on, or one company that I was on the board of, issued the same statement to seven or eight companies within two weeks. The same, exact wording! They were Chinese companies, just like what you were talking about. With these same, exact words. I wasn't on the board of eight companies; I was on the board of one that was affected, but there were seven others—*all* of them did the same fraudulent act, and the accountant, the accounting firm, the auditor firm had to withdraw, and the lawyer then just folded right away and said, "You owe me a month's worth of fees, and you didn't pay, so I'm out of here."

Now, the question is, Harvey, how do we deal with this? Richard, do I just call you and say, "Make this go away!"

RICHARD LEVICK: Yes! [LAUGHTER] No, I actually think you call Kieran and say, "How much D&O insurance do I have?" [LAUGHTER]

HARVEY KELLY: Look, the standard playbook *should* be—it doesn't always work—ought to be, very quickly get competent and independent legal and forensic accounting advisors, and try to have that discussion of reason with the auditors, and say, "Look, guys, what do you want from us? We've now gone out—we hear you—do you think there's an issue? We've hired independent people that have no skin in the game as to the outcome; they're just here to do their job, and we think they're the most reputable out there to do this kind of work; they're certainly experienced at it. We'll get to the bottom of these issues as quickly as possible, and we don't think you need to fire off the letter to the SEC saying we're not doing the right thing—we *are* doing the right thing." That's what the standard playbook would be.

KIERAN HUGHES: One thing to keep in mind is, it's not an automatic proposition; it's not a matter of the auditing firm says, "There is a semblance or a suspicion of fraud here, and we're writing a letter to the SEC." There are some strict guidelines in place, but they have to give the audit committee, the board, the opportunity to investigate. If there is evidence that that investigation is not being undertaken, or that the complaint or the suspicion is not being realized or looked at seriously, then there's a further obligation for the auditor to then report it to the SEC, and to withdraw as the auditor of that company. So it's not just a one-step-and-you're-done; there is an opportunity for the company to undertake an investigation. It's how the company responds, it's how the audit committee responds, as much as it is how frightful is the auditor—and it sounds like there's maybe a panoply of issues there—or was it just, it's a Chinese company, all hell is breaking loose with the Chinese companies; I'm caught in a quagmire, so I'm going to issue the same letter."

You don't know the basis; maybe each of those eight companies had a reason for that letter issuing. Maybe it was a fundamental flaw that was seen. But the company has the obligation to undertake an investigation, and there has to be transparency, as well as the auditor saying, "You're not taking it serious; now I have to report you by letter."

[AUDIENCE MEMBER:] If you're an SEC-qualified private investor, and you're doing a private placement—let's say for a couple million dollars—and there's been accounting fraud in a small start-up firm that you're looking to put a private placement into. What is the threshold for SEC involvement, or if there were private placements where there was misrepresentation of accounting as part of a company investment or of the takeover from an SEC-qualified investor in private placement? So, I'm asking what's the threshold enforcement, and then if you're in the process of acquiring and there's this criminal activity around the

accounting, let's say, what's the threshold at which enforcement would be warranted or would be looked at by the SEC?

KIERAN HUGHES: For a private company, off of a private placement?

[AUDIENCE MEMBER:] Yes. If I have misrepresentation, and I'm a qualified private investor by SEC guidelines, do I come under any of this disclosure and enforcement by the SEC?

KIERAN HUGHES: Ellen, I don't know if you have a different view—but if I understand the question correctly, if it's a question about misrepresentations being made about the financial condition of the company in connection with your investment or an investment the thresholds are the ones that the enforcement staff traditionally follow, which is what is the level of proof, what is the amount of harm that's being incurred, what is the history and characteristics of this particular entity. It's those factors that are typically applied as to whether or not there's going to be an investigation and then any enforcement action taken. This is a little bit general, but I think that's the answer.

PAUL FERRILLO: Let's change it up just a little bit. If I were a director sitting in an audit committee meeting, and I was sitting with Ellen and Chris and Richard, and heard of facts unfolding that sounded really terrible to me, one of my thoughts would probably be to call Dana Kopper and say, "Dana—how much D&O insurance do we have?" Tell us, Dana—I bet you've got that phone call before, and tell us a little bit, where does a broker fit in when an accounting crisis comes to pass at a company?

DANA KOPPER: Simply stated, the broker is the pivotal link between the company's risk and its risk program. Out of my office, we handled probably a bit north of 1,100 claims a year, many of them in this particular category. At some point in time, folks tend to believe that they're only going to talk to the broker *after* a public announcement has been made. We

counsel, under certain strategic circumstances, and certainly when appropriate NDAs have been executed at the beginning of a relationship. That communication should take place very early on.

In a recent example, we had a general counsel call three days before the inception date of their program and say, "We've discovered some accounting irregularities, some issues that may impact how we deal with our finances; we may have to restate seven quarters. Should we tell the insurer that we are going to have to restate, potentially?" [LAUGHTER]

PAUL FERRILLO: So you told him to wait for four days?

DANA KOPPER: No. [LAUGHTER] Then a friend of a board member—because every board member has a friend—says, "Well, you're really not going to know whether you're going to have to restate for four, five, or six months. Just let it lie; it looks like, on preliminary analysis, that maybe the restatement's going to improve earnings by a penny, so just let it simmer and just stay low on the radar."

We disagreed vehemently, and it happened to actually involve AIG, and we ended up within that three-day period of facilitating a link between the insurer's claim group, the forensic accounting firm, the audit firm, the defense counsel, the general counsel. We had everybody talking. It did increase premiums, but it also resulted in an affirmative statement from AIG that they would accept the restatement risk. They agreed to refund the additional premiums if there were no claims or circumstances noticed within that twelve-month period. Well, fast-forward: half a dozen securities claims, four or five derivative actions within six months. Two years later, AIG writes a big check for that. The client will tell you today, that particular general counsel, he would advocate for that level of open communication every day of the week.

PAUL FERRILLO: God, that's a good company! [LAUGHTER]

DANA KOPPER: The point is that the broker is oftentimes thought of as a transactor of business, and all too often, what happens in our environment is claims are reported, they get noticed to the insurance company, and then the broker sits back and doesn't do anything.

There are a lot of good brokers out there. I would encourage that brokers be involved because brokers are the ones that go in and make sure that these things happen. They are typically the ones that have negotiated the contract, if coverage counsel isn't involved. They are typically the ones that are noticing. They are typically, when they're doing their job right, are the ones that are organizing the entire claim management process.

One other very quick example and I'll stop. A defense contractor was involved in a *qui tam* action. Within ten days of the notice, we had the head of claims, two claims directors, the CEO, CFO, general counsel, investigation counsel, defense counsel, coverage counsel and ourselves in a meeting. We actually had that *qui tam* action paid within about 75 days, because as a defense contractor, under a *qui tam* action, they were debarred from any sort of revenue flow with the government.

My point is that collaboration between all of the parties is key. Because all too often, you, as insureds, and your insurer, don't really know each other the way you should. That brings me to a final point. Pay close attention and develop that relationship with insurers and their claim groups *long* before there's ever a need.

[AUDIENCE MEMBER:] In keeping with the subject of insurance, Dana, and challenges for directors, what's going on now with the SEC in terms of possible limitation of indemnification and insurance?

PAUL FERRILLO: Well, maybe I can answer that question, because it comes up a lot here. We've had that issue come up a number of times in very, very high-profile, large

companies. The SEC—and Chris, you can correct me if I'm wrong—the SEC and the DOJ, by and large, understand the need and value for D&O insurance; they do not want a director or officer to go unrepresented or not have insurance. They appreciate the value of it. You may, on occasion, run into situations in a Section 11 claim where there has been, I'll call it *dicta* over the years, that you can't indemnify for a Section 11 violation because of the strict liability nature of the claim. But we have not seen that to be a particular problem. One of the other issues that has changed in this area—and Dana, I'm going to direct this back to you—a friend of mine once said to me, they thought Side A insurance, Side A directors' and officers' insurance, was like something that sat up in the ether world. It sat up there, just sitting up there, and it was nice to be talked about, but it never factored into a situation involving a claim. I said to that person, "Well, what about the financial crisis of 2008 and what's happened since then?"

[AUDIENCE MEMBER:] My point was, there was a pronouncement lately, out of Mary Jo or someone else at the Commission, questioning the availability of indemnification and insurance, going in the current environment.

