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Business As Usual: Pitfalls For The Unwary Corporate Counsel In The Post-Enron Era

By Karen Lee Turner and Vlad Tinovsky

The largest Chapter 11 filing in U.S. history by energy giant Enron Corp. has brought to light questionable document retention and accounting practices. As a result, reform is likely in the areas of securities laws, accounting and auditing practices, as well as other areas. As governmental agencies such as the Securities and Exchange Commission ("SEC") and the Department of Justice take issue with the document retention and accounting practices of Enron and its auditors, corporate counsel must be ready to identify the often illusive warning signs of these problems in its own backyard. This article will identify some issues related to document retention and accounting practices that can spell trouble for unwary corporate counsel in the post-Enron era. Spotting these potential pitfalls may be the difference between an ounce of prevention and a pound of cure, which could have a significant impact on a company's bottom line.

***Karen Lee Turner** is a Member of the Corporate and Bankruptcy Practice Groups in the Philadelphia office of Eckert Seamans Cherin & Mellott, LLC. Ms. Turner focuses her practice in bankruptcy, debtor-creditor relations, banking, and commercial law, including commercial litigation and lender liability. **Vlad Tinovsky** is an Associate in Eckert's Corporate and Bankruptcy Practice Groups. Mr. Tinovsky focuses his practice in general corporate, mergers and acquisitions, securities law and bankruptcy matters.© Eckert Seamans Cherin & Mellott, LLC.*

I. Effective Document Retention Policy

Most companies have a policy that governs the retention of documents before they are destroyed. Corporate counsel will likely be called upon to develop a document retention policy that is both effective and can be easily implemented, or to revise an existing policy to comply with the lessons of Enron. In structuring such a policy, careful consideration should be given to the way a company conducts business, applicable laws that may require the retention of certain documents, and the retention of electronic documents due to increasing reliance on computers and networks.[1]

Corporate counsel should also consider:

- emphasizing a clarity of statement and purpose;
- specifying the documents subject to the policy and exceptions thereto;
- varying retention periods for specific types of documents;
- designating responsible parties for maintaining the program and responding to inquiries; and
- establishing an audit procedure to ensure that the policy is implemented properly.[2]

Unfortunately, the true test of a document retention policy comes under the most unpleasant of circumstances, *i.e*., a governmental agency investigation or lawsuit. Corporate counsel should also be aware that following the retention policy might not provide a safeharbor for a company or its employees.[3] Accordingly, corporate counsel should take great care in structuring a document retention policy that is specific to the needs of a company and the particular problems it may face in the future.

II. The Smoke And Mirrors Of Accounting

Corporate counsel should also be aware of the dangers that may lurk in a company's financial statements. The seemingly endless sea of companies that have restated earnings due to the discovery of accounting irregularities provides important lessons for corporate counsel. The following is a glimpse of some questionable accounting practices that have received notoriety in recent weeks.

Off-Balance-Sheet Transactions. Corporate counsel should be leery of off-balance-sheet devices used to remove debt off the balance sheet. Enron artfully eliminated liabilities from its balance sheet through the use of off-balance-sheet entities. A similar effect was achieved by Krispy Kreme by its use of "synthetic leases" to hide debt while enjoying certain tax benefits. Other such tactics include the use of "sale-leaseback transactions" and "special purpose entities." Many of these transactions will be

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tucked away in the notes to the financial statements or other sections of a company's disclosure document. Regardless of the means, the use of such off-balance-sheet transactions may blur the picture of a company's financial position and render its financial statements materially misleading. Corporate counsel, and investors alike, should be mindful of this gimmick if terms like these riddle a company's financial statements or disclosure document.

Tracking and Accounting for Inventory. Properly tracking and accounting for inventory is another gimmick, which is particularly prevalent in the retail market. Generally, a company must write down inventory when it becomes obsolete or outdated. This write-down reduces margins because the retailer receives fewer revenues on an item whose cost remains the same. Companies, however, run afoul of this rule when they fail to write down such inventory, which has the effect of overstating margins. Many times this problem is overlooked or ignored because it is deemed immaterial by a company or its auditors. Corporate counsel should not be led astray, however, because the cumulative effect of many immaterial issues can result in the determination that the financial statements, as a whole, are materially misleading.

Questionable Reporting. The recent SEC action against Trump Hotels & Casino Resorts, Inc. highlights the need for proper reporting of items of income.[4] In this case, Trump Hotels reported a $17.2 million one-time gain from a termination of a restaurant's lease of space at the Taj Mahal Casino Resort as operating income, rather than reporting it as a separate item. The company's earnings release also came under scrutiny for attributing the positive results to operational improvements, decreased marketing costs and increased noncash revenues. The result was a restatement by Trump Hotels, which avoided a fine.

