AFTER ENRON: SEC COMPLIANCE, DISCLOSURE AND ENFORCEMENT CHALLENGES IN THE NEW ERA

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Jonathan C. Dickey and Steven Buchholz

Gibson, Dunn & Crutcher LLP

Palo Alto, California

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I. RESTATEMENTS, EARNINGS MANAGEMENT, AND OTHER FINANCIAL SCANDALS HAVE PROMPTED WIDESPREAD SEC ENFORCEMENT, LEGISLATIVE AND RULEMAKING ACTIVITY

All Enron, All the Time

Even before the currently unfolding disasters of Enron and Global Crossing, we have witnessed an enormous number of new and highly visible accounting debacles visited upon public companies. Notorious accounting problems at Cendant, Waste Management, Livent, Rite-Aid, Microstrategy, Informix, McKesson HBOC, and other public companies have prompted aggressive SEC enforcement responses, and in some cases criminal indictments. The losses in market capitalization caused by such accounting scandals is staggering. The market cap loss for Microstrategy alone was $11.9 billion, and for McKesson it was $8.8 billion.[1] The class action settlements in cases involving some of these companies averaged well in excess of $100 million. In Cendant's admittedly unique circumstances, the settlement was in excess of $3 billion. The Enron-related government investigations are clearly the most high-profile of a growing number of no-holds-barred enforcement actions. And there is no clear "bottom" yet to where the enforcement, rulemaking and legislative efforts will go.[2]

To what can we attribute this explosion of enforcement activity? A major cause has been the fact that many companies have been restating their financial results due to the discovery of serious accounting manipulations by management and others, sometimes with catastrophic consequences. FEI reports that the number of public company financial restatements jumped significantly beginning in 1998, from an average of 49 restatements per year in the period 1990 to 1997, to an average of 150 per year in 1999 and 2000. The largest number of these restatements by far are attributed to revenue recognition problems. Even adjusting for special circumstances of some of these restatements,[3] the trend of restatements has been troubling. In addition to continuing to aggressively pursue issuers and their directors and officers who commit fraud, the Commission now may begin targeting the customers, distributors and other third parties who sometimes are involved in the sales or other activity that is at the heart of these

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[1] "Quantitative Measures of the Quality of Financial Reporting," Financial Executives Research Foundation (June 2001).

[2] As but one example, the California state legislature is now holding hearings on whether additional state law protections and reforms should be enacted, including the liberalization of a private party's right to sue accountants for alleged wrongdoing, without the requirement of privity. Among the testifying experts before the state assembly in February 2002 was William Lerach of Milberg Weiss Bershad Hines & Lerach.

[3] In 1999, for example, the SEC initiated a major inquiry into alleged financial statement manipulations in the form of write-downs of in-process research and development costs ("IPRD"). In response to the SEC's initiative, many companies determined to restate their prior period financial results. In 1999, this accounted for 57 known restatements, in addition to the 150 "other" restatements reported that year.

accounting manipulations—and bring enforcement actions against them as "aiders and abettors."[4]

Invariably, a publicly disclosed restatement also triggers the filing of civil class action lawsuits under the Private Securities Litigation Reform Act. According to a recent study by PricewaterhouseCoopers LLP, the majority of recently-filed securities class actions under the PSLRA are accounting cases—53-54% in 1999 and 2000. In accounting cases brought in 2000, 66% involved alleged revenue recognition violations. In that same year, accounting cases settled for an average of $20.7 million.[5]

In light of Enron, an argument now being advanced by plaintiffs' counsel and shareholder advocates is that the growth in the number of class actions involving accounting fraud or restatements is a direct by-product of the PSLRA's alleged elimination of liability for accounting firms. Under this theory, the elimination of "joint and several" liability except in cases of "knowing" securities fraud made it impractical to sue accounting firms, since the claims against the auditors would be subject to the PSLRA's "proportionate liability" rules, and thus unlikely to produce a "deep pocket" verdict. Without any threat of being sued, plaintiffs' argue, the accounting firms chose to "look the other way", comfortable in the knowledge that they wouldn't be sued if their audit clients pursued overly-aggressive accounting practices. But an equally plausible explanation is that many restatements can be traced to tougher audits, and to more conservative accounting pronouncements and guidance from the SEC and the governing accounting industry standard-setting organizations. No real empirical evidence has been advanced to show that the Big 5 accounting firms have simply defaulted on their audit responsibilities due to the absence of "joint and several liability".

Government Beefs Up Its Enforcement Tools

Not surprisingly, the accounting scandals of the last few years have led to coordinated efforts by the SEC Enforcement Division and the U.S. Department of Justice to combat accounting fraud. The SEC has publicly stated that the number of open investigations relating to financial statement improprieties represents a sizeable increase over prior years, and that currently there are nearly 260 open accounting investigations.[6] In 1999 alone, the Commission brought actions against 120 corporate officers and employees in cases involving alleged acts of accounting fraud. In that same year, the Commission brought 90 financial fraud enforcement actions, of which 44 involved either improper revenue recognition, or booking fictitious sales. The Commission also created a Financial Fraud Task Force, which focuses on companies, their management and auditors, where the Staff believes that the financial statements may reflect improper earnings management or other GAAP violations.

In addition to the heightened level of SEC enforcement scrutiny, the possibility of a criminal indictment has increased, as the Commission now pursues many of its investigations in

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[4] E. McDonald and D. Kruger, "Aiding and Abetting," Forbes Magazine (April 2, 2001)

[5] PricewaterhouseCoopers LLP 2000 Securities Litigation Study (June 2001).

[6] "SEC List of Accounting Fraud Probes Grows," *Wall Street Journal*, July 6, 2001.

parallel with the U.S. Attorney's office.[7] Even before Enron, the Justice Department's lead Enron lawyer, Leslie Caldwell, was well known to defense lawyers in Silicon Valley for her tough enforcement efforts targeting criminal fraud in the "high tech" sector.[8]

In light of Enron, SEC Chairman Harvey Pitt has stated that it is a priority to expand the Commission's enforcement staff and resources, and to increase budget, in order to pursue enforcement investigations more aggressively and expeditiously. The era of "real time" enforcement is now upon us. As Director of Enforcement Stephen Cutler recently said, "real time enforcement focuses on conducting investigations and bringing enforcement actions more quickly than ever before." He added that parallel criminal prosecutions "are, in our view, terribly important to achieving deterrence, and, in the long run, investor protection."[9]

Congress and the White House Get in the Act

Bills, Bills, Bills. The legislative reaction to Enron has been swift and furious, with overheated committee hearings and public tongue-lashings of virtually all participants—including the spectacle of key witnesses being forced to assert their Fifth Amendment privileges before the world. Various bills have been introduced on both sides of the aisle, chief among them H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 ("CARTA"), introduced by Congressman Oxley, who chairs the House Financial Services Committee. Some of the pending bills can be seen as well-intentioned efforts to respond to the perceived enforcement "gaps" that Enron highlighted, while others as a thinly-disguised attempt to dilute or eliminate altogether some of the key protections afforded to public companies and their officers and directors under the Private Securities Litigation Reform Act of 1995 ("PSLRA").[10]

The Oxley bill would, *inter alia,* direct the SEC to create a "Public Regulatory Organization" or "PRO" to oversee the accounting profession, which would a) be self-funded, b) be capable of reviewing the quality of audits, c) have rulemaking and disciplinary authority, and d) be composed of two-thirds members from outside the accounting profession. The Oxley bill

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[7] *See, e.g.,* "SEC Goes Criminal on Fraud," National Law Journal (May 1, 2001) (reporting on the SEC's efforts to cooperate with U.S. Attorneys nationwide).

[8] Ms. Caldwell is profiled in the article "When the Numbers Just Don't Add Up," *New York Times,* August 19, 2001.

[9] Remarks of Stephen M. Cutler, Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002).