PAUL FERRILLO: I would say again, speaking with the United States, the DOJ and SEC in New York, we have *not* seen that situation happen. But, Dana, let me go back to the Side A question here, and again, this may be a difficult topic for a lay person. Can you talk a little bit about the—especially in the new world, the new paradigm of accounting irregularities cases and accounting issues becoming perhaps more prevalent, the importance of Side A coverage and what it really means today, and the improvements in the Side A coverage.

DANA KOPPER: Certainly. I think, first off, it's important for those who don't understand "insurance-ese" completely: traditional insurance contracts typically have three parts to them—A, B and C—A covers non-indemnifiable loss, protecting personal assets; B, corporate

asset protection, protecting against indemnifiable claims; C, corporate asset protection, protecting against corporate liability claims.

So, you typically have A, B and C in an underlying program. DIC—Difference in Conditions—is a form of non-indemnifiable loss coverage that is qualitatively superior to everything else that is in the program.

Oftentimes, we don't call it this, but we liken it to a personal umbrella. The limits are dedicated to the individual; they can't be impaired by organizational liabilities; they can't be seized by a bankruptcy court. The coverage grants are expansive. Typically there is a narrow personal conduct exclusion. There are a lot of other benefits to the program.

The total proportion of program design now, a difference in conditions component, if you have A, B and C in the underlying, on top, a DIC program, that program should represent somewhere between 20 to 50% of the total program design.

In this particular environment, we have to look at where things are trending. Number one, plaintiffs have always embraced derivative actions, we continue to see derivative actions on the rise. All too often, people tend to think of DIC, and brokers tend to talk about DIC programs, in the context of insolvency. Insolvency isn't the critical risk; it *is* a risk, but it is not the critical risk. The issue and the qualitative value of a DIC contract *is* the scope of its cover, and how it responds, because there are really two triggers in those program: no underlying insurance, and no indemnification. It *is* the ultimate financial safety net for these individuals.

Now, getting back to the rise of derivative actions, they used to be relatively modest settlements. But there is a long litany of cases out there now that are over 20, 50, and some even over 100 million dollars, in terms of settlements on derivatives.

Derivatives fundamentally, because of the circularity of money, are non-indemnifiable actions. Your corporation could have a billion, $5 billion of cash sitting on the balance sheet. They can, in most states, have the ability to indemnify you for defense expenses associated with a derivative, but when it comes time to settle, they fundamentally have to say, "Sorry—we can't do anything for you, because a derivative action is non-indemnifiable."

So when you think about the rise of derivative actions, and then you overlay that with accounting irregularities—if you look at them statistically—they are far less likely to be dismissed; they take far longer to resolve; and they make up a much greater proportion of the overall settlement value in the marketplace today. When you have issues of accounting irregularity, and you have your officers that are in the crosshairs of that sort of action, oftentimes you're going to have multiple path actions. You'll have the civil action, the criminal action, the regulatory action—all of those things conspire to consume an enormous amount of limits. You see limits going down. That's why some directors and officers—and you've probably heard the term, and I'm not trying to sell anything here, but you've heard the term "IDL"—Independent Director Liability—some independent directors now are opting to have the primary program, which protects everybody, corporate assets, personal assets; the DIC program that is protecting all of the individual directors and officers; and then a separate program way at the top that is protecting only the independent directors, because in those programs—it's debatable on the value of it—most of them don't even have personal conduct exclusions for the independent directors. That's a topic for another story.

The point is that a well-crafted D&O program in today's environment, especially with a view towards accounting irregularities and the other things that are happening, has to embrace a healthy dose of DIC program protection.

PAUL FERRILLO: Excellent.

[AUDIENCE MEMBER:] First is context. I'm a behavioral business strategist, so I'm looking at what we're discussing from a very different perspective, i.e., looking at managerial decision-making, practices and policies that reinforce good behavior or bad behavior. I appreciated Harvey's quote, although it put a lot of onus and responsibility on auditing firms. However, the audit committee has dual responsibility, unless we empower the auditing firms to have more power over the organization leadership practices and identify it before day one. Mr. Levick, look at pre-day one, which you referred to, Mr. Kopper, because it's all about what's happening beforehand, and how we are reinforcing and acknowledging the good practices, and identifying bad practices, and rewarding good practices, and punishing bad practices, which we are not doing—until it hits the media, and until it gets explosive.

What can we do, as professionals, to try to change that business climate so we don't go to day one auditing crisis?

PAUL FERRILLO: Richard, do you want to take a crack at that? Or Ellen?

ELLEN ODONER: Well, I just wanted to say, I think what you are referring to is actually on the agenda of the audit committee and the board as a whole. The catch phrase is "tone at the top." Also a subsidiary catch phrase is "tone in the middle." There is at least from my perspective, a lot of attention being paid to both of those norms, and as directors go around the company, as senior management goes around the company, there is an ethical norm that we expect to behave with, and we expect you to surface issues. I'm not saying this is perfect, but I do see from my perspective, much more emphasis in recent years on that.

[AUDIENCE MEMBER:] Should supporting firms have more power over internal auditing committees?

ELLEN ODONER: No, not at all. It's side by side. Obviously, Sarbanes-Oxley set up the structure where the auditor has a big cudgel. But this is really an overall board responsibility, which I do see more attention being paid to. I don't mean to be Pollyanna-ish about it and say that it works perfectly in every company, but I do think that this is on the radar screen more and more.

PAUL FERRILLO: We're running out of time, here, and we want to make sure we get through all the materials for today. We have a special announcement here. Unbeknownst to all of you, if you go to tab 6 of your brochure, you'll see a hypothetical fact pattern of an accounting irregularities crisis, which I dropped on each of the speakers last night, by the way, so they would be completely and totally unprepared for the conversation, and completely and totally unprepared for their answers. But for you, sitting in the audience, as lay people or people who have not gone through a crisis before, I thought this was probably the best way to convey sentiment in terms of what's going on.

By the way, please excuse all the names; please excuse the fact I'm a Marvel comic book fan; Hermann Schmidt was Captain America's arch enemy in *Captain America*, but no other meanings therefor.

So if we could go to tab 6 of the presentation. Hermann was a brilliant Nazi scientist, and while trying to develop a super-soldier for Nazi Germany, decided to inject his super-serum into a three-pack of golf balls. To his great surprise, Hermann, being a terrible golfer, shot a 67 for 18 holes—greater than he had ever performed before! The next day, he shot a 64. Suddenly, inventing weapons to kill Allied troops became passé; gold became his passion. Shortly after Nazi Germany lost the war, Schmidt escaped to the U.S. with the funding of a young defense contractor named Tony Stark. He opened his first golf ball factory in Columbus, Ohio, where he

incorporated his business, although his bylaws dictate that Delaware law will govern. There, he met a young phenomenon, Zach Stickler, whom he gave a few dozen golf balls, and Zach became unstoppable and took over the game. Hermann called the ball the "Hydra". His motto was, "It's unstoppable, and so am I."

Hydra Golf quickly took over in the U.S., and built plants in the U.S. and overseas; in 2000, it went public on the New York Stock Exchange. Named to its board were several esteemed individuals to whom he owed a substantial amount of money, due to several ill-advised bets on golf games. On his audit committee was Clint Barton, who used to be CFO of another public company before he started his own very successful archery company, as well as John Thor and Arnold Hulk, who were billionaires in their own right. Another noted golfer, Judge Dread, was head of the corporate governance committee, and also served as lead director. Each director was paid an enormous sum of money for their ability to be a director. There were four director meetings a year at famous golf courses, and four telephonic board meetings.

The company's auditors, Cook the Books & Run, remained at Hermann's side throughout the growth of the company. His lead outside counsel, Barry, remained at Hermann's side throughout the growth of the company. So did his firm, Barry & Hyde, a vaunted Wall Street firm that primarily did corporate work for the company and billed about $7 million a year for the past five years. For sixteen quarters, Hydra met or exceeded guidance; revenues climbed steadily, from $200 million in 2005 to $400 million in 2010, and the company had no debt of any kind. Things were good.

Unfortunately, a competing company, called Sniper, in 2009 found out that Hermann did not properly patent his golf balls, nor the super-serum, so they created a ball called the "Freedom golf ball" and used Hermann's old adversary, Captain America, who, at the spry age of 90, could

still get around the golf course pretty well. Sales of Freedom golf balls took off dramatically and put a dent in Hydra's sales almost immediately. Yet both companies did well in the marketplace.