Enron also violated the most basic of accounting principles by recording equity from the receipt of a note, when equity can only be recorded when cash is received. As a result, Enron's unaudited financial statements overstated notes-receivable assets and shareholder equity by a total of $172 million and $828 million in 2000 and 2001, respectively.[5]

These are just a few gimmicks used to distort the financial position of a company, and are by no means an all-inclusive list. As one commentator noted, "Accounting, like all aspects of management, adds shareholder value. But management should not confuse finance with the revenue-generating business of the company."[6] Corporate counsel should be mindful of these and other gimmicks that could plague a company's financial statements. As recent restatements have shown, compliance with GAAP may not protect a company that has materially misled investors about its financial position.

This is not to say that all accounting irregularities arise from questionable accounting practices. Some accounting irregularities are the result of plain fraud. For example, in the Chapter 11 case of Phar-Mor, a drug store chain, the company overstated profits by more than $500 million through fictitious invoices and false accounting entries. False reporting of sales and receivables, however, can be detected quite easily if you know what to look for. Because cash does not actually result from fictitious sales, an inconsistency arises between the statement of cash flows and the income statement. Corporate counsel should be aware that trouble might be lurking if a company has high levels of income but comparably low levels of cash on hand.

III. Take Action Before You Receive A Subpoena

Government investigation and prosecution of cases like Enron is bound to increase, and if corporate counsel should discover deficiencies in the company's document retention policy or any accounting irregularities, remedial action should be taken immediately.

On October 23, 2001, the SEC issued a report entitled "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement" ("Section 21(a) Report").[7] The Section 21(a) Report explains the circumstances under which the SEC will give "credit" to companies, officers and directors for cooperating with its investigations. Corporate counsel should familiarize herself with this report, which may prove useful in developing a suitable document retention, policy or when dealing with the discovery of accounting irregularities.[8]

However, corporate counsel should be cognizant of some pitfalls associated with blind adherence to the Section 21(a) Report. Compliance is often expensive and time consuming. In addition, waiver of the attorney-client privilege and work-product protection may result from sharing the results of an internal investigation with the SEC.[9]

IV. Conclusion

The post-Enron era calls for corporate counsel to be more alert then ever when dealing with document retention and accounting practices of a company. Adding the above issues to her lexicon will provide a good starting point for corporate counsel to identify potential problems and formulate solutions palatable to both the company and corporate counsel.

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[1] See *Michael R. Overly,* Electronic Document Retention: Reducing Potential Liability For Email, E-DISCOVERY & PROCEDURE, *v. 1, no. 7 (December 2000).*

[2] Id. *at p. 4.*

[3] See Jordan v. Paccar, Inc., *1996 U.S. App. LEXIS 25358 (6th Cir. Ohio Sept. 17, 1996), where the court noted that "some document retention policies may be so unreasonable as to constitute other 'misconduct' that could justify granting a motion for a new trial under Rule 60(b)(3)."* See also Lewy v. Remington Arms Co., *836 F.2d 1104, 1988 U.S. App. LEXIS 83, CCH Prod. Liab. Rep. P11662, 24 Fed. R. Evid. Serv. (CBC) 516 (8th Cir. Mo. 1988), where the trial court instructed the jury that it could infer that missing documents were unfavorable to a gun manufacturer notwithstanding the manufacturer's compliance with a policy of destroying documents after three years absent any action concerning such documents. On appeal, the court did not determine whether this instruction was given in error, but remanded the matter with additional factors for consideration before the trial court gave this instruction again.*

[4] SEC Release No. 45287 (Jan. 16, 2002).

[5] *How Accounting Establishment Is Responding to Enron Debacle,* FINANCIAL EXECUTIVES NEWS, *p. 4 (February 2002).*

[6] David Priebe and Henry C. Montgomery, *Enron Provides Lessons on Audits for Accountants & Public Companies,* LEGAL BACKGROUNDER, vol. 17, no. 14 (Mar. 8, 2002).

[7] SEC Release No. 44969 (Oct. 23, 2001).

[8] See generally Richard S. Smith and Edward B. Whittemore, *"Cooperation Counts" - The Message of the Commission's Recent Section 21(a) Report*, THE METROPOLITAN CORPORATE COUNSEL (January 2002).

[9] See Daniel J. Kramer, SEC Guidelines Credit 'Cooperation'; Steps Can Be taken to Avoid or Mitigate Penalties For Accounting Irregularities, NEW YORK LAW JOURNAL (Feb. 4, 2002).