[10] Among the other pending bills are the Corporate and Criminal Fraud Accountability Act of 2002 (Sen. Leahy); the Investor Protection Act of 2002 (Sen. Shelby); the Accountability for Accountants Act of 2002 (H.R. 3617, Rep. Markey); the Securities Fraud Prevention Act of 2002 (H.R. 3644, Rep. Conyers); the Shareholder and Employee Rights Restoration Act of 2002 (H.R. 3829, Rep. Stupak); the Independent Investment Advisers Act of 2002 (H.R. 3671, Rep. Hastings); the Auditor Independence Act of 2002 (H.R. 3693, Rep. Jackson-Lee); and the Comprehensive Investor Protection Act of 2002 (H.R. 3818, Rep. LaFalce).

also would prohibit audit firms from providing audit clients with either IT consulting or internal audit services. The bill would make it unlawful for any officer or director of an issuer to "willfully and improperly influence, coerce, manipulate or mislead any accountant performing an audit for the purpose of rendering the financial statements being audited materially misleading." On the topic of disclosure, the Oxley bill would direct the SEC to develop new rules for "real time" reporting of financial and operational information, and to consider modifying rules to require the reporting of key accounting principles, *and explain how these key accounting policies were selected.* With regard to insider trading, the Oxley bill, like several other bills, would require immediate disclosure of insider trades, which most practitioners do not oppose. Chairman Pitt recently testified before the Oxley Committee, and expressed qualified support for the Oxley reform package. In some cases he observed that the SEC already has the powers sought by the bill to deter fraud, such as pursuing enforcement actions based upon lying to auditors. The Oxley bill would give the SEC exclusive civil enforcement authority over acts involving improper influence on audits.

Ironically, some of these proposed legislative reforms favoring "real time" disclosure come at the same time that many industry and legal groups, independent of the Enron scandal, are advocating changes to existing SEC Regulation FD, which requires certain kinds of material information to be disseminated via Form 8-K or press release, in order to avoid selective disclosure. On February 1, 2002, the ABA Committee on Federal Regulation of Securities issued its report on Regulation FD, proposing various changes to the Regulation. Importantly, the ABA Report on Regulation FD was critical of the SEC’s perceived coupling of Regulation FD disclosure requirements to the materiality standards enunciated in the SEC’s Staff Accountancy Bulletin No. 99 (“SAB 99”). The Report observed that when SAB 99 is imposed on top of the pre-existing case law definition of materiality, “the concept of materiality may be too blunt and imprecise a standard to trigger affirmative disclosure obligations under a rule with the broad reach of Regulation FD.” The Report also commented that SAB 99’s materiality standard “introduces unwarranted uncertainty . . . and can be ascertained only with the benefit of 20/20 hindsight.”

Where the legislative debate will go is unclear as of press-time for this article. The mark-up session for the Oley bill on April 11 was contentious, with no less than 40 amendments in the offing. The hearing adjourned with the Financial Services Committee having taken up only sixteen of those amendments, and the Committee will reconvene on April 16. Early indications are that the House will not report out a bill with very many radical amendments from the version of H.R. 3763 originally introduced.[11] Ironically, perhaps, many of the Democratic amendments were designed to eliminate the SEC's ability to rulemake on particular topics, but rather to arrogate that power to the Congress.

The President's Ten Point Plan. In tacit recognition of the importance of the Enron-related legislative debate, the White House issued its own "Ten Point Plan". On some issues, the President's position is to recognize the existing authority of the SEC to review and propose

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[11] *See* "Republicans Rebuff Democrats on Accounting Oversight Bill", National Journal News Service (April 11, 2002).

appropriate rules. At least one area where that is not the case, and where the President supports the concept of new legislation, is to permit the SEC to bar officers of public companies from continuing to serve, and to impose such "director bars" through administrative proceedings, without need to bring an action in federal district court. As discussed below, that is a topic of some controversy within the legal community. The President's "Ten Points" are:

- Each investor should have quarterly access to the information needed to judge a firm's financial performance, condition and risks.
- Each investor should have prompt access to critical information.
- CEOs should personally vouch for the veracity, timeliness, and fairness of their company's public disclosures, including their financial statements.
- CEOs or other officers should not be allowed to profit from erroneous financial statements.
- CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions.
- Corporate leaders should be required to tell the public promptly whenever they buy or sell company stock for personal gain.
- Investors should have complete confidence in the independence and integrity of companies' auditors.
- An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards.
- The authors of accounting standards must be responsive to the needs of investors.
- Firms' accounting systems should be compared with best practices, not simply against minimum standards.

The White House has established a "President's Working Group", led by Treasury Secretary Paul O'Neil, that is reviewing and considering all pending proposals, and is coordinating with the SEC.

New Corporate Governance Guidelines and "Best Practices"

With the upsurge in congressional and SEC activity, it should be obvious that public companies, their top officers, and their audit committees should take steps to look critically at their existing corporate governance and compliance standards. As the Enforcement Division has declared on more than one occasion, the Division is particularly focused on wrongdoing by senior management personnel, and on situations where senior management, either directly or via an overly aggressive "tone at the top," has pushed subordinates to violate accounting rules in order to achieve analysts' expectations, to mask adverse trends in the business, or to otherwise manage earnings. Strong corporate governance and compliance programs are one of the "cures"

for these kinds of ills. As will be discussed in Part IV below, such "self-policing" programs also may serve as a basis for avoiding corporate liability in the event of an enforcement problem.

Underscoring these new corporate governance challenges in light of Enron, the American Bar Association recently announced the creation of a Task Force on Corporate Responsibility, to examine issues affecting investor confidence in public companies and their boards.[12] In addition, the Business Roundtable, which has in the past played a leadership role in the development of "best practices" for boards of directors in the area of corporate governance, has issued its own statement setting forth six basic principles of corporate governance that should be considered by boards of directors in light of Enron, which can be summarized as:

- The Board's duty is to oversee management.
- It is the responsibility of management to run the company on a day-to-day basis, and senior management needs to have a deep understanding of the company's business and risks.
- It is the responsibility of management to produce accurate and reliable financial statements.
- The Board and the Audit Committee are responsible to ensure that a good audit occurs, and that nothing impairs independence of the outside auditor.
- It is the outside auditor's responsibility to make sure it is independent in fact, and be both timely and complete in its disclosures to the audit committee of any concerns.
- The Company has a duty to operate employee benefit plans fairly and equitably.[13]

Modified Listing Standards. Other corporate governance standards may be developed as a result of the re-consideration and modification of listing standards by the major stock exchanges. On February 12, 2002, Chairman Pitt sent a letter to the New York Stock Exchange and NASDAQ, in which he outlined possible areas for new or improved listing standards, including:

- Requiring formal codes of conduct for public company officers and directors.
- Requiring “compliance mechanisms” to ensure that directors and officers follow existing standards and ethical codes.

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[12] A Gibson, Dunn & Crutcher LLP partner, John Olson, is among the panel of experts named to the Task Force.

[13] Statement of the Business Roundtable on Corporate Governance Principles Relating to the Enron Bankruptcy (Feb. 11, 2002).

- Considering further training and education for directors and officers.

- Requiring that audit committees have inclusive authority to hire and fire outside auditors.

The NYSE already has formed a Special Committee on Corporate Accountability and Listing Standards. On April 12, the NASD announced that it, too, is intending to issue new corporate governance rules, including rules requiring shareholder approval of executive stock option grants (see the discussion on stock option reforms below). In the private sector, Financial Executives International also is reviewing a recommended code of conduct for financial executives.

Proposed Stock Option "Reform." Following Enron, the drumbeat has started to reform the compensation practices of public companies, most significantly in the area of executive stock options. So long as management is compensated for "hitting the numbers," the argument goes, the motivation for "earnings management" will exist. Of course, just a few years ago, institutional investors clamored for "pay for performance" compensation policies – *exactly* so that management's interests would be aligned with shareholders' interests, through the achievement of revenue and earnings growth, and increases in share price. Eliminating stock options, or requiring public companies to expense them on a current basis, does not necessarily eliminate motives to manipulate earnings.

Chairman Pitt has stated that he opposes current proposals to require public companies to expense stock options on their financial statements, a move strongly opposed by business groups, particularly in the high tech sector. However, acknowledging the fact that stock option grants sometimes have resulted in executive compensation rewards that appear to be out of sync with companies' underlying performances, Chairman Pitt also has announced a proposal to strengthen the requirements for granting executive stock options. His April 2002 proposal has three components:

- A special committee comprised of independent directors would be required to decide whether to grant options to senior management.

- Any and all stock option plans that include grants for officers and directors should be submitted for shareholder approval.

- The award of stock options should be tied "in the main to the long-term performance of companies."

On the last point, Chairman Pitt elaborated: "corporate boards would do well to consider whether officers should be required to demonstrate sustained, long-term growth and success before they can actually exercise any of their options."