Seeing his stock price slip in 2010, Hermann called a meeting with his two key lieutenants, Bernie Ebers and Scott Sullivan, to discuss ways to boost sales and profits. Being the bright lieutenants on their own, although having a somewhat checkered past, and having a long time to practice their golf game, Bernie and Scott quickly went to work. Noting that it was near the end of the first quarter and somewhat close to the start of golf season in the northern climate, Scott suggested tripling deliveries to the company's key suppliers, like Paul-Smart, Matthews and K-Smart, even though those companies did not express a desire for the golf ball shipments. In negotiations with each of the companies, Scott offered extensive rights of return, as well as other incentives, such as covering the customer's carrying costs, in side letters which he kept conveniently in his desk and out of Hydra's normal recordkeeping system. Second, taking advantage of Hydra's extensive pro shop connections, Bernie concocted a scheme where he would ship single trailers full of golf balls to each critical pro shop, and park them behind each of the stores and behind each of the locations. Rather than give the pro shops the right to remove the golf balls from the trailers, it was decided that trucks would remain locked for safety.

Nevertheless, sales were booked upon shipment. Hermann, Bernie and Scott got through the first quarter. Sales were up comparatively; they exceeded guidance by four cents a share; the stock price closed at $3.00 higher at the end of the trading day. After the trading window opened following the analyst's call, Hermann, Scott and Bernie dumped 2 million shares of stock each, reaping a hundred million shares in proceeds.

Then, there was the next quarter to deal with. Flash sales reports, which Hermann, Bernie and Scott received daily, showed sales slipping to the Freedom golf ball almost

immediately in Q2. Internal e-mails sent between Hermann, Bernie and Scott during the period sounded concerned at best. "Ouch, dude! The numbers are terrible! Why aren't we doing better?" "Dude! Why won't America embrace the Hydra? I thought we were unstoppable." "Dude! Offer Paul-Smart whatever they want to take another 2 million golf balls by June 15th, or this will be another long quarter."

During the July 9th Q2 earnings call, Hermann blamed a so-so quarter on greater competition and higher promotional activity during the quarter due to the company's battle with Sniper, but at the same time, he announced the introduction of the Hydra II, a new version of the Hydra which he developed with an improved and now-patented super-serum. Upon injection of the new super-serum into the golf balls, they'd be bombarded with gamma rays to make them even more powerful. He increased guidance by ten cents a share, predicting that the Hydra II would revolutionize the game. The stock jumped $3.00 a share on this announcement on a volume of 30 million shares.

Indeed, the Hydra II really did work—almost 20 yards longer per drive than the old Hydra or the Freedom. The problem was, the golf balls had a tendency to explode upon impact, and Hermann had trouble recruiting golfers to use them after a couple of regular pros were wounded by shrapnel when their metal woods blew up upon impact. [LAUGHTER] However, Hermann continued to perfect the Hydra II throughout July, to the point where he thought he'd fixed the problem. The balls quickly became approved for use by the PGA and USGA, and sales of the Hydra II took off like a rocket ship.

To be safe, Bernie and Scott continued overshipping Hydra I golf balls to key suppliers like Paul-Smart, under the same side letter terms, and sales of those balls continued to do well—

at least on paper. Finally, Bernie and Scott decided to double up shipments on the Hydra II to the same customer.

For the next two quarters, Hydra Golf did fabulously well, and by the end of the year, the stock price was up to $100 per share, from a mere $50 per share at the start of the quarter. Although sales of the Hydra I were still strong, sales of the Hydra II exceeded all expectations—450 million by year-end.

In December, Hermann, Bernie and Scott entered into 10b5-1 trading plans, which would enable them to unload a great deal of Hydra stock in the year to come. The first of those sales came in January, which each netted them $100 million.

Then the wheels fell off. Two things happened that they couldn't have anticipated. Now that it was audit season, Cook the Books & Run was on the scene and was working closely with Scott and his staff. At the very end of February, a woman in dark glasses and a broad-rimmed fedora, whose name was Natasha, came to Mr. Cook in a darkened parking lot and told him about the extra shipments to key customers. She said she already reported this concern on the company's confidential hotline, but nothing had been done, and she was considering going to the SEC. She gave Mr. Dewey a copy of the side letters, and then disappeared into the darkness. Mr. Cook drove away, shaken. The next week, he and his team dug in deep.

Then, during a golf tournament the next day at a famous Florida resort, three golfers using the Hydra II golf ball blew themselves up at impact, injuring 20 spectators. Hermann quickly called his PR advisor—*not* Richard—who told them, "Say nothing to the press!" Of course, Hermann ignored this advice and told the press this was a case of industrial sabotage and that these golf balls must have been tampered with, noting that these were the first-ever incidents

involving a Hydra II golf ball since Hermann had perfected the serum. He also reemphasized that the sales of the Hydra I golf ball were doing very well.

To make matters worse, the next day, Mr. Cook came to Hermann and told him he had some major questions about quarter-end shipments of the Hydra I and Hydra II to the company's major customers, and said, somewhat sheepishly, that the company might need to restate its earnings. Hermann, now panicked, called his lawyer, John Hyde, who stated, in sum and substance, "Let me handle everything. Don't speak with the press." He stated he would deal with the auditors, and "don't worry about anything." ***

While on the phone with Hyde, Hermann saw a PR Newswire report that Hydra just got named in seven securities class actions in the Southern District of Ohio. By evening, two more shareholder-derivative actions were filed—one in Delaware, and one in Ohio.

Scott and Bernie were not so sure that John Hyde could handle such a delicate situation, and having some prior experience with sinking ships, suggested that Hermann call Ellen Odoner at Weil, Gotshal & Manges. [LAUGHTER]

As Hermann was getting Ellen's number from the Weil website, he received a panicked phone call from one of his Hydra II plant managers in Dayton, Ohio, that the FBI just appeared at the door with search warrants for the company's documents and computer files. So Hermann slowly picked up the phone and dialed Ellen's number. [APPLAUSE]

Thank you. Ellen—suppose you just got off the phone with a very panicked Hermann, and Hermann laid out all these problems for you—his accounting issues; the deaths; Natasha, the whistleblower who works for Scott; and the FBI search warrants. Where do you start, who do you involve, and how do you start sorting out a mess like this?

ELLEN ODONER: Okay. Well, let me tell you about what I would have done on that phone call. The first thing would have been to ask Chris if he could come down to my office and take it with me, because this is a mixed problem, and it really requires all hands on deck.

I would have given Hermann the very sad news that this was a textbook case where he was going to lose control of this situation very fast. This involved his two key lieutenants; it involved, I guess what we would call "golf ball stuffing," which is endemic in the golf ball industry; disclosure violations; potential for insider trading; integrity problems at senior management, which the company's own control system didn't discover—it came through the outside auditors. Then there are allegations from Natasha, with the hat and the glasses, that the company hadn't pursued a hotline complaint; and this is one where it has to go immediately, not just to the audit committee chair, but to the entire board of directors. I would have told the board of directors that this is a situation where you really need to have outside experts handle the problem; that they needed to form a committee and, given the facts here, it's a little dicey who you would put on the committee, because they were all extremely involved with Hermann and the development of the company.

PAUL FERRILLO: Except Judge Dread!

ELLEN ODONER: Yes, except Judge—so it may have been a committee of one! Then I would have suggested to Judge Dread that he immediately call—I would have given him a short list of people that I would have recommended—although obviously it's his choice—of forensic accountants and outside counsel. Of course, Harvey would have been at the top of the list!

PAUL FERRILLO: Ellen, as you're thinking about your conversation with Hermann, are there any day one public disclosure issues here, or is it too early, knowing the communications you got from Hermann?

ELLEN ODONER: Assuming that you don't have an earnings release the next morning, you have a little bit of breathing room here, apart from the fact that there are exploding golf balls. You do have to get to the point where you clean up the statements very quickly that it was due to industrial sabotage, if that clearly wasn't the case. You've got at least a day to try to get your handle around the facts, because you don't want to make the situation worse by disclosing something that's incorrect. Sometimes you are lucky, and a problem surfaces at the beginning of a quarter, and the company doesn't have an analysts conference or an investor conference scheduled the next day. Sometimes you are very *un*lucky, and these problem arise the day before the earnings release, or even worse, between the earnings release and the 10-Q, where it calls into question the veracity of the earnings release. So you want to get a handle very early on what are the commitments the company has made to speak publicly, because you have to be very careful to prevent further misstatements, and it's an opportunity to clean up what's been said in the past.

