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When companies investigate themselves: Too easy?

By Edward Iwata, USA TODAY

On a cool, blustery day in March at the Mandarin Oriental hotel in Washington, skeptical shareholders fired questions at UnitedHealth Group executives and their outside attorney.

UnitedHealth, a \$72 billion health insurer, was the largest company entangled in the stock-option backdating scandals. Prosecutors and regulators were investigating UnitedHealth's backdating practices, and the company's board had hired WilmerHale, a high-powered Washington law firm, to run an internal investigation.

Completed last fall, WilmerHale's inquiry found backdated options over 12 years and led to the ouster of longtime CEO William McGuire. UnitedHealth President Stephen Hemsley was named CEO.

Some shareholders still had doubts. UnitedHealth and legions of companies were investigating their own backdating practices. But shareholders wonder whether the investigations are hard-hitting or watered-down.

At the hotel, Hemsley, director James Johnson and Bill McLucas, a former SEC enforcement chief and the attorney in charge of the internal probe, spoke of the investigation and UnitedHealth's reforms, including adding five directors. They vowed the firm would be a corporate-governance leader.

Shareholders asked if the investigation was thorough and independent, according to McLucas and several others there. McLucas said he replied that WilmerHale had full access to people and documents.

Several pension-fund and corporate-governance officials later praised the executives. "We give them credit for taking swift action and improving their governance," says Dan Pedrotty, investment director of the AFL-CIO labor federation, with \$400 billion in pension assets.

Pressured by shareholders, prosecutors and regulators, and facing stiffer anti-fraud rules, 250 U.S. companies in the past year launched internal investigations into backdating, says proxy-research firm Glass Lewis. Attorneys say the backdating issue has spurred the most internal probes since the 1970s foreign-bribery scandals.

Internal and federal investigations into backdating have led to the ouster of executives from 40 firms, including Vitesse Semiconductor, Brocade Communications, Affiliated Computer Services, KB Home and Take-Two Interactive Software, says Glass Lewis.

Some attorneys, shareholders and corporate-governance experts praise internal probes for flushing out fraud, heading off potentially devastating government charges and leading to stronger oversight.

"A company's goal is to be an Eagle Scout, to reassure shareholders and the government that it's honest," says Nell Minow, founder of The Corporate Library investor-research firm.

But whether the investigations are unbiased probes, or are influenced by corporate officers and directors, has ignited debate.

"Some appear to be rigorous, while others appear to be coverups," says Ted White, a consultant and former director of corporate governance at the California Public Employees' Retirement System.


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The Securities and Exchange Commission and Justice Department view the investigations as valuable legal road maps for companies and the government.

"The SEC can't be in all places," says SEC spokesman John Nester, "so the fastest way to stop illicit behavior is for the company to take the first steps." If a company's probe is lacking, the SEC may broaden its own investigation of the firm, Nester adds.

UnitedHealth appeared to take its investigation seriously. After *The Wall Street Journal* wrote last year about backdating at UnitedHealth, the UnitedHealth board hired McLucas, who ran internal probes at Enron and WorldCom.

The half-year investigation found 29 stock-option grants over the past 12 years that likely were backdated, including 1 million options to McGuire and 500,000 options to Hemsley.

UnitedHealth announced a \$1.6 billion restatement, McGuire's departure and the promotion to CEO of 54-year-old Hemsley, former chief financial officer at Arthur Andersen. The board also formed a special litigation committee of two former Minnesota Supreme Court justices to review the firm's lawsuits and internal probe.

But shareholder and defense attorneys still fault UnitedHealth's investigation.

"Who was responsible for allowing the backdating to happen?" says attorney Karl Cambronne, who is suing UnitedHealth executives. "Was the board complicit in allowing management to reap extraordinary gains?"

Cambronne says the review went lightly on Hemsley. It said Hemsley played "a more limited role" in the option granting.

"Hemsley was the second-largest recipient of backdated options, and the penalty he suffers is a promotion to CEO," Cambronne says.

In a statement, McGuire's attorney, David Brodsky of Latham & Watkins, says that the options process was "transparent and appropriate," and that the WilmerHale investigation "disregarded many crucial facts en route to its faulty conclusion."

UnitedHealth's senior officers, directors and legal and accounting experts "never raised concerns at the time" about the options, Brodsky says. He says the board compensation committee was advised by attorneys and human-resource professionals, yet routinely backdated grants.

McLucas defends the investigation, saying he's "comfortable with our assessment of the facts" and UnitedHealth's "dramatic remedial actions." The investigation and reforms, he says, are stronger than what other companies have done with their backdating probes.

"From a governance perspective," he says, "this process worked precisely as it's supposed to work."

Internal investigations took off 30 years ago during the foreign-bribery scandals, when the understaffed SEC asked U.S. firms to investigate themselves and report their findings. Some 650 ran bribery investigations, and the SEC charged 65, says Stanley Sporkin, a former SEC enforcement chief and retired federal judge. "In effect, the companies that did internal investigations would get amnesty," he says.