Many details of the various stock option reform proposals remain unresolved. If a public company was faced with the possible departure of key employees, for example, and wanted to use stock option grants as part of a package of compensation emoluments to retain these key employees, would the company need to wait six months or more for shareholder approval in order to make the option grants? How often would a company need to go to shareholders, and at

what cost? Would a "shelf" shareholder approval be sufficient, leaving the specific grants to individual employees within management's discretion? Is the problem one of dilution, or is it more than that? These questions and more are still being debated as this article goes to press. It is noteworthy that major opinion-makers are expressing strong opinions on both sides of the issue. A very recent example is an editorial opinion from Warren Buffett, in which he strongly supports the notion of expensing stock options, and took issue with industry's reluctance to accept this approach.[14]

What Boards Can Do Now. A veritable cottage industry of analysis has been spawned by Enron on the subject of what Boards and Audit Committees now should do to review and strengthen their policies and practices. Our own guidance can be distilled into four main recommendations:

- Boards and audit committees should tailor their policies and procedures to their own companies and the specific issues and risks facing those companies.
- Board and audit committee review of policies and procedures should focus on the adequacy of staffing, and on regular communication with management, outside auditors, internal auditors, and finance personnel.
- The audit committee should be fully and consistently briefed on critical accounting policies, and in particular any policy that requires the exercise of subjective accounting judgments and the use of estimates. As well, the audit committee needs to review off-balance sheet financing, or other material contractual relationships, whether or not falling within the traditional boundaries of "related party" transactions.
- Audit committees should maintain flexibility in their charters to focus on any matters that are important to the company's business, operations, and financial risk profile, whether or not strictly a matter of accounting.

We do not believe that extensive revision to audit committee charters is necessary or desirable for the typical public company—although the various stock exchanges are themselves exploring the degree to which the financial literacy requirements for audit committee members may need to be changed or strengthened.

A more complicated question to ask—and for which there is no "one size fits all" answer—is how financial manipulations typically occur, and how audit committees, auditors and shareholders can prevent such manipulations from happening. Legal commentators, scholars,

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[14] W. Buffet, "Stock Options and Common Sense," Washington Post p. A19 (April 9, 2002).

and the financial press are beginning to delve more deeply into this area, but so far only at the level of generalities.[15]

A critical area for corporate boards to begin asking questions is on the subject of how the company guides the analyst community, and how it strives to achieve analysts' consensus estimates. The "results-oriented" school of accounting – the unceasing need to "beat the street" – is often one of the root causes of financial fraud. The received wisdom in Silicon Valley is that material end-of-quarter transactions are necessary and expected. Yet it is frequently these very kinds of transactions that involve the most aggressive sales practices and creative accounting. The quarterly earnings cycle is itself a function of the SEC-mandated periodic reporting regime, and will persist so long as that the SEC reporting requirements continue to foster the "predict and reveal" pattern of reporting financial results. Undoubtedly Chairman Pitt's "real time disclosure" rulemaking initiatives will spark further debate on the wisdom of the current disclosure regime, and the practicality of any alternative models.

Directors also can ask themselves, "do our corporate disclosures really explain our business, where we're going, and what our risks are?" If the company's story isn't being explained—or is overly "bare bones"—perhaps there are more questions to be asked of management. Examples of what a director reading a company's SEC filings might want to see addressed include:

- How understandable are the company's reported financial results? Is the MD&A vague in explaining quarterly trends?

- How does the company actually make money? How much of that money is cash? Are there material variances between revenues and cash flow? If so, why?

- Are the company's business and revenue heavily price-sensitive, relationship-dependent, or otherwise subject to material adverse impacts that can be dictated by one or a handful of competitors, customers or suppliers?

- Have mergers added value, or have they disguised problems? How have mergers made it difficult to make comparisons to prior period results?

In the final analysis, attentive and involved auditors, audit committees and CFOs are the first, last and best line of defense against financial fraud. No single set of corporate governance guidelines will guarantee that the right questions are always asked at the right time. Parallels to Delaware corporate governance standards can be drawn. For years, the "business judgment rule" has mandated that directors make informed decisions based on adequate information that has been timely presented and considered. In the context of major corporate transactions, Delaware courts examine, *inter alia,* how much time the Board devoted to the matter, and the Board's use of and reliance upon inside and outside experts and professional advisors. While the parallels are

[15] A. Rappaport, "To Avoid a Tumble, Look for These Red Flags," *Wall Street Journal* (Feb. 25, 2002).

not always exact, many of the current reform initiatives seem to emphasize similar goals for directors in addressing day-to-day accounting and business issues, namely to: a) spend more time on their jobs, b) understand the details of the company's business better, c) have greater dialogue with management, and d) exercise greater independence, energy and professional skepticism.

II. RECENT AND PROPOSED SEC RULEMAKING DIRECTED TO AUDIT COMMITTEES, AUDITOR INDEPENDENCE, AND ACCOUNTING POLICIES AND PRACTICES GENERALLY

Recent Rules and SEC Releases on Audit Committees, Auditor Independence and Accounting Policies

In 1999 and 2000, the Commission promulgated several new rules and regulations designed to impose greater accountability on audit committees of public companies, and to insure the independence of outside auditors. Chief among these new rules are the rules on audit committees announced in December 1999.[16] In addition, effective November 15, 2000, the Commission adopted new auditor independence rules, which include certain required disclosures and procedures to be followed by audit committees in assessing the independence of the outside auditors.[17] Finally, the SEC also has issued Staff Accounting Bulletin Nos. 99, 100, and 101, on the subjects of materiality, restructuring and impairment charges, and revenue recognition. In SAB No. 99 in particular, the Staff set forth pointed guidance on how companies must use qualitative as well as quantitative judgments in determining the potential materiality of corporate events—and made it virtually impossible for companies to continue using any "rules of thumb" that certain accounting items could be ignored because they were quantitatively immaterial.

A more recent SEC Release, unrelated to Enron, addresses the use of "pro forma" financials.[18] This SEC guidance is clearly a "warning shot" that in the current era of depressed earnings and a troubled economy, companies that are tempted to report quarterly earnings on a basis other than GAAP proceed at their own peril.

In light of Enron, in the past few months the SEC has issued several significant releases on disclosure-related topics. In the first release, the SEC underscored the importance of making detailed disclosure of related-party transactions. *See* SEC Release Nos. 33-8056, 34-45321 (Jan. 22, 2002). The audit committee is urged to take an expansive view of what constitutes a "related party" transaction, focusing on "sweetheart" deals that may not fall strictly within the definition of a "related party."

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[16] SEA Release No. 34-42266, 17 CFR Parts 210, 228, 229, 240.

[17] SEA Release Nos.33-7919, 34-43602, 35-27299, IC-24744, IA-1911, and FR-56. As an example of recent SEC enforcement activity challenging auditors' independence, see *In the Matter of Arthur Andersen LLP,* SEA Release No. 44444 (June 19, 2001) (imposing sanctions on AA in connection with its audit of Waste Management) [discussed in Section IV below].

[18] *See* Release Nos. 33-8039, 34-45124, and FR-59 (Dec. 4, 2001).

In the second release, the SEC strongly states that public companies should, in MD&A, disclose their most critical accounting policies. *See* SEC Release Nos. 33-8040, 34-45149 (Dec. 12, 2001). As Chairman Pitt recently observed, every public company has "three, four, or five ... critical accounting policies upon which its financial status depends, and which involve the most complex, subjective, or ambiguous decisions or assessments."[19] The Release emphasizes several key points in determining what to disclose as a "critical" accounting policy. A company's "critical" policies are those that a) are the most important in portraying the company's financial condition and results, and b) require the company's most difficult, subjective or complex judgments. This ideally includes "the uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions."

The spirit of the SEC's pronouncements on critical accounting polices seems *not* to be, "disclose the GAAP accounting principle," but rather, disclose the subtler areas of accounting judgment that a company's finance staff in the past had a tendency to implement without detailed discussion even with the Audit Committee, much less in any public disclosure. An example would be the basis upon which a company determines its reserve for product returns: is it based on historic returns? If the products are sold through distributors, are there levels of "channel inventory" that the company views as typical and customary? Is there a relationship between the return reserve and some average number of weeks of channel inventory? How is the reserve affected by new product releases? At a minimum, these are questions that the Audit Committee should ask. Management should be able to defend the quality and reasonableness of its judgments underlying the given policy. Of course, if there are areas of "gray", the SEC now encourages public companies and their auditors to consult with the SEC accounting staff.