PAUL FERRILLO: Chris, very quickly, whether you were in Ellen's office or not, Ellen says Hermann's got an FBI problem. Chris, how would you counsel Hermann and Hydra to deal with an immediate crisis—people knocking at their front door, probably with yellow "caution" tape and search warrants.

CHRISTOPHER GARCIA: First of all, I can't imagine a more perfect or imperfect storm as this one.

PAUL FERRILLO: I tried!

CHRISTOPHER GARCIA: And you succeeded! [LAUGHTER] To a point, frankly, that Richard made before, the best thing that you can have happen at this point, if you're in the situation of Hermann, is to have had a crisis management plan in place before the call came, so that it could be implemented. As Ellen, Richard and everybody up here will tell you—and it's probably obvious—you are in, at this point, an absolute flat-out sprint to get as many facts as possible, in order to credibly be able to tell the government and others who are quickly or already on your doorstep that the situation is under control; that responsible people are on top of it; and to start developing a relationship that, frankly, will let you develop as many of the facts as possible to put your company in the best posture as possible going forward.

With regard to the very specific question of when you have FBI agents on the doorstep and potentially with search warrants it's clear that you immediately have to get someone who has experience working with FBI agents—counsel on the scene. When we have these problems, immediately go out to where the search warrant's being conducted, get a copy of the search warrant, identify what the proper scope of the search warrant is, and make sure it's lawfully enforceable. Then there are a number of important steps that need to be taken—one, whoever the lawyer is who is going to be principally responsible for interfacing with the FBI has to develop a very good relationship with the agent. People who are on the ground need to be advised very quickly, and I mean employees on the scene, among other things. They have no obligation to talk to the FBI; it's appropriate to direct or have all questions asked by the FBI directed to counsel; it's important to immediately release all non-essential employees—the key here being that when the FBI is there and they are collecting documents, they're also going to talk to people. The biggest exposure, frankly, are the documents, and you'll catch up with what those documents say later on. The biggest exposure that the company has when the warrants are

being executed are the statements that—or potentially improvident statements that people are going to make, not having had the benefit of advice of counsel in that situation. So, you release non-essential employees; you establish control of information flow with the FBI through a principal person, like a lawyer, and a lawyer representing the company. You note and document exactly what the FBI is doing, in order to monitor whether or not they are staying within the scope of the search warrant, and to know what they've taken, because you may have the opportunity to raise problems with the conduct of the search later on.

That's what you do in an immediate aftermath of the FBI search.

PAUL FERRILLO: Chris, are there any immediate issues that Hermann needs to think about with Natasha, who you could call, in some sense, a whistleblower or a potential whistleblower?

CHRISTOPHER GARCIA: Yes, the immediate concern is that the FBI may be there because she's already gone to the FBI, and she may have gone to the SEC already.

PAUL FERRILLO: She hasn't gone yet, but you never know.

CHRISTOPHER GARCIA: You never know, so what you have to do, among the laundry list, and immediately, you have to draw up a list of who you're going to attack first in terms of trying to talk to them and get an understanding of the facts. This is really important, because these facts are so bad, and with the government on the doorstep, people are going to be getting lawyers very quickly. That may inhibit your ability, if you're conducting the investigation on behalf of the company or the board committee, to access them and talk to them. Among other things, you are going to want to try and identify who Natasha is, if you can, and talk to her as quickly as possible, among other people, before they're lawyered up.

PAUL FERRILLO: Assuming, Ellen referred Richard to Hermann, and Hermann downloaded all of this information, Richard, where on Earth do you start with this one?

RICHARD LEVICK: Of course, having seen this fact pattern so many times in real life, I'm prepared to deal with this. [LAUGHTER]

We would probably use the Kevin Tway/Hudson Swafford/Kevin Streelman strategy, which I'm sure all of you are so familiar with. They are the three golfers at the very bottom of the earnings list of the PGA tour, and if they are not the ones who lost their lives in this explosion, the amount of attention that is going to be on this issue is not going to be on accounting restatements and financial issues. They are not going to be covered until about day five, six or seven.

Imagine what happens—first of all, I don't know how you have an explosion on a golf course and two others are still playing through. But you have three deaths, so that means it's a T.V. story. It's ESPN, it's CNN, it's CNBC. It's T.V. Wait—because there are twenty spectators, everyone's got it on video, and now they're also blogging about their own injuries. So, that story, for the first two days, is the only thing that people are covering. You've got the social media strategy going on.

Now we have another problem, too—we've got the combination of "no comment" but, wait—"false comment". So any opportunity for trust, now, is gone—the false sabotage—sabotage is an issue with something that people are more sensitive to after 9/11, when we had the great Cleveland energy blackout and here in New York, we thought it was international sabotage—again, that's where our minds went.

Not going to work now, and after, within 48 hours, the media's going to understand that was a false issue. Now what happens? You've got Hermann, who's got no credibility, so the

absence of the good patents; the fact that he was a Nazi—did we mention that? That's never a good fact! [LAUGHTER] That's going to work its way into the news stream.

Now, there is the trust issue. You're going to start getting it—now, by about day five, you start getting into the stock dumping issue. So we're all the way down pretty far into the story before the financial issues or even the FBI comes up. It just extends the life of the story.

There are a couple of points. One, one of the things that's remarkably different about Penn State, which we would all think of with the Sandusky crisis, versus, AIG and BP, is that as bad as Penn State was, it was five or seven time zones? That's it. It's not an international story. It's maybe the Caribbean through Alaska—that's it. That means after 10, 11 hours a day, people can get in front of the story. AIG, it's 24/7 for 210 days. BP, it's 24/7, internationally, for 109 days. It's remarkably difficult; it's impossible. Your teams are working around the clock, seven days a week—they're going to make more mistakes. The challenge here, because of the visuals, is it's at least a national story; depending on who the golfers are, it may be international. The country club is also not going to be sitting by because it's concerned about liability. You have other adversaries who are going to be pushing the story and saying, "Not me."

PAUL FERRILLO: Richard, is there a corrective statement that you would recommend Hermann put out, at least on the doubts on the golf balls? Because, remember, we are very clear that this is a real company with real earnings, with real sales; this is not a company circling the drain—this is a company that has just run into a bunch of bad problems.

RICHARD LEVICK: One of the challenges is that people look at crisis communications, to just fix it. It's awfully hard to talk your way out of something you've acted your way into. I don't know how many try that in their marriages—how is that working? [LAUGHTER] There was a lot of muffled laughter on that one!

What we have here is a situation where you have a company that has a series of bad acts. What's your bridge here? What are you going to turn to? The first thing that I want to do is I want to have the engagement through Weil, not only for purposes of privilege, but because we're going to have to have conversations pretty early on about replacing board members, replacing the C-suite, and I doubt very seriously we can have that open conversation. We're going to defer to the lawyers, but we're very much going to want that flexibility.

PAUL FERRILLO: Chris and Harvey, assuming Ellen's advice to the audit committee was followed and there's a full-blown accounting investigation that gets immediately commenced, how do you guys work together to quickly collect the facts, the documents, the quick-and-dirty interviews, knowing what we know—that this stock is probably trading on faulty financial information.

CHRISTOPHER GARCIA: We work seamlessly, hand-in-glove. I retain Harvey to preserve privilege. Harvey gets to work, amassing the financial data, looking at ledgers, looking at how transactions were booked, and trying to figure out the scope of the problem, of who did what, where, when, and what is the significance of it—at the same time, helping me as I approach interviews, trying to interview as many people in the company as possible to get an understanding of what happened.

HARVEY KELLY: Yes, what everybody wants, from the top of the board, to people like Richard, to people like Chris—everybody wants to know how big the problem is. Trying to get a parameter around that, and everybody wants to push the button and call the *Wall Street Journal* and tell them exactly what size it is, it's no bigger than "X", hundreds of millions of dollars. That's a very dangerous proposition. I always like to look on the bright side of things. The bright side in this fact pattern is that there *are* some real sales—people wouldn't have blown

themselves up if they didn't buy a golf ball. Somewhere along the line, notwithstanding all these crazy shipments and all these return side letters and so forth, at least some of this stuff constituted real business, real sales, that deserve accounting treatment. Obviously, you don't have to be a sophisticated accountant to know that some of this other stuff doesn't meet the revenue recognition rules, but it's a complicated factor.

