REPORTING UP-THE-LADDER: UNCLEAR CASE LAW CREATES TOUGH DECISIONS

Scenario One

The chief financial officer at Company A decides to fraudulently inflate the bottom line to show a profitable fourth quarter. He tells the controller that the $10 million in employee options can legally be classified as a private placement, which is not true. The general counsel has no knowledge, nor did he participate in the scheme. Later, the general counsel finds out about the scheme, but fails to immediately tell the board or the CEO.

Scenario Two

The chief financial officer at Company B engages in the same fraudulent scheme. This time the general counsel finds out about it, but agrees, wrongly, that the options can be classified as a private placement. He fails to report the scheme to the board because he doesn’t think it’s illegal.

So, which general counsel is more likely to face civil prosecution by the Securities and Exchange Commission under the Sarbanes-Oxley Act?

Not sure? Join scores of other attorneys who—two-plus years after the Act’s passage—still can’t say for sure what the SEC would do.

The uncertainty stems from the fact that there is no case law on the lawyer’s duty to report up-the-ladder. And without case law, the subjectivity built into the wording of the rules remains just that—subjective. What is certain, though, is that lawyers are now on the SEC’s radar screen.

“Younder this new law, lawyers are among the SEC’s newly crowned gatekeepers for public accountability,” says Douglas R. Young, partner at Farella Braun + Martel LLP. “Lawyers are being viewed by the SEC in the same way as auditors. They are charged with trying to keep the company from committing fraud and breaching its fiduciary duty. The SEC is putting lawyers in a much more proactive role.”

According to the SEC’s own enforcement director, in the past two years lawyers were named as defendants or respondents in more than 30 enforcement actions. Despite the heightened scrutiny, many lawyers are still not sure what their duties are under the new law.

Young spoke to a gathering of in-house counsel at a March Association of Corporate Counsel, San Francisco Bay Area Chapter meeting, “Corporate Counsel & Sarbanes-Oxley: Recent Developments and Practical Tips on Dealing with the Dilemmas of "Reporting Up" and Internal Investigations.”

“Without a doubt, the most common question we get is, ‘Are we doing it right?’” says Young.

Young interpreted this section to mean that a lawyer must report up-the-ladder when a prudent, competent lawyer would conclude there is credible evidence of a violation.

Fagel reminded the audience of the new gatekeeper role of the attorney by citing the recent case against Google. In January 2005, the SEC charged Google and its General Counsel, David C. Drummond, with failure to register over $80 million in employee stock options. The federal securities laws require companies issuing over $5 million in options during a 12-month period to provide detailed financials to recipients or register—thereby publicly disclosing financial and other information. The Commission further found that Drummond was aware that the registration and related disclosure obligations had been triggered, but believed that Google could avoid providing the information to its employees by relying on an exemption from the law. The exemption was, in fact, inapplicable.

Duty of the Chief Legal Officer

When a reporting attorney informs the chief legal officer of a potential material violation, Young recommends that the CLO launch an inquiry. “It’s probably best that the lawyer have a record showing that he or she did something, rather than sweeping the situation under the rug or turning his or her back on it. The Commission wants the lawyer to exercise his or her judgment.”

If the company has a legal compliance committee, the lawyer may want to turn the inquiry over to the committee. But the committee must have been established before the event occurred.

“One advantage of having a legal compliance committee is that you avoid a conflict issue,” says William P. Keane, partner at Farella Braun + Martel. “Without a legal compliance committee, the audit committee is usually involved in the investigation, but its members are also often witnesses.”

If the chief legal officer determines no violation has occurred, it is ongoing, or is about to occur, he or she needs to notify the attorney who reported the alleged violation.
If there is a problem, and the chief legal officer does nothing to remedy the problem, or fails to respond in a reasonable amount of time, the reporting attorney must then report the matter to the audit committee or to the full board of directors.

And if the audit committee or board do nothing? Under the new rules, 205.3 and 205.2, the lawyer can go to the SEC. But for many lawyers this poses a problem. For instance, under California Business & Professions Code section 6068(e) an attorney is required to keep confidential his or her client’s communications. To go to the SEC and report the problem would violate this code section. “I’m not aware of any state that allows attorneys to violate this privilege and report after-the-fact to the SEC,” says Keane.