New Rulemaking Proposals

On February 13, 2002, the SEC announced its intention to issue new corporate disclosure rules, some of which could have a material impact on current practices, and potentially create new—and perhaps unintended—burdens and liabilities.[20] Specifically, the SEC intends to propose new rules that will:

- accelerate the reporting of insider trades
- accelerate the filing of 10-Ks and 10-Qs
- require the posting of SEC periodic reports on companies' websites
- require disclosure of critical accounting policies

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[19] Testimony Concerning Legislative Solutions to Problems Raised by Events Relating to Enron Corporation, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Feb. 4, 2002).

[20] SEC Press Release 2002-22 (Feb. 13, 2002).

- expand the kinds of information that must be disclosed via Form 8-K

Of the proposed areas for rulemaking, the last two appear to be the most significant. The particular events or circumstances that the SEC includes in its press release as possible topics for disclosure on Form 8-K are in some cases frighteningly vague, and potentially a fertile ground for future litigation (e.g., "any material events"). Whether these two areas will result in near-term rulemaking remains to be seen. In the meantime, the SEC already has issued specific rulemaking proposals on the first three items mentioned above.[21] It will be many months before the full scope of possible SEC rulemaking becomes apparent.

Public Accountability Board. The SEC has advocated the creation of a new Public Accountability Board, funded by the private sector, with responsibility for auditor and accountant discipline and quality control, and led by persons independent from the accounting profession. It is anticipated that specific rulemaking proposals for the Accountability Board will be issued by mid-May. Despite the SEC's support for the creation of a new Public Accountability Board, Chairman Pitt has publicly opposed the concept that public accounting firms should be barred entirely from performing non-audit services for their audit clients. The current House debates over the Oxley bill include the question of whether Congress will set the rules of engagement for the POB, or rather leave that to the POB itself to decide.

"Real Time Disclosure." In a speech last fall, Chairman Pitt outlined his vision for a "real time disclosure" regime that would replace the current quarterly report system of disclosure: "In the system we envision, companies would assume an affirmative obligation to disclose unquestionably significant information *whenever it arises and become available*. ..." [Speech to the Consumer Federation of America Financial Services Conference (November 29, 2001)]. Clearly this approach would represent radical surgery on the existing disclosure system, and in the view of many defense counsel would drastically increase the amount of "fraud by hindsight" class action litigation based on second-questioning of when a public company "should have" disclosed "significant information."

Director and Officer "Bars". Omitted from the February 13 announcement of the SEC's intended areas for future rulemaking is the topic of SEC authority to impose "director bars" in administrative proceedings. This idea was publicly advocated by the SEC's Director of Enforcement, Stephen Cutler, in a speech on February 15, 2002. As he noted, the Commission's current authority to do this is problematic, and therefore he said that "Congress could also help in this area by granting the Commission the authority to impose officer and director bars in

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[21] *See* Release Nos. 33-8090 and 34-45742, 17 CAR Parts 230, 239 and 249 (Apr. 12, 2002) (addressing accelerated reporting of insider trades); Release Nos. 33-8089 and 34-45741, 17 CAR Parts 229, 240 and 249 (Apr. 12, 2002) (addressing accelerated filing of 10-Ks and 10-Qs and posting of SEC periodic reports on companies' websites).

administrative proceedings."[22] We assume that if such authority is to be sought, it will be through congressional action, as opposed to rulemaking.

Defense practitioners already have begun to voice serious objections to the proposal. Many defense lawyers note that the SEC's ability to obtain such relief in an administrative proceeding is not subject to the same due process rights for a defendant as exists in a federal district court action. Moreover, the appellate remedy is impractical, since it may require a defendant to pursue a federal district court action to challenge the administrative action, with no mandatory stay of the "bar order" in the meantime—requiring, in effect, that an officer or director step down from his or her post while seeking a district court appeal, which itself would be subject to a more stringent "arbitrary and capricious" standard of review.

Finally, giving the SEC a director and officer "bar" remedy in administrative proceedings does not really address the substance of the SEC's articulated complaint, which is that director and officer "bars" allegedly are hard to obtain because the judiciary has applied too conservative an interpretation of the Securities Enforcement Remedies Act and Penny Stock Reform Act of 1990. As Director Cutler noted in his speech, the Act requires, *inter alia,* a finding that an individual officer's or director's conduct "demonstrates substantial unfitness to serve as an officer or director." The SEC contends that contrary to several reported court decisions, this statutory language should be interpreted as a "first strike" rule, that does not require any showing that the conduct in question is likely to recur. Perhaps there is room for legislative reform with respect to this standard—but providing the SEC with the ability to seek such director and officer "bars" in administrative proceedings does not in and of itself solve this problem of statutory construction.

The prognosis for this SEC proposal is unclear, but its chances of success have been strengthened by the fact that it has received White House support. Indeed, one item in the President's "Ten Point Plan" is an explicit call for this additional legislation.

Lawyer Liability. Finally, among the calls for SEC rulemaking is a March 2002 letter from a group of law professors, (including one who will serve on the ABA Task Force noted above), calling for enhanced liability for outside lawyers who advise public companies found liable for securities fraud. These professors urge the Commission, through its existing authority under SEC Rule 102(e), "or another Commission rule", to require a lawyer to inform the board of directors if the lawyer knows that the client is violating the securities laws and senior management does not "promptly" rectify the violation. The letter concludes that "after promulgating such a rule requiring the lawyer in such a situation to go up the ladder all the way to the board of directors, the Commission should enforce it vigorously and consistently."[23] We view such a "lawyers liability" proposal to be seriously flawed. The SEC already has issued a letter indicating that it is unlikely to take up the proposal for increasing liability rules in this area.

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[22] Remarks of Stephen M. Cutler, Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002).

[23] March 2002 letter to Chairman Harvey Pitt, signed by nineteen law professors from such law schools as Harvard, Stanford, Yale, Cornell, NYU, and UVA.

III. RECENT SEC ENFORCEMENT ACTIONS INVOLVING HIGH-PROFILE FINANCIAL FAILURES

Although there is bound to be prolific enforcement activity related to Enron, this will not be new territory for the SEC: following are just a few recent SEC enforcement cases launched by the Commission in the last three years involving high-profile financial failures. Prominent among them is the SEC's most recent high-profile case brought against the former management of Waste Management, filed on March 26, 2002, discussed below.

A. In the Matter of Waste Management Inc.

The opening sentence of the SEC's 138-page complaint filed against Waste Management's former management in March 2002 provides the most succinct statement of the government's case: "This action concerns a massive financial fraud motivated by greed and desire to preserve professional and social status."

Waste Management, now known as WMX Technologies, was alleged to have entered into a fraudulent scheme to inflate its financial statements during the period 1993 to 1996. The aggregate effect of the false inflation was to increase Waste Management's reported pre-tax earnings by $1.4 billion, and to understate its associated tax expense by hundreds of millions. The company allegedly used improper accounting to inflate income and other aspects of its financial statements, primarily by deferring recognition of current period operating expenses into the future.

In February 1998, Waste Management announced that it was restating its financial statements for the five-year period 1992 to 1996, and the first three quarters of 1997. According to the SEC, this restatement represented the largest restatement in the Commission's history. The restatement came about after top management left the company in late 1997, and new management commissioned a review of the company's prior period financials.

As a result of its investigation, the SEC initially brought and settled an enforcement action against Waste Management, including a cease-and-desist against future violations. The SEC's Order noted the "prompt response of the company" to investigate the facts surrounding the restatement. The Order also notes the company's cooperation during the course of the investigation. *See* SEA Release No. 34-42968, June 1, 2000.

On March 26, 2002, the SEC filed a federal complaint against six former members of senior management at Waste Management alleging securities fraud, filing false periodic reports, falsifying books and records, and lying to the outside auditors. The action names former Chairman and CEO Dean Buntrock; President, COO and CEO Phillip Rooney; CFO James Koenig; CAO and Controller Thomas Hau; General Counsel Herbert Getz; and Vice President of Finance Bruce Tobecksen. According to the complaint, every financial officer at Waste Management from its inception in 1971 through 1997 was formerly an auditor at Arthur Andersen. The complaint seeks a variety of forms of relief, including injunctive relief, disgorgement, civil money penalties, and permanent bars against all defendants from serving as directors and officers of public companies.