Now, we have another interesting coordination effort in *this* fact pattern, which is we have the FBI having taken some volume of the business records that may well be critical for us trying to get our arms around how big the problem is, and trying to understand what side letters did exist or didn't exist. They cleaned out the office of the purchasing guy or the sales guy; all of a sudden, you're not going to find it in the computerized general ledger, a little notation on the side of each entry that's subject to a side letter. We're going to work very collaboratively with Chris to get an appropriate working relationship with the FBI in this instance, to get access to the information. Generally speaking, it's been my experience that with all of their criminal prosecution responsibilities at the top of their mind, they're also well aware that a company has to continue on. They're not interested in putting a company out of business any more than anybody else is; and with the appropriate protocols in place, they will generally be willing to cooperate in a way, at least, that I can get my job done on the accounting side.

CHRISTOPHER GARCIA: That's right. If you were dealing particularly with sophisticated FBI agents in the northeast and some other regions, you'll be able to both get from them a catalog of what they've taken and quickly get copies of what they've taken, because they understand that the company not only has its own desire to continue operations, but also recognizes that the company and its directors have fiduciary obligations that they need to fulfill, and it's important for them to be able to fulfill them by understanding what the problem is.

This, again, goes to the point which we mentioned earlier—it's critical to have someone involved in this process on behalf of the company, or the committee, who can have a very good relationship with the FBI, who can talk to the FBI, and work cooperatively with them.

HARVEY KELLY: Yes, it actually surprises some people in these situations, that the *quid pro quo* very often is at the back end of the process. We quite clearly share our findings, our analysis, with the government as part of the process. That's negotiated, it's not a guaranteed outcome.

CHRISTOPHER GARCIA: Here's the truth—every accounting firm investigation I ever conducted, I would not have been able to conduct in the time that I conducted them without the benefit and help of the lawyers who represented the company, and the forensic people that they hired. The truth of the matter is the government doesn't really have resources; it has power; it has the ability to subpoena. We don't have a team of forensic accountants in the back office who can do the work that, frankly, Harvey will do when he comes in when he's retained by the company. There is a relationship that can be developed there that's mutually beneficial, which is what you're pointing out, which is an opportunity.

Selfishly and strategically, in this kind of environment, working with the government, if they're going to credit you and rely on you and think that you are credible, they'll actually trust you to provide information to them. This enables you to put the appropriate posture around the information, and the context around the information, from the beginning. That's important.

PAUL FERRILLO: We're going to hold questions to the end if we could, please, just because we're running out of time, because I do want to complete the fact pattern. Richard, Ellen get together, issue a press release about the deaths, about safety is job number one, and actually stabilize the company stock price for the next two weeks. During that period of time,

Chris and Harvey have been taking quick-and-dirty interviews; they interviewed Scott Sullivan, who appeared without counsel and talked about the side letters and said, "Don't worry—Cook the Books & Run knew all about it." Bernie Ebers said, "I'm not speaking with you guys!" Natasha was extremely helpful. Harvey and his team were able to get copies of the electronic general ledgers, and in their week two planning meeting, they decide that because of the side letters, there's revenue recognition problems. The net effect of the problem appears, to Harvey's team, to be about $90 million a year; the net effect of the trailer shipments is about $10 million a year. But Harvey stresses this is just an estimate.

Remember, all out there in the audience, combined golf ball sales recorded for the year were 750 million in the U.S., and according to Harvey's team, there were no other accounting problems at the time. Harvey notes it will take about another month or two for his team to drill down and make all these confirmations. Ellen, Harvey and Chris then meet with the audit committee at three o'clock to go over these findings.

I'm going to ask the panel a question here. Are we now in a position to determine whether or not there needs to be a restatement of earnings for 2010?

ELLEN ODONER: I'll jump in. I'll say that there may not be a determination that we have to do a restatement for 2010, but I think there's enough here that says that there's no longer confidence in the published financial statements.

PAUL FERRILLO: For the first three quarters of 2010?

ELLEN ODONER: For the first three quarters. I would say that while the outside auditors may be pushing, it will be the advice of all the independent advisors that the audit committee reach the conclusion that there should be no further reliance on those previous financials, and put out what's called an Item 402 8-K, which informs the market that you should

no longer pay attention to the previously published financial statements. It tries to put some context around the situation; tries to size it, if it's at all possible—which it may not be. Obviously, that document is a key document in messaging the situation—it's a technical document for the SEC; the auditors have to be happy with it; but you also want to have some messaging in it, if it's possible. When that document goes out, usually the lenders go into an uproar; customers can go into an uproar. It's very important for people in an operating company that there's a plan that basically, simultaneously with that filing hitting EDGAR, there are phone calls to all the key constituents outside the company. There will also have to be employee communications. It may be that as part of this, the board, or at least Judge Dread, decides that some of the key players in the company have to either go or be put on leave, and you need to promote from within or bring in an outside expert to actually be the CFO for the moment. That will prompt certain types of required disclosures. That's really the moment where you want to get out as comprehensive a story as you possibly can.

PAUL FERRILLO: Speaking of an uproar, in the interim, Hermann calls Dana Kopper and gets on a conference call with Kieran Hughes, and everyone decides it's time to lawyer up. Kieran, what role do you play in this messy situation, and let's just assume for the moment, everybody wants their own counsel.

KIERAN HUGHES: A lot of times, that's what you run into. You run into board members, as well as C-suite individuals, who know a brother, a sister, a brother-in-law, a sister-in-law, cousin, and they're not really a securities attorney, but they're my brother-in-law and I'd like to hire them. You have to say, "Okay, we need to back up—it's a more serious problem; we need to have the right attorneys available."

One of the most important things—and you've heard it from every panelist here—is the *before*. That is to say, a crisis management plan. You need to know who your insurer is; you need to know who your broker is. You need to know who your attorneys are—whether they're for the white collar, the civil aspect, or regulatory attorneys. They're usually not the same people; sometimes it's the same law firm; sometimes different law firms; sometimes boutique firms.

The question I would have first of all is, how many people here in the position of a C-suite individual or a director have run a mock scenario, for example, where you get a letter from an SEC or a regulatory body, and how many people have actually actively pursued that type of a mock scenario in their companies, involving the C-suite individuals, involving the board, and saying, "These are the phone calls we need to make," and not enumerating one, two, three, four, but rather, "These are your responsibilities—the general counsel's going to call the white collar crime lawyers. The risk manager is going to get Dana on the phone. They're going to get the insurance company on the phone. We need to get Richard involved. We need to get the forensic accountants involved; we need to do this now. Who's going to get reach out to Harvey?" You need to have those responsibilities enumerated.

You have all these lawyers and all these experts now coming in. Who's going to pay Harvey? Who's going to pay for all the different attorneys? Someone at some point is going to turn around and say, "Don't we have insurance to cover this?" That might be a little late! You need to have the risk manager or someone within the C-suite make that phone call to Dana, make the phone call to the insurance company. It might be a little late to say, "Who handles our claims work? Is that internal, or do they hire some outside company, or how does that get done?" If you're in a C-suite or you're in a board of directors, you ought to be nervous if you don't know

what kind of claims department is going to work with you and work with your general counsel, the CEO, the CFO, the board of directors. If you don't know that, you need to know that.

You're going to turn around and you're going to say, "What insurance do we have?" All of a sudden, the risk manager, or whoever was responsible for the property casualty, was given a budget; and everyone's going to be saying you did get the best insurance company; the highest limits of liability. We have seen cases, for example, where, in a criminal defense of three individuals of a public corporation, over $106 million was spent for three individuals in the defense of criminal actions that eventually got dismissed on technicalities. Can these numbers run up? Absolutely. One hundred six million dollars, and that was just a criminal defense of three individuals. Besides that, you have derivative lawsuits and a securities class action. You had SEC investigations. You really want to know the size of your company. Are you a mid-cap company or a large-cap company? You need to know the size of your tower—is it sufficient? Then you can get back to Dana's conversation about the different traunches that you have available—A, B, C, Side A, DIC—Difference in Conditions. Who is going to handle this? Do I have a single layer of a very competent carrier at $10 million, and within the first month and a half, because of all the experts we had to bring in, all the attorneys we had to bring in, that $10 million is gone; who is my first excess? Do they know anything about it? Should I have a larger primary policy, or do I want to stagger it more? What do I have on the Side A-insured person policies? Do I have just one small layer and I stack up ten layers to reach $60 million, or $100 million, or do I have one larger layer, where you know that the claims department has experience, you know what they can do, you've met them *not* in a crisis situation, and you said, "Tell me what your philosophy is, and I want you to handle this because you understand the vagaries of the different types of investigations, the securities class actions.