A second wave of internal investigations hit during the Enron, Tyco, WorldCom and Fannie Mae scandals. Now executives must take their watchdog roles more seriously in light of the anti-fraud Sarbanes-Oxley Act, stricter industry accounting rules and shareholders' calls for stronger corporate governance. Directors also are liable in civil lawsuits if they don't monitor companies' legal and financial issues.

"No one wants to be second-guessed," says managing director Jerry Behar of Financial Intelligence, a consulting firm that specializes in SEC investigations.

But even as more companies police themselves, shareholders' attorneys and former regulators and prosecutors say that some firms — plus the outside attorneys and auditors hired to run internal probes — whitewash their investigations, shield executives and fail to find criminal wrongdoing.

Directors' ties

Ideally, directors are independent watchdogs of management. But most internal probes are overseen by directors who often are close to management, making a truly independent investigation unlikely, say attorneys and corporate-governance experts.

At Apple, for one, director and former IBM executive Jerome York served on a special committee heading Apple's internal probe into backdating — even though he sat on its compensation committee when some of the backdating took place.

"It's inconceivable to us how he could have been appointed by the board to serve on this investigative committee," says Mark Molumphy, a shareholders' attorney at Cotchett Pitre & McCarthy who has sued Apple executives for breach of fiduciary duty and fraud.

Shareholders' attorneys and corporate-governance experts also charge that Apple's investigative findings, disclosed in December, downplayed

the role of CEO Steve Jobs and other executives. The investigation, by law firm Quinn Emanuel Urquhart Oliver & Hedges, found that 6,400 grants may have been improperly backdated, including two large grants to Jobs in 2000 and 2001.

Apple said Jobs knew of the backdating and recommended favorable grant dates but did not benefit financially or "appreciate" the accounting significance. That was challenged last week by former chief financial officer Fred Anderson, who said he warned Jobs in 2001 that Apple might have to take an accounting charge on a large backdated grant to executives.

The SEC last week filed backdating-related charges against Anderson, who settled for \$3.5 million, and Apple's former general counsel Nancy Heinen, who denies the charges. The SEC praised Apple for its "extraordinary cooperation" and said it would not press charges against the company. The Justice Department continues to investigate Apple.

In corporate scandals over the years, judges have shown they expect independent, conflict-free investigations by companies.

In a 2003 ruling involving software firm Oracle, the Delaware Chancery Court allowed a shareholders' lawsuit to proceed after finding that a committee investigating inside-trading allegations against CEO Larry Ellison couldn't make unbiased decisions. Two panel members were Stanford University professors; Ellison had made donations to Stanford and a research institute with ties to the committee.

Many boards, though, form informal investigative committees that lack the legal accountability of special litigation committees.

"Most of those committees would not stand up in court," says attorney Eric Zagar at Schiffrin Barroway Topaz & Kessler.

Another seeming conflict in many corporate investigations: companies paying millions of dollars in legal fees to outside law firms that investigate the company. That makes law firms "hired guns and advocates for companies who pay their bills," says Lynn Turner, a former SEC chief accountant now managing director at Glass Lewis.

In the Enron scandal, for instance, Enron's longtime Houston law firm, Vinson & Elkins, was criticized for its internal probe of the now-defunct energy giant. A report by University of Texas Law School dean William Powers said the firm "should have brought a stronger, more objective and more critical voice to the disclosure process."

Shareholders' attorneys and corporate-governance experts also accuse companies of cloaking their investigations in secrecy; few full reports are ever released. More often, companies release summaries or brief reports of their findings.

In contrast to the backdating cases, boards in a few earlier, high-profile accounting scandals — Fannie Mae, Enron, WorldCom — released investigative reports hundreds of pages long.

Corporate counsel and defense attorneys say watered-down investigations are rarer than years ago. Many investigations are run by former prosecutors and regulators. Boards also are more conscientious, says former assistant attorney general Christopher Wray, a partner at King & Spalding. "People need to have confidence in the integrity and quality of the review," Wray says.

Pressure from government

The biggest catalyst for internal probes has come from the Justice Department and SEC. If businesses investigate their own and hand over their findings, the government weighs that favorably in deciding whether to charge companies.

Defense lawyers accuse the government of forcing firms to conduct costly investigations that last years. To appease the government, companies sometimes waive legal privileges that protect attorney-client confidentiality. Corporations also feel pressured to boot possibly innocent executives who haven't been charged, attorneys say.

"The government expects a company to investigate itself and to bear the costs of the investigation," says Robert Bennett, a partner at Skadden Arps who has represented Enron, HealthSouth and KPMG. "It's like legalized extortion."

A strong internal investigation can save a business, Wray says. No firm wants the fate of Enron's auditor, Arthur Andersen, convicted in 2002 of obstructing justice. The Supreme Court tossed the conviction, but Arthur Andersen had gone out of business.

And shareholders are closely watching the internal investigations. The AFL-CIO, for one, has had confidential talks with UnitedHealth, Home Depot and KB Home about their backdating issues, says the union's Pedrotty.

If backdating and other problems keep surfacing, internal investigations are unlikely to wane.

"In today's environment," says Frederick Krebs, head of the Association of Corporate Counsel, "the consequences of a mistake are much higher."