Finally, in earlier related proceedings, the Commission announced cease-and-desist resolutions against Waste Management's outside auditors. In those settlements, the Commission imposed severe sanctions against the accounting firm and four of its individual audit partners, which it characterized as the first antifraud injunction against a Big 5 accounting firm in more than 20 years, and the largest ever civil penalty ($7 mil) against a Big 5 accounting firm. Besides the civil penalty, the sanctions include: 1) an injunction and cease-and desist against the accounting firm, including express findings of violations of the anti-fraud provisions of the 1934 Act by the firm and its individual audit partners; 2) formal censure (i.e., a finding that AA was "lacking in character or integrity or...engaged in unethical or improper professional conduct"); and 3) prohibition against practicing as a CPA before the Commission, for periods ranging from one to five years. The Commission made express findings that AA had "failed to stand up to management to prevent the issuance of materially misstated financial statements." *See* In the Matter of Arthur Andersen LLP, SEA Release No. 44444, June 19, 2001, SEC v. Arthur Andersen LLP, et al, Release No. LR-17039, June 19, 2001, Robert G. Kutsenda, Walter Cercavschi, Edward G. Maier, and Robert E. Allgyer, Lit. Release No. 17039, June 19, 2001.

B. Xerox Corporation, Lit. Rel. No. 17465, April 11, 2002

The Commission filed a civil fraud injunctive action against Xerox Corp. in the Southern District of New York on April 11, 2002, alleging violations of the antifraud, reporting, and record keeping provisions of the federal securities laws. Xerox agreed to a settlement of the enforcement action, which relates to alleged accounting misstatements by Xerox that have been under investigation since June of 2000. Under the terms of the settlement, Xerox will pay a $10 million civil penalty (the largest ever imposed by the Commission for financial reporting violations), restate its financial results for the years 1997-2000, and appoint a special committee composed of outside directors to review the company's accounting controls and policies.

Xerox sells most of its products and services under bundled contracts that typically include equipment, service, supplies, and financing components. According to the complaint, during the relevant time period Xerox used a variety of accounting actions to allow a greater portion of revenue to be recognized immediately, in violation of GAAP. The actions allegedly taken by the company to artificially improve operating results include the improper use of reserves, the improper recognition of gains, and various improper lease accounting related actions. The restatements called for under the settlement reportedly will reflect changes in revenue recognition for leases, and could involve a reallocation of equipment sales revenue of more than $2 billion. The restatements will also include adjustments that could exceed $300 million related to reserves and other items.

The Commission stated that it is continuing its investigation of other parties with involvement in Xerox's financial statements from 1997 to 2000. On April 10, 2002, the Wall Street Journal reported that at least six individuals have received Wells notices indicating that the Commission intends to file civil enforcement actions against them related to the Xerox enforcement action. Among those potentially being targeted are former Xerox Chairman Paul Allaire, former Xerox CFO Barry Romeril, and KPMG partner Michael Conway, one of the partners formerly responsible for the independent audit of Xerox's financial statements. KPMG was replaced as the company's independent auditor in October of 2001. According to the Wall Street Journal, the Xerox case is seen by the Commission as "one of the most serious accounting

cases in recent years," and sends a message that the Commission is "serious about combating accounting fraud in the wake of the Enron scandal." The Xerox case may also be seen as a test of the Commission's ability to successfully investigate and take enforcement action against a company that provides very little cooperation. Xerox, which has stated that it cooperated fully with the SEC while at the same time exercising its legal rights to protect the company's interests, at one point challenged the Enforcement Division's actions by going to the Commission's accounting branch. The challenge was rejected.

C. Cendant (formerly CUC), Admin. Proc. No. 3-10225, June 14, 2000

During a twelve-year period, certain members of CUC's senior and middle management engaged in a complex scheme to inflate the company's operating income, with the alleged goal of always meeting Wall Street analysts' earnings expectations. Beginning in the mid-1980s, CUC management would, at the end of each fiscal quarter, compare the company's actual financial results with analysts' expectations. If the actual results fell short of expectations, management directed mid-level financial reporting managers to add whatever amounts were necessary to raise results to the expected levels. These transactions were maintained independently from CUC's accounting records, and were used as the basis for consolidated financial reports.

As the difference between actual and reported revenues grew, CUC management turned to manipulating recognition of the company's revenues to increase reported earnings. This practice was augmented by the improper maintenance of inadequate balances in two sales-related liability accounts. In addition to understating liabilities from certain sales, CUC management would occasionally reverse these liability accounts directly into revenue.

As CUC's sales grew, it became increasingly difficult to manufacture the necessary increases in revenue to meet previous years' levels and expectations. In the mid-1990s, CUC began a series of mergers and acquisitions, providing management with the opportunity to tap reserves associated with these transactions in order to further inflate revenues. Reserves associated with any given transaction were artificially inflated without regard to actual liabilities, and CUC management subsequently reversed these reserves into income at the end of the fiscal year. Additionally, in fiscal years 1996 and 1997, CUC management inflated income by ignoring the impairment of certain CUC assets.

The CUC earnings manipulations eventually were discovered following CUC's merger with HFS Incorporated. Management of the surviving company (Cendant) discovered the fraud in April 1998. Cendant announced the need to restate its financial statements on April 15, 1998. In the three days following the April 15, 1998 announcement, Cendant lost over $11 billion in market value.

The SEC responded vigorously to Cendant's announcement. Cendant entered into a cease-and-desist agreement with the SEC. The Commission also brought civil actions against former CUC CEO Walter Forbes and former CUC President and COO Kirk Shelton, seeking cease-and-desist orders, disgorgement, civil money penalties, and permanent bars against either person serving as officers of public company. Criminal actions also were commenced against CUC's former CFO, Corigliano, former Controller Pember, and the former Vice President of

Accounting, Sabatino. All three pled guilty to wire fraud and conspiracy to commit wire fraud. Sabatino entered into a cease-and-desist agreement with the Commission, as well as a permanent bar against his acting as an officer or director of a public company. In February 2001, a Grand Jury indicted Forbes and Shelton.

Mid-level financial reporting managers were subject to cease-and-desist orders, disgorgement of any ill-gotten gains, payment of civil penalties in the $35,000-40,000 range, and a minimum five-year ban against appearing before the Commission as an accountant. SEC actions against lower-level financial reporting CUC employees generally involved cease-and-desist agreements, three-year bans on appearing before the Commission as an accountant, and payment of a $25,000 civil penalty.

D. Livent, Inc. Admin. Proc. No. 3-9806, January 13, 1999

Between fiscal year 1990 through the first quarter of 1998, former senior management of Livent allegedly engaged in a complex accounting fraud scheme designed to misappropriate funds for their own use, disguise production costs of certain theatrical productions, and inflate revenue. Fund misappropriation allegedly was achieved through the payment of inflated invoice amounts for services rendered to Livent, with the overpaid amounts then returned in substantial part to members of Livent's management.

Livent management inflated revenue by transferring production costs for certain theatrical performances into fixed-asset accounts, increasing the time frame over which those costs were expensed. Livent management augmented this process at the end of each fiscal quarter by removing certain expenses and liabilities from the company's books. Further, Livent entered into a series of licensing transactions that essentially obligated Livent to return all monies paid. In order to conceal their activities, Livent management routinely lied to the company's auditors, providing them with falsified records.

In August 1998, new members of Livent's senior management discovered the existence of certain side letters relating to licensing transactions. A rapidly-conducted investigation uncovered additional evidence of accounting irregularities, and on August 10, 1998, Livent disclosed the accounting irregularities to the public, the SEC, NASDAQ, and the Toronto Stock Exchange. Following a more thorough investigation, Livent issued restated financial statements on November 18, 1998.

The restated financial reports reduced net income for the covered period by over $98 million (Cdn). Livent's stock dropped 95 percent in post-restatement trading, resulting in a market-value loss of $100 million (US).

An SEC investigation followed Livent's restatement. Livent settled the Commission's claims by agreeing to a cease-and-desist order. The SEC filed a civil action against former Livent Chairman and CEO Garth Drabinsky, seeking a cease-and-desist order, assessment of monetary penalties, and a permanent bar against serving as an officer of a public company. The U.S. Attorney also filed a criminal action against Drabinsky, alleging 16 felony violations of securities laws. Identical actions were brought against Myron Gottlieb, the company's former President.

Gordon Eckstein, Livent's former Senior Vice President of Finance and Administration, and Maria Messina, Livent's Chief Financial Officer, settled the SEC's claims against them by agreeing to cease-and-desist orders, and both pleaded guilty to one count of felony violation of the securities laws. Former Livent General Counsel Jerald Banks entered into a cease-and-desist agreement and paid a $25,000 fine.