Dana mentioned it before: You want someone to coordinate, facilitate the different meetings. You're going to have that through the company, the company personnel, but at times, you may find that the general counsel can cross over. For example, Ellen mentioned that there was an SLC, perhaps—an internal committee that's going to perform an internal investigation. The general counsel cannot lead that; that's an independent organization. They're going to hire independent counsel. That independent counsel is going to hire independent accountants to come in. Everybody's going to be looking for Harvey.

The point is, where is the money coming from; what is or isn't covered; why or why not; and we can't forget Richard, because if somebody decides to bring Richard in two weeks from now, he's probably going to say, "Yes, I'm going to play golf—and not with Hydras!" [LAUGHTER] The problem is, you need to have Richard on board, as well, and there's a component to insurance policies called "crisis fund." It's not a huge part of a policy, but it's one that is often overlooked, and it does provide corporations funds to get Richard on board. Just as certain companies, insurance companies—and I'd encourage you, regardless of whether it's AIG or any company—look into who is on their panels, who is on their recommended list, who will they let you hire or not hire. That goes from vendors for eDiscovery to attorneys. eDiscovery for mid- and large-cap companies take a huge part of any insurance tower. I can sit here and tell you, easily, $3 million to $5 million will be spent within the first six months of active discovery, just on documents. That will be just the first production of two or three rolling productions. It depends where your documents are stored—are they in one place? Are they, as we have found, international?

There are a lot of different components to the insurance coverage and the insurance compartmentalization, if you will, and we need to be able to work with clients, direct, hand-in-

hand with clients, hand-in-hand with defense counsel. Why? So that you're not spending $106 million on one aspect of the case and leaving the company high and dry, or the board of directors high and dry, or the C-suite individuals high and dry, who are not part of that.

It's a long-winded answer; I can go for about two hours more if you have the time!

PAUL FERRILLO: Well, let me think about that. No. [LAUGHTER]

Last fact, and then we're going to take some questions and answers. Assuming the non-reliance letter goes out, Ellen works on it with Richard and Chris, the stock drops another $10 a share—not a surprise—another seven more lawsuits come in, and two days later, Chris, the general counsel of Hydra gets a letter from the SEC announcing an informal inquiry on the accounting issues presented by the company in its press release. Chris, does the informal inquiry nature of the SEC now being involved on top of the FBI, does that change things? Does it complicate these things? Or are we just adding another party into the mix to keep happy?

CHRISTOPHER GARCIA: It's not a surprise. It might be actually formal. It may complicate things a little bit. Traditionally, in my experience with the SEC, the SEC and the FBI and the Department of Justice will work very closely, so it doesn't *have* to complicate things all that much. It may complicate things, though, strategically. Among other things, what you'll see is an effort by the SEC to depose certain people, which will make a public record of things that might otherwise be private if just the U.S. Attorney's Office and the FBI were handling the investigation. That may lead to and result in additional civil litigation follow-on suits, and it is another party to potentially keep happy. It has the potential to complicate things, although right now, at this point, given what we know about the facts, any additional wrinkle is going to be marginal in the complication that it adds.

PAUL FERRILLO: Well, ladies and gentlemen, we could go on for about 70 more minutes with all the facts in the Hydra fact pattern, and we thank you for your patience to get through it, and would like to be able to take any questions and answers you might have for the panel.

[AUDIENCE MEMBER:] At a board meeting with the auditors, in the process of telling us what they were going to be charging us, they also gave us a lesson on what they had just heard from the SEC, apparently their responsibility had just been ratcheted up. I was wondering how that might affect this whole discussion. In the past, where they approached the auditor, they might have been okay if they were comfortable with what management could do, and that management had a methodology that they followed, and they felt that they could sign off on it. It's a whole different ball game now. Now they, the auditors, themselves, have to understand what management's methodology is, and they have to consult. Now, we'll say I understand—not just that I agree that the CEO or whoever's responsible for methodology, but the auditor now has to get comfortable with it, so that our fees may go up another 30 or 40%, because it will add that much more work for them to get comfortable and sign off.

PAUL FERRILLO: Harvey, that goes to you about when a company's involved in an accounting crisis. I assume that means for the public auditor, more field work, more testing, more review and more people thrown at the engagement.

HARVEY KELLY: Yes, there's no question about that. The question is really in the ordinary course of business, not facing an accounting crisis. The question is, can somebody place more confidence or something in the auditors because they're doing more, or they're charging for more work currently.

[AUDIENCE MEMBER:] No, as an audit committee person.

HARVEY KELLY: I understand.

[AUDIENCE MEMBER:] Does that alleviate, does it just add to, does it do anything?

HARVEY KELLY: Let's put it this way: If you end up facing what is an accounting crisis, that's not going to be the pitch that you heard; they're not going to remind you about that story was they just told you. In all seriousness, it's a circumstance-by-circumstance situation as to the depth of what an auditor does, but I think any auditor will tell you that their responsibility is separate and distinct from the company's corporate governance responsibilities, and that regardless of whatever level of comfort they, in their professional judgment, decide they need to get, you're not entitled to place more reliance on them because they've told you they're going to do more testing. People may differ on that, but that would be the accountant's view of the world. He'd say, "Nothing's changed; the financial statements are the responsibility of management, and the audit committee and the board have whatever appropriate responsibilities they have in the corporate governance structure."

My personal advice would be, to any management official or board member, not to take my foot off the gas because some auditor said they're looking at something more closely. I wouldn't do that.

CHRISTOPHER GARCIA: I'd suggest to you that the scrutiny, not only for board members generally, but for audit committee members, has increased. These are not times for boards of five, ten, twenty years ago. The responsibilities are greater, not just for board members generally—for audit committee members in particular, and also for auditors. I don't think that the statements made by Mary Jo White in the SEC are meant to say, "Audit committee members can rely to any greater degree on the pressure that we are now applying to auditors," because the day that the mistake is made, and the auditor does make a mistake or turns around and there's a

disconnect between the audit committee and the auditor, the auditor is not going to say, "Well, it's really my fault because they were relying on me"; the auditor is going to say, "We gave them the information, and we relied on the information they gave us." But it's not the SEC saying the auditor has a lesser responsibility or that the audit committee can rely upon them solely. It's increased responsibility for everybody; it's increased transparency; they are going to be held to a higher standard, just as directors have been escalating that way, as well.

PAUL FERRILLO: Any other question?

[AUDIENCE MEMBER:] In view of the new COSO framework, is there a better roadmap that can be followed?

PAUL FERRILLO: Harvey?

HARVEY KELLY: That's for me? For those who didn't hear the question, it relates to the new COSO framework, which is really the framework on internal controls and so forth within a company, and there's been a new framework put out—what impact does that have. It is more detailed. It is updated. Most companies say that when—public companies are required to report on your evaluation of controls under some standard framework, and so most companies say that they apply the COSO framework. There is going to be some cost associated with modifying, to comply with the new framework, if you will, as you evaluate your control system. The auditors, in turn, have to evaluate management's evaluation of controls, so there's a doubling-up there.

Generally speaking, I would say in the industry, the perception is that it is an improvement; that it has been 20 years since it had been updated. Generally, the reaction, other than the fact that it's going to cause some cost to transition, has been pretty positive about it.

[AUDIENCE MEMBER:] I have a question for the lawyers. Who is your client, and are there any cautions about whom you should be talking to at the company, whom you should not be talking to, whom you should be warning that their conversations might not be privileged?

PAUL FERRILLO: Ellen and Chris, excellent question. Who's the client in an accounting irregularities investigation?

CHRISTOPHER GARCIA: It depends on who you've been retained by, but if you're retained by the committee, which we were talking about, that's your client. You raise a good point about privilege. You're going to hit the ground running and start interviewing people, but that communication that they're going to have with you, they need to understand it's not a conversation that's confidential as to them; it's not a privilege that they participate in personally; and that you, as the investigator, can do whatever you will with the conversation that you have with them, including reporting it to the regulators and to the FBI, if you decide to take a cooperative posture.