The SEC maintains that Part 205 trumps state law. On the other hand, the California State Bar states, “While the Part 205 Rules purport to preempt state law, the preemption issue has not been resolved by any court and is currently the subject of much debate.”

One way to handle the conflict without violating privilege is for outside counsel to resign. In January 2005, the SEC brought an action against TV Azteca, S.A. de CV, its parent company and three current and former employees. The SEC asserts that the CEO personally profited in certain related-party transactions without disclosing those transactions to the SEC. TV Azteca’s outside counsel repeatedly advised the company that disclosure of the profits, which exceeded $100 million, was, in fact, required. In the face of the company’s refusal to disclose, its outside counsel resigned, explaining in a confidential memo to the company’s board and management that its resignation was consistent with its obligation under section 307 of the Sarbanes-Oxley Act. This confidential memo was leaked to The New York Times, which led to the SEC investigation.

“Resignation may be the only option for a lawyer,” observed Fagel.

INTERNAL INVESTIGATION

In many cases, the inquiry into whether a material violation has occurred will require an internal investigation. Such an investigation might also win the good graces of the government.

“The first question we get from the SEC is ‘What did you do to prevent this from happening?’” says Young.

The company also needs to determine who will supervise or oversee the investigation. “Will it be the bar, legal compliance committee or the audit committee?” queries Keane.

“In considering whether to conduct an investigation into a matter, there are particular accounting areas that should raise red flags for the company,” says Kenny L. Francis, a forensic accounting partner at Deloitte & Touche, LLP. Francis suggested three financial accounting and reporting areas for the general counsel to pay particular attention to: revenue recognition, expenses and also accruals and reserves.

Improper revenue recognition is one of the most common reasons for internal investigations and accounts for the highest percentage of restatements.

“Watch out for hidden side agreements between the company and a customer that may impact when a company reports revenue,” she says, “or a contingent agreement that allows a customer to pay when they get financing rather than when payment is due.”

If a general counsel hears questions raised about how expenses are recorded, that, too, should prompt an inquiry. “For example, look for under-reporting of expenses when invoices are held and not recorded timely.”

For accruals and reserves, a general counsel should follow up when he or she hears reports of “cushions in accruals” or “bleeding reserves back into the p&l” which may indicate that extra reserves are being released to the income statement.

HIRING OUTSIDE COUNSEL

If evidence of material violation is raised through a government inquiry, subpoena or search warrant, it’s time to seek outside counsel.

“It’s preferable to work with an outside law firm that does not have a prior relationship with the company or the financial deals at issue,” advised Keane. The firm should also have experience handling this type of matter.

In hiring outside counsel, the scope of the investigation should be spelled out in the engagement letter. A number of other issues should be addressed by outside counsel at the outset, including timing, the budget, evidence preservation and the team. “The

waiver of privilege. The class-action plaintiffs in California obtained the report; the federal class-action plaintiffs did not because the issue was mooted on appeal before production. Other state courts in related class actions have ruled to the contrary, upholding McKesson’s privilege despite disclosure.

“Let me just say, the SEC has been receiving fewer written reports,” says Fagel.

SO WHAT WOULD THE SEC DO?

So do you have the answer to the opening scenario? While not a Part 205 case, a recent case brought by the San Francisco district office of the SEC may shed some light on how the SEC might analyze a Sarbanes-Oxley matter.

In September 2004, the district office brought an enforcement action against John E. Isselmann, Jr., the former general counsel of a publicly traded company, Electro Scientific Industries, Inc. It charged the general counsel with a violation of Rule 13b2-2 of the Exchange Act for failing to provide important information to ESI’s audit committee, board of directors and auditors regarding a significant fraudulent accounting transaction that enabled ESI to report a profit rather than a loss. The SEC didn’t claim that Isselmann participated in the scheme to boost profits, nor that he knew about the fraud. However, the SEC found that after he learned of the fraud, Isselmann’s failure to report the transaction up-the-ladder constituted a violation of the securities laws. In his settlement with the SEC, Isselmann neither admitted nor denied the agency’s allegations. Then 35 years old, the lawyer agreed to pay a $50,000 civil penalty and consented to a cease-and-desist order.

“As this case suggests, the SEC is not going after the malpractice cases where the lawyer makes a mistake,” says Fagel. “An attorney who doesn’t see an issue is less problematic than one who sees it and disregards it.”

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