A final twist to the Livent saga: on March 5, 2002 a federal district court ruled that Drabinsky and Gottlieb could not seek indemnification against sixteen other parties by way of cross-claims and third-party complaints, holding that "permitting claims of indemnification for alleged perpetrators of fraud would run counter to the paramount policy objectives of the securities laws to punish violators and to deter fraudulent conduct." The district court also denied these officers the rights to assert contribution claims against the sixteen other parties, "because the Court has already determined that many of them could not as a matter of law be liable to plaintiffs [shareholders] for securities fraud and because the Court has already dismissed them from the action." Finally, the Court invoked the so-called "fugitive disentitlement doctrine" to hold that because of the egregiousness of the conduct of Drabinksy and Gottlieb, it would be improper to "absorb the resources of this Court and the parties for their benefit."[24]

E. Informix Corp., Admin. Proc. No. 3-10130, January 11, 2000

Between fiscal years 1994 through 1996, and the first quarter of 1997, employees of Informix, including salespersons and members of management, allegedly engaged in a series of fraudulent activities designed to inflate the company's earnings in order to meet analysts' expectations.

Attempting to recognize revenue within a given quarter, Informix employees were allegedly to have routinely backdated software licensing agreements, despite the fact that those agreements were not signed until the following quarter. Informix employees also allegedly entered into side agreements with software resellers that negated a substantial amount of the revenue for Informix's software licenses. On occasion, Informix employees allegedly paid resellers fictitious consulting or licensing fees, which would then be returned to Informix as payment for software licenses.

The SEC alleged that as it became increasingly difficult to meet analysts' expectations, Informix's reliance on side letters increased, and Informix employees continued to improperly booked the revenue from these sales. Additionally, according to the Commission, Informix employees improperly recognized revenue from a variety of other questionable transactions. Informix's periodic financial reports between fiscal years 1994 through 1996, and the first quarter of 1997, were falsely inflated due to these alleged accounting improprieties.

On March 31, 1997, Informix filed its Form 10-K for 1996, which included disclosures concerning some of the improper sales transactions. The following day, Informix announced

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[24] *In re Livent Securities Litigation*, Nos. 98-CV-5686, 98-CV-7161, 99-CV-2292, and 99-CV-9425; 2002 U.S. Dist. Lexis 3854 (S.D.N.Y. Mar. 5, 2002).

that revenues for the first quarter of 1997 would be $59 million to $74 million below revenues for the same quarter of 1996. This announcement caused a substantial drop in Informix stock price, resulting in a drop in market capitalization from $2.3 billion to $1.5 billion. Acting on a tip from a former employee, Informix began an investigation into some 20 suspect transactions. Informix management allegedly attempted to limit the scope of the inquiry in an attempt to prevent a restatement. Their attempts were unavailing, according to the Commission, and on November 18, 1997, Informix restated its financial statements for fiscal years 1994 through 1996.

The following day, Informix restated its financial statements for each interim quarter of 1996 and the first quarter of 1997. The restatements identified $114 million of accounting irregularities, mostly involving resellers. Due to the pervasiveness of reseller irregularities, Informix and its auditors determined that all such transactions for the three-year period ended 1996 should be restated to defer revenue recognition until the software was resold to end-users.

Informix's restated financial figures reduced net income for the covered period by approximately $236 million. Informix's stock price dropped 60 percent in post-restatement trading, leading to a market-value loss of over $1.5 billion.

Following Informix's restatement, the SEC conducted an investigation into the accounting irregularities. Informix entered into a cease-and-desist order with the SEC, and agreed to provide the SEC with requested information regarding the suspect transactions.

The SEC filed a separate civil action against former Informix Vice President Walter Königseder, charging him with directing Informix's revenue overstatements. The U.S. Attorney also filed a criminal action against Königseder, charging him with wire fraud and criminal securities violations. On May 23, 2001, the Commission obtained a default judgment and permanent injunction against further violations of the Exchange Act after Königseder, a German national, failed to respond to the SEC's complaint. The criminal action against Königseder has yet to be resolved. The SEC's investigation as to other unnamed individuals and entities is continuing.[25]

F. McKesson HBOC, Inc., 126 F.Supp.2d 1248, Sept. 28, 2000

In October 1998, McKesson announced a pending merger with HBO & Company (HBOC), a healthcare software company. In November 1998, McKesson registered shares for the combined company, McKesson-HBOC, with the SEC. As part of the registration process, McKesson filed a registration statement that included information from HBOC's financial statements. On November 27, 1998, the two companies solicited proxies through a joint proxy statement and prospectus in order to obtain the necessary shareholder approval to consummate the merger. This joint prospectus contained the same HBOC financial information included in McKesson's SEC registration statement. Shareholder approval was obtained, and the merger

[25] One of the former officers of Informix was represented by the author of this paper in connection with the Commission's investigation.

was effectuated on January 12, 1999, at which time the McKesson-HBOC stock traded at $89.50 per share.

On April 27, 1999, McKesson-HBOC announced the discovery of more than $42 million in improperly-recognized revenue that needed to be reversed. These accounting errors, all originating from HBOC, involved the improper booking of contingent sales transactions. Certain HBOC executives concealed contingencies in software sales contracts in side letters, which were hidden from HBOC's accounting staff. Certain transactions were backdated, to allow them to be booked within the preceding fiscal quarter. Additionally, these HBOC executives made fraudulent journal entries designed to understate expenses and inflate HBOC's net income.

At the time of the April 27, 1999, announcement, McKesson-HBOC disclosed a pending audit, and the possibility that other improperly booked contingent sales might be discovered. Within 24 hours of this disclosure, McKesson-HBOC stock dropped from the previous day's close of $65.75 to $35.50, resulting in a loss of $9 billion dollars in market value.

On July 14, 1999, McKesson-HBOC issued a press release detailing the audit's results. Disclosed were over $327 million in improperly-recorded transactions, of which at least $50 million were not likely to become recognizable sales. McKesson-HBOC then filed restated financial statements with the SEC on July 16, 1999.

In October of 2000, the SEC commenced civil actions against two former HBOC executives who participated in the improper revenue recognition. The Commission charged HBOC's Co-Presidents and Co-CFOs Jay Gilberston and Albert Bergnozi with directing in the above-described fraudulent activities, as well as unjustly enriching themselves with bonuses tied to HBOC's financial performance, and sales of HBOC stock at prices inflated by their fraud. The Commission is seeking cease-and-desist orders, disgorgement, possible civil monetary penalties, and permanent bars against either person serving as an officer of a public company. Criminal actions also have been commenced. As of this writing, these civil and criminal actions have not been resolved.

Concurrent with the filing of actions against Gilberson and Bergnozi, the SEC settled its complaint with HBOC's Vice President of Enterprise Sales Dominick DeRosa, who agreed to a permanent injunction against future violations of SEC regulations and the disgorgement of $361,528 in ill-gotten gains, as well as a civil penalty of $50,000. DeRosa also agreed to be barred from serving as an officer or director of a public company for five years.

G. MicroStrategy, Admin. Pro. No. 3-10388, Dec. 14, 2000

MicroStrategy began operations in 1989, providing software consulting services and custom-designed database management software. As the company's business matured, MicroStrategy began concentrating on the development and sale of data-mining and decision-support software.

By 1996, software license sales made up the majority of MicroStrategy's revenue. MicroStrategy licensed its software through its sales department, resellers, and original equipment manufactures. Overall, MicroStrategy's revenues derived from three sources: 1) product licenses; 2) maintenance and technical support fees; and 3) consulting services.

MicroStrategy went public in June 1998. Soon after its IPO, MicroStrategy entered into a series of larger and more complex transactions involving software sales and software development and consulting services. By the end of 1998, MicroStrategy began to develop an information network (Strategy.com), designed to provide personalized news, weather, traffic, and financial information to subscribers.

During the development and licensing of Strategy.com, MicroStrategy improperly recognized revenue from certain types of software sales. MicroStrategy delayed signing of several software licensing arrangements in order to apportion revenue between fiscal quarters. Additionally, MicroStrategy improperly booked revenue from complex service agreements when these agreements were entered into, rather than recognize revenue as the services were provided.

On March 20, 2000, MicroStrategy announced that it would restate its reported financial results for fiscal years 1998 and 1999. The restated results, which eventually included fiscal year 1997, reduced revenues by almost $66 million. In the weeks following the March 20 announcement and the subsequent restatement of fiscal year 1997, MicroStrategy’s stock dropped from a high of $333 per share to $33 per share. Overall, the restatements resulted in an overall market loss of over $11 billion.