This hypothetical has so many manifold problems and complexities, not the least of which is the representation question, and the extent to which, for example, you identify people that you may want to get independent counsel because there's conflicts. Then do you get into joint defense agreements? What are the merits of those? Do you not do those? It is rife with those complexities.

PAUL FERRILLO: We have time for one last question from the audience.

[AUDIENCE MEMBER]: This is partially a comment.

PAUL FERRILLO: Comments are okay, too!

[AUDIENCE MEMBER]: Harvey mentioned that the SEC has new technology tools.

HARVEY KELLY: Robocop.

[AUDIENCE MEMBER:] Richard mentioned the information revolution had addition of video as something to be thought of as an issue, and we're all very aware of what kind of communications can still take place between the C-Suite and Directors. Can we get your comments on that?

PAUL FERRILLO: I guess, Harvey, what does Robocop add to the new environment?

HARVEY KELLY: The SEC is implementing what they call, an AQM is the acronym [Accounting Quality Model]. But it's basically a predictive software program where they're applying it, and of course they're keeping closely guarded the particulars of it, but it analyzes some of the financial statistics; it analyzes the words; and how they actually are going to implement this remains to be seen, but in essence, it's going to flag for them instances where there's nothing—no company's self-reported, no whistleblower claim has come in—but their computer software has said, "You'd better look at XYZ Company; it has some indicia of potential earnings management."

[AUDIENCE MEMBER:] They are borrowing from the NSA.

HARVEY KELLY: Yes, there you go. This poses an interesting challenge—and I agree with you—it's a much broader topic than we have for today. But one interesting challenge it poses for companies is that software has the possibility and the likelihood, of having both false positives—meaning it says this company has a problem when, in reality, it doesn't—and it has the likelihood, the SEC thinks, at least, of identifying some real problems that heretofore haven't been identified. Imagine yourself as a corporate director who says, you know, "Wow, all of a sudden we got a letter—my CFO or my general counsel tells me we got a letter from the SEC asking about some accounting question or our reserve levels or something. We have no reason to think there's a problem; there's not been a whistleblower letter or anything. This CFO, we

trust Charlie; he's been here for many years; he seems like a good guy; he always presents well in front of the board." Do you go immediately to outside counsel, because you've gotten this SEC question? Do you go out and hire independent people to look into it, or are you going to trust Charlie, when maybe Charlie's been cooking the books all along and pulling the wool over your eyes? It's really a delicate question, because you don't know whether you've got a false positive. Or maybe the software worked this time around, and, frankly, you won't even know. The SEC is not going to say, "AQM kicked you guys out; this is why we're asking the question"; you won't have a clue why they're asking the question—they're just asking it.

It really poses some very definite challenges, because there's one thing for sure: if you don't go the outside, independent route or seriously look into it, and it later proves to be a real problem, you're going to be Monday morning quarterbacked for sure.

CHRISTOPHER GARCIA: You're in a much worse situation. Apart from this hypothetical, which has all sorts of hair on it, just generally speaking, even short of having an identifiable accounting firm that you are affiliated with, the attention here by the SEC is just going to require everybody to think more about having plans to respond to the SEC. The SEC's approach in this space is going to be a lot like the approach they've taken previously. They're talking about not just using the AQM, but doing industry sweeps. They are talking about a robust attack of this space that I think means that the likelihood of you having some contact with the SEC, unfortunately, is much higher today in this space than it's been in the last ten years.

PAUL FERRILLO: There is one thing for sure. You guys have been a terrific audience. We thank you very much on behalf of Weil, Gotshal for participating in today's event. Thanks so much for coming and being with us today.

Kieran P. Hughes

Chartis Inc.
Vice President of Financial Lines Claims
New York, NY, USA

Kieran Hughes is Vice President of Financial Lines Claims at AIG. Kieran joined AIG in 2003 as a Complex Claims Director in D & O following a 17 year career practicing law during which he earned the designation of Certified Civil Trial Attorney. He also served a judicial clerkship in the Superior Court of New Jersey. Kieran was promoted to Senior Complex Claims Director in 2005 and to Assistant Vice President in 2006 before assuming responsibility for the Directors & Officers, National Accounts Claims unit in 2009. He is responsible for supervising and handling class actions, collective actions and high exposure claims including securities and employment practices liability claims. Kieran holds a Bachelor of Arts degree from Rutgers University with a BA in Journalism, Political Science and English Literature. He obtained his Juris Doctorate degree from Seton Hall University.

RICHARD S. LEVICK

ESQ.
CHAIRMAN & CEO

BIOGRAPHY

Under his leadership, LEVICK has set new standards in global communications and brand protection for corporations, countries, and major institutions. Mr. Levick is one of the communications industry's most important spokespersons and thought leaders.

A powerful advocate for the strategic initiatives that companies must pursue in today's perilous environment, he regularly addresses corporate boards as well as industry and government leaders around the world, providing guidance on their most complex communications and reputation management challenges. He is featured in, and authors, countless articles, and is a frequent guest on prime time national and international television programs.

Mr. Levick is a much-sought after keynote and graduation speaker and is a columnist for the top business blogs including *Forbes* and *Fast Company*.

Mr. Levick has co-authored four books including, *The Communicators: Leadership in the Age of Crisis; Stop the Presses: The Crisis and Litigation PR Desk Reference*; and *365 Marketing Meditations*.

EXPERIENCE

On a daily basis, Mr. Levick's prestigious team of professionals spearheads many of the world's highest-profile campaigns – including Guantanamo Bay; the Catholic Church; the Wall Street crisis; the Gulf oil spill, and some of the most important public affairs matters globally.

Mr. Levick sits on a variety of boards including the World Economic Forum's Partnering Against Corruption Initiative (PACI) and the National Foundation for Credit Counseling, and, through a Joint Business Relationship, he is an integral part of PricewaterhouseCoopers Anti-corruption Center for Excellence.

He is the past Director of American University's School of Public Affairs Leadership Program, and a former professor of crisis communications in the graduate school at Georgetown University in Washington, D.C. He lectures regularly at Harvard, Stanford and Georgetown Law Schools and West Point.

AWARDS & RECOGNITION

- Named for four consecutive years on the list of "The 100 Most Influential People in the Boardroom" by the NACD's *Directorship* magazine
- Several professional Halls of Fame for lifetime achievement
- Multiple other professional awards, including Crisis, Litigation, Investor Relations, and Food Crisis Communications Agency of the Year

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About AlixPartners

AlixPartners LLP is a global business advisory firm offering comprehensive services in four major areas: enterprise improvement, turnaround and restructuring, financial-advisory (including litigation and investigation) services and information-management services. The firm's specialty is urgent, high-impact situations when results really matter. Founded in 1981, the firm has more than 1000 professionals and 19 offices around the world. We can be found on the Web at www.alixpartners.com. Our Financial Advisory Services professionals serve a variety of clients and possess numerous industry disciplines, in areas such as corporate investigations, litigation consulting, valuations, transaction advisory, creditor advisory, intellectual property, and forensic and investigative accounting. Our Financial Advisory Services professionals assist legal counsel, board members, and corporate executives by:

- Providing expert testimony in court
- Conducting internal investigations related to corruption, accounting fraud, or other fraud
- Assisting with the establishment of effective risk management, compliance, and anticorruption processes, controls, and procedures
- Preparing valuation models and financial or economic analyses for the purposes of quantifying damages in antitrust and commercial litigation and disputes
- Utilizing electronic-discovery and other techniques in litigation or in situations in which financial or other data must be preserved, mined, reconstructed, or analyzed

- Performing economic and financial analysis in a broad range of issues involving litigation, antitrust, and other regulatory investigations
- Carrying out valuation analyses for mergers and acquisitions, financial reporting, bankruptcy and workout, and tax-planning services

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HARVEY R. KELLY
MANAGING DIRECTOR

Harvey is a Managing Director with AlixPartners, LLP responsible for the firm's Financial Advisory Services practice. He has over thirty years of experience as a financial consultant specializing in forensic investigations, litigation consulting, and auditing.

Harvey's experience includes extensive investigative and forensic accounting analysis related to financial reporting and transactional concerns. He has broad experience in financial reporting practices across a wide variety of industries.

Mr. Kelly has represented boards of directors, investors, creditors, and even the federal court in financial investigations. In connection with such matters, he has consulted with clients on SEC reporting implications, restatement of previously issued financial information, and loss recovery efforts. Among other issues, he has investigated financial reporting errors and fraud, potential violations of the Foreign Corrupt Practices Act, stock option practices, insider trading, ponzi schemes and related party transactions. He has been responsible for investigations in over 30 foreign countries.