In the wake of the restatements and the precipitous drop in MicroStrategy’s stock price, the SEC conducted an investigation into the company’s accounting procedures. MicroStrategy entered into a cease-and-desist agreement with the SEC, and agreed to establish several internal accounting provisions designed to prevent future violations.

MicroStrategy's top three officers, Michael Saylor, co-founder and CEO; Sanjeev Bansal, co-founder and COO; and Michael Lynch, former CFO; agreed to cease-and-desist orders, disgorgement totaling $10 million, and the payment of $350,000 each in civil penalties. Antoinette Parsons, MicroStrategy's Controller, Director of Finance and Accounting, and Vice President of Finance, entered into a cease-and-desist order, as did her subordinate accounting manager Stacy Hamm.

H. Sunbeam Corp., Admin. Proc. No. 3-10481, May 15, 2001

From the last quarter of fiscal 1996 until June 1998, Sunbeam senior management engaged in fraudulent accounting practices designed to create the illusion of a successful restructuring of that company. Sunbeam management sought to inflate the company's stock price and improve its value as an acquisition target.

To achieve that end, management improperly created $35 million in restructuring reserves as part of a 1996 restructuring. These reserves were then reversed into income the following year. In 1997, Sunbeam management booked revenue from guaranteed sales, improper "bill and hold" sales, undisclosed acceleration of sales, and other fraudulent practices.

Unable to find an acquirer by the end of 1997, and faced with a deteriorating financial condition, Sunbeam management increased the use of improper accounting practices. Sunbeam recognized revenue from additional accelerated sales, deleted certain corporate records to conceal pending merchandise returns, and misrepresented Sunbeam's performance and future prospects to the public, financial analysts, and lenders.

Negative statements about the company's sales practices promoted Sunbeam's Board of Directors to begin an internal investigation in June 1998. The investigation resulted in the termination of Sunbeam's CEO Al Dunlap, CFO Russell Kersh, and other members of senior management. Sunbeam then issued revised financial statements for the fourth quarter of 1996 through the first quarter of 1998, reducing fiscal 1997's reported income by 50 percent. After the restatement's release, Sunbeam's stock fell from a March 1998 high of $52 to approximately $7.

An SEC investigation resulted in Sunbeam entering into a cease-and-desist order. The Commission has filed a civil action against both Dunlap and Kersh, seeking a permanent injunction against further violation of the securities laws, and a permanent bar against either person serving as an officer of a public corporation. The SEC settled an administrative action against former Executive Vice President, General Counsel, and Secretary David Fannin, who agreed to a cease-and-desist order. The Commission also has sued the former controller, Robert Gluck, the former V.P. of Marketing, Donald Uzzi, the former V.P. Sales, Lee Griffith, and one of the outside audit partners of Sunbeam from Arthur Andersen, Phillip Hanlon.

I. In re Aurora Foods, Admin. Proc. No 3-10407, January 24, 2001

Aurora Foods, the maker of such retail brand-name foods as Duncan Hines, Aunt Jemima, Mrs. Pauls, and Celeste Pizza, announced a restatement in April 2000 of its 1998-1999 financial results, the aggregate effect of which was to overstate operating income by over $80 million during that period, following the forced resignations of its senior management team. The restatement was prompted by the discovery by Aurora Foods' outside auditors of deliberate efforts by the Company's senior management to "cook the books" by concealing and/or mis-booking certain trade promotion expenses, with the effect of under-accruing those expenses over an eighteen month period in 1998-1999. Senior management concealed these expense manipulations from both the Board of Directors and the outside auditors.

In January, 2001, the SEC entered into a cease-and-desist with the Company, involving injunctive relief and many significant new corporate governance requirements to remedy perceived inadequacies in the company's system of internal controls. In addition, the SEC brought a civil enforcement action against the former CEO, Ian Wilson, the former Executive V.P., Ray Chung, and the former CFO, Laurie Cummings, and other lower-level employees at the company. The U.S. Attorney for the Southern District of New York also brought criminal charges against these same former officers, each of whom subsequently pled guilty.[26]

J. Boston Scientific, Admin. Proc. No. 3-10272, August 21, 2000

Of the cases summarized here, Boston Scientific is the only case in which senior management was not sued. The restatement was prompted by the discovery that managers at that company's Japanese subsidiary had recognized revenue from a significant number of fraudulent transactions. The restatement resulted in a $1.7 billion loss in market value. Despite this sizable

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[26] One of the authors of this paper represented Aurora Foods in the related securities class action and derivative litigation brought by the company's investors and bondholders.

amount, and the SEC's conclusion that inadequate internal accounting controls prevented timely discovery of the false sales, the Commission was satisfied with a cease-and-desist order against the Company only.

During fiscal years 1997 and 1998, Boston Japan (a wholly-owned subsidiary of Boston Scientific), recognized over $75 million dollars of revenue from fraudulent sales. Boston Japan sales managers recorded false sales to distributors, and shipped the "sold" goods to leased commercial warehouses. The sales managers concealed these false sales from Boston Japan management, and then "resold" the same goods to other distributors. The sales managers also colluded with distributors on certain transactions, booking revenue upon shipment of goods, with the understanding that these goods would eventually be returned to Boston Japan. These improper revenues were included in Boston Scientific's period financial filings for all of 1997 and the first three quarters of 1998.

Boston Scientific discovered the false sales activities at Boston Japan in the fall of 1998, after a new management information system uncovered cash flow problems and a high rate of returns at Boston Japan. A subsequent outside audit by Boston Scientific confirmed the fraudulent nature of these transactions. On February 23, 1999, after determining extent of the fraud, Boston Scientific restated its financial results for all of 1997 and the first three quarters of 1998. In the three-day period following the restatement, Boston Scientific lost $1.7 billion in market value.

Following the restatement and disclosure of the fraudulent sales, the SEC conducted an investigation into Boston Scientific's accounting procedures. The Commission concluded that Boston Scientific failed to maintain accurate books and records, and failed to maintain an adequate system of internal accounting controls. Boston Scientific agreed to a cease-and-desist order, and the SEC declined to seek additional penalties against the company or its officers.

IV. THE COMMISSION'S SECTION 21(A) REPORT: A NEW EMPHASIS ON "SELF POLICING" AND VOLUNTARY COOPERATION WITH THE SEC

In October of 2001, the Commission issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 (the "Section 21(a) Report"), which included the Commission's "Statement on the Relationship of Cooperation to Agency Enforcement Decisions" (the "Statement on Cooperation").[27] The Section 21(a) Report and Statement on Cooperation laid out thirteen criteria that will be considered by the Commission in determining whether, and how much, to credit a company under investigation for voluntary remedial actions and cooperation with Commission investigation efforts. In summarizing the Statement in the press release accompanying the Section 21(a) Report, the SEC highlighted four key concepts:

- Public companies should have effective compliance procedures in place prior to the discovery of alleged wrongdoing.

[27] SEA Release No. 44969, AAE Release No. 1470 (Oct. 23, 2001).

- Companies should stress "self reporting" of misconduct, including disclosure to the public and to the regulators.
- Prompt remedial actions should be taken when wrongdoing is uncovered, including discipline and/or dismissal of the wrongdoers.
- Cooperation with law enforcement officials should be promptly given, including providing the SEC with all information about the alleged misconduct.

In encouraging swifter and greater cooperation from companies under investigation, the Statement on Cooperation poses a number of challenges for companies wishing to cooperate with the SEC, in light of the potential parallel exposure of the company in related civil proceedings, including the possible waiver of applicable attorney-client privilege.[28] Nevertheless, it provides a useful "roadmap" for public companies wishing to eliminates potential exposure to SEC enforcement claims, and sets forth a strong philosophy on "self policing" that all public companies should take to heart. Some background on the underlying investigation in the *Seaboard* matter is instructive.

A. The Seaboard Investigation and Proceedings Against de Leeron-Meredith

The Commission's Statement on Cooperation arose from an investigation of accounting misstatements by Ms. Gisela de Leon-Meredith, Controller of Chestnut Hill Farms ("CHF"), a wholly-owned subsidiary of Seaboard Corporation ("Seaboard" or the "Company"). Seaboard is a diversified international corporation engaged in, among other things, agricultural production, transportation, energy generation, and commodity brokering. CHF is primarily engaged in the production and marketing of agricultural products. One of the largest assets on CHF's balance sheet is "deferred farming costs," which consists of costs incurred in planting or growing agricultural products that have not yet been harvested. As harvesting occurs, these assets are amortized by expensing the costs against revenues generated by the harvested crops.