Harvey possesses extensive experience in evaluating the propriety and adequacy of existing accounting policies and procedures and the internal controls intended to ensure compliance with stated policies. He has coordinated such efforts with company accounting personnel as well as internal and external auditors. In many instances, he has assisted with the design and evaluation of enhancements to accounting policies and internal controls as part of an entity's remedial efforts subsequent to discovery of internal control problems.

Mr. Kelly has also served as an independent monitor of companies' remedial efforts as required by Deferred Prosecution Agreements and Settlement Agreements with federal regulators. He has also served as a court-appointed Examiner in bankruptcy proceedings.

Harvey holds a Bachelor of Science degree in accounting from Pennsylvania State University. He is a certified public accountant, certified in financial forensics and a member of the American Institute of Certified Public Accountants. He has authored several articles on financial accounting, financial fraud, securities litigation and related matters. Harvey is also a frequent speaker on these topics.

Weil

Firm Overview

Weil, Gotshal & Manges LLP is a leader in the marketplace for sophisticated, global legal services. Weil's pioneering 'one firm' approach, including the integration of 21 offices, multiple practice areas, and approximately 1,200 attorneys worldwide, allows the Firm to partner with many of the world's most successful organizations on matters as complex and interconnected as the businesses themselves. Recognized by clients, the media and professional commentators as best in class, our lawyers are known for the clarity, timeliness and effectiveness of their counsel and, as a result, have become our clients' call of first resort for solutions to their toughest Corporate, Litigation, Regulatory and Restructuring challenges.

Paul A. Ferrillo

Paul Ferrillo is counsel in Weil's Litigation Department, where he focuses on complex securities and business litigation. He has substantial experience in the representation of public companies and their directors and officers in shareholder class and derivative actions, as well as in internal investigations. In particular, Mr. Ferrillo has coordinated numerous internal investigations on behalf of audit committees and special committees, and handled the defense of several significant securities class actions alleging accounting irregularities and/or financial fraud.

Mr. Ferrillo has represented companies in a wide range of industries, including retail, apparel, financial services, energy, oil and gas, and real estate. Among his recent notable matters, Mr. Ferrillo is part of the Weil team representing American International Group in securities class action litigation relating to the financial crisis, as well as the Weil team representing lululemon athletica in shareholder class and derivative litigation. He also was part of the team representing Kinder Morgan Inc. in the successful defense of shareholder litigation. Mr. Ferrillo's investigations experience includes work on behalf of the boards of Krispy Kreme Donuts and OM Group.

Mr. Ferrillo also has extensive experience in the area of directors' and officers' liability insurance issues by virtue of his prior employment with American International Group (AIG), in its major US underwriting subsidiary, National Union Fire Insurance Company of Pittsburgh, Pa. (the largest writer of D&O insurance in the US), where he held numerous senior-level positions in its claims and underwriting areas. He is recognized nationally as a leader on D&O insurance issues, and frequently counsels public companies and their boards of directors on a vast array of issues relating to the nature, extent, types and availability of all D&O and Management Liability Insurance-related products.

Mr. Ferrillo received his J.D. in 1989 from St. John's University School of Law, and received his B.S. in Accounting in 1986 from St. John's University.

Christopher L. Garcia

Christopher L. Garcia is a partner in the Firm's Securities Litigation and White Collar Defense and Investigations practices, where he focuses on defending companies and individuals in connection

with regulatory and criminal investigations, conducting internal investigations, and litigating securities class actions in state and federal courts across the US. He also counsels boards of directors, executives, broker-dealers, and others on securities and corporate governance issues, among other things.

Currently, Mr. Garcia represents numerous confidential clients in connection with alleged violations of the Foreign Corrupt Practices Act (FCPA); a former senior trader at a major financial institution in connection with the DOJ's ongoing criminal investigation into alleged manipulation of LIBOR; a former senior director at another major financial institution in connection with a CFTC investigation into alleged manipulation of ISDAFix,. Since joining Weil, Mr. Garcia has also represented General Electric Company and several of its senior officers in connection with securities class action litigation. Other representative clients include Morgan Stanley, Barclays, AIG, DirecTV, and Optimer Pharmaceuticals, Inc.

Prior to joining Weil, Mr. Garcia was Chief of the Securities and Commodities Fraud Task Force in the US Attorney's Office for the Southern District of New York. In this role, he led a unit of more than 35 prosecutors, law enforcement agents, and staff in all aspects of securities fraud investigations, trials, appeals, and other litigations. During his tenure, Mr. Garcia supervised the investigation and prosecution of more than 300 cases.

Mr. Garcia is a member of the bars of New York and Massachusetts and is admitted to practice in the US Court of Appeals for the Second Circuit and the US District Courts for the Southern and Eastern Districts of New York. He received his law degree from Harvard Law School, where he served as Senior Editor of the *Journal of Law and Public Policy* and as President of the Board of Student Advisers. He also received his A.B., *magna cum laude*, from Harvard College.

Ellen J. Odoner

Ellen Odoner heads the Firm's Public Company Advisory Group, which advises US public companies and US-listed foreign private issuers on corporate governance, SEC disclosure, financial restatements and internal control matters. She is one of the leaders of the firm's high-stakes corporate counseling team. She also specializes in merger and acquisition and securities transactions, particularly those with cross-border elements.

Ms. Odoner represents boards of directors, audit committees, special committees of independent directors, disclosure committees and legal and financial officers of US and non-US companies. She has extensive experience representing non-US companies in the US and in structuring multi-jurisdictional transactions to harmonize US and non-US regimes and obtain innovative SEC relief.

Representative transactions include GE's cross-border acquisitions of Wellstream plc and Amersham plc and $15 billion public capital raise and investment by Berkshire Hathaway; Tyco Electronics' cross-border reincorporation; Reuters' acquisition by The Thomson Corporation; Whirlpool's acquisition of Maytag; various acquisitions by L'Oreal S.A; Pirelli SpA's sale of its optical components business to Corning; and numerous acquisitions, disposals and demergers by non-US companies including Hanson plc, Invensys plc and BPB plc.

Ms. Odoner assisted the Financial Crisis Advisory Group established to advise the Financial Accounting Standards Board and the International Accounting Standards Board on the standard-setting implications of the global financial crisis. She is recognized in *Chambers USA, Best Lawyers in America* and in various other publications on both sides of the Atlantic.

Ms. Odoner earned her law degree at Harvard Law School and completed her undergraduate studies at Yale University, where she graduated *magna cum laude*.

Dana Kopper
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Professional Profile

Dana is a Senior Vice President with Lockton Companies, LLC, and the Director of the Governance Risk Management Group.

He has provided a broad range of governance and risk management consulting and transactional services to public, private, for-profit, and not-for-profit organizations for the past 31 years.

He is one of the country's leading D&O and professional liability brokers – a noted expert in the areas of directors' and officers' legal liability, investment management professional liability, governance infrastructure design, board effectiveness, director accountability, organizational compliance efficacy, and associated risk mitigation strategies.

Dana is also the co-chair of Lockton's Investment Management Advisory Group, advising international investment management, private equity, hedge funds, and mutual funds.

Prior to his career in risk and insurance management, Dana was a federal agent with the Office of Special Investigations (OSI) – criminal and counterintelligence.

Previous Positions

- Marsh and McLennan Companies
  Senior Vice President
  National Practice Leader – Advisory
  Chief Operating Officer – BoardWorks
  Principal – Mercer Delta

- Corroon & Black Corporation
  Region Head
  Public Entities National Company

Professional Designations and Affiliations

- Forum for Corporate Directors (FCD)
  Member, Board of Directors
  Chair, Governance Committee
- University of California, Irvine
  FCD Faculty Member
  Paul Mirage School of Business
  Governance Risk Management
- Corporate Directors Forum (CDF)
- Stanford University Directors College
- National Association of Corporate Directors
- Directors Roundtable
- Lecturer
  University of California, Los Angeles
  University of Texas
  Rice University
  Stanford University
  University of Delaware
  Directors Roundtable
  American Bar Association
  American Corporate Counsel
  Society of Corporate Secretaries
  Financial Executives International
  American Electronic Association
  California Biotechnology Summit
- Professional Liability Underwriters Society
- Certified Insurance Counselor (CIC)
- Associate in Risk Management (ARM)