From 1995 through the first quarter of 2000, Ms. de Leon-Meredith made improper accounting entries overstating deferred farming costs and understating farming expenses. Although Ms. de Leon-Meredith knew by December of 1998 that the entries were improper and had caused deferred farming costs to be substantially overstated, she continued to make improper accounting entries through mid-2000 in an attempt to conceal her wrongdoing. Beginning in late 1999, Seaboard personnel began inquiring about unusual entries in CHF's monthly financial reports. Finally, in July of 2000, Ms. de Leon-Meredith confessed her actions to her immediate supervisor at CHF after being questioned about apparent discrepancies in deferred farming costs by Seaboard's internal auditors.

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[28] *See* J. Sturc and E. Schneider, "Credit for Cooperation: The SEC's Section 21(a) Report", Insights (December 2001), in which the authors discuss the case law and risks associated with voluntary disclosures of privileged work product and other discovery materials to the SEC.

After the confession, Seaboard's internal auditors promptly conducted a preliminary internal investigation and advised company management about the accounting misstatements. Management informed the Company's Audit Committee and full Board, which authorized the hiring of an outside law firm to conduct a complete investigation. Within days after this action was taken, Ms. de Leon-Meredith and two employees who had failed to properly supervise her were terminated. The following day, Seaboard informed the Commission, and publicly announced, that its financial results would be restated, which it did on August 28, 2001. The Company's stock price did not decline dramatically following the initial announcement of the restatement, or following the restatement itself.[29]

In response to Ms. de Leon-Meredith's conduct, the Company also endeavored to strengthen its financial reporting processes. It developed a detailed closing process for subsidiary accounting personnel, consolidated subsidiary accounting functions under a Seaboard accountant, began requiring the Seaboard controller to interview and approve the hiring of all subsidiary senior accounting personnel, hired three additional accountants to assist with preparation of CHF's financial statements, and redesigned CHF's minimum annual audit requirements.

During the Commission's investigation, the Company provided extensive cooperation with Commission staff. It produced to the Commission all information related to the underlying violations, including all details of its own internal investigation and the investigation conducted by outside counsel. It produced notes and transcripts of interviews with Ms. de Leon-Meredith and others, and at no time did it invoke attorney-client privilege, work product protection, or any other privileges or protections related to information requested by the Commission.

On October 23, 2001, after completing its investigation of the matter, the Commission initiated and settled a cease-and-desist proceeding against Ms. de Leon-Meredith, finding that she had engaged in various violations of the federal securities laws.[30] In its "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 Decisions," issued the same day, the Commission concluded that no enforcement action would be taken against Seaboard.[31]

It is important to note the several key ways in which the facts in *Seaboard* are atypical of the situations usually confronting defense counsel. First, unlike the posture in which many

[29] The initial announcement was made in a press release issued after the close of trading on August 9, 2000. Seaboard stock closed at $198.00 per share on August 9, 2000, and again at $198.00 per share on August 10, 2000. The restatement was included in financial results released on August 28, 2001. Seaboard stock closed at $276.00 per share on August 27, 2001, and at $275.00 per share on August 30, 2001.

[30] *See* Admin. Proc. No. 3-10626; Exchange Act Rel. No. 44970; Accounting and Auditing Enforcement Rel. No. 1471 (Oct. 23, 2001).

[31] *See* Exchange Act Rel. No. 44969; Accounting and Auditing Enforcement Rel. No. 1470 (Oct. 23, 2001).

public companies find themselves, there was no parallel civil class action litigation involved in *Seaboard.* Second, the Report noted the absence of any significant stock price decline as a result of the disclosure of adverse information. Third, the misconduct appears to have been confined to a single employee of a subsidiary operation who quickly confessed to her wrongdoing. Thus no complicated investigative steps or "self policing" seems to have been necessary. The complications that arise from more complex or pervasive financial manipulations were simply not present in the *Seaboard* situation.

B. The Section 21(a) Report's Guidelines on Cooperation

In the Section 21(a) Report, the Commission explained that its decision not to take enforcement action against the Company was due to the actions taken by the Company after learning of the accounting misstatements, and the level of cooperation provided during the Commission's investigation. Specifically, the Company was given "credit" for "self-policing, self-reporting, remediation and cooperation," which minimized the necessary expenditure of government and shareholder resources and brought swifter relief to investors. The Commission noted, however, that a decision not to take any enforcement action against a company in response to securities violations is indeed an "extraordinary step," and that depending on the circumstances in a given case, the credit given in exchange for cooperation could also include reduced charges, lighter sanctions, or "mitigating language" in documents announcing enforcement actions.

Before laying out the criteria to be considered in determining whether and how much to credit cooperation of a company under investigation, the Commission warned that enforcement decisions remain highly fact-specific, and that in circumstances where violations are egregious and harm to investors is great, no amount of cooperation would justify a decision not to take enforcement action. The Commission emphasized that the criteria included in the Statement on Cooperation are simply points of consideration, subject to the ultimate "broad discretion" of the Commission to reach whatever result it deems to be in the best interests of investors in a given case.

The Commission then proceeded to set forth thirteen criteria to be considered in determining whether and to what extent a company should be rewarded for voluntarily initiating remedial actions and cooperating with Commission investigation efforts following discovery of securities violations.

1. What is the nature of the misconduct involved?

2. How did the misconduct arise?

3. Where in the organization did the misconduct occur?

4. How long did the misconduct last?

5. How much harm has the misconduct inflicted upon investors and other corporate constituencies?

6. How was the misconduct detected and who uncovered it?

7. How long after discovery of the misconduct did it take to implement an effective response?

8. What steps did the company take upon learning of the misconduct?

9. What processes did the company follow to resolve many of these issues and ferret out necessary information?

10. Did the company commit to learn the truth, fully and expeditiously?

11. Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation?

12. What assurances are there that the conduct is unlikely to recur?

13. Is the company the same company in which the misconduct occurred, or has it changed through a merger or bankruptcy reorganization?

On each of these points, the Commission expounded on the basic criteria with examples of how the criteria might be satisfied. For instance, on point 11 regarding cooperation with Commission staff, the Statement explicitly noted that companies may wish to consider waiving privileges and protections with regard to the Commission's requests for information. Recognizing that a waiver of privileges and other protections may put a company or its employees at risk in related civil and/or criminal actions, the Commission stated its opinion that a waiver of privilege pursuant to a confidentiality agreement with the Commission should not be deemed a waiver with respect to third parties.[32]

C. The Section 21(a) Report's Effect Thus Far On Cooperation With Agency Investigations

Since the Commission's issuance of the Statement on Cooperation, several highly publicized and widespread investigations into alleged accounting improprieties have been instigated, including Enron, Global Crossing and Xerox. Although these investigations are ongoing, it is clear that cooperation will influence the SEC's decision whether to pursue enforcement actions. Indeed, in the *Xerox* matter, the Commission has chastised the company for its alleged lack of cooperation.

In addition to the above, the Commission has noted the criteria set forth in the Statement on Cooperation in various public speeches and papers since the Section 21(a) Report was issued, and in at least one enforcement action. A few examples follow.

Remarks of Director Cutler. On February 15, 2002, Director of Enforcement Stephen Cutler delivered a speech in which he clearly raised the stakes for public companies and their officers and directors in enforcement actions before the Commission. Cutler emphasized in

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[32] SEA Rel. No. 44969; Accounting and Auditing Enforcement Rel. No. 1470, at n.3.

particular what may happen to public companies that do *not* adhere to the "cooperation" directives the SEC outlined in its Section 21(a) report: "those of you who are familiar with [the Section 21(a) Report] know that to receive maximum credit for cooperation, a public company must, among other things, promptly disclose, both to the regulators and the public, the wrongdoing it discovers." This requirement, he said, was intended to "force significant news into the public domain quickly." The downside risk for companies that failed to meet the SEC's edict of speed: "the Commission will be more willing than ever to seek civil penalties against public companies that drag their feet during the course of an investigation." To borrow a phrase, in the "real time enforcement" world, time is of the essence.[33]

The IGI Case. One recent enforcement action attempted to apply the Section 21(a) Report's factors to a more complicated alleged accounting fraud. IGI, Inc. is a diversified company engaged in the production and marketing of cosmetics, skin care products, and animal health products. One of its primary products during the years 1995-97 was a poultry vaccine. During 1995, 1996, and the first three quarters of 1997, the former President and Chief Operating Officer of IGI, John Gallo, allegedly manipulated the company's quarterly and annual earnings by directing former members of IGI's management to materially overstate assets, revenues, and net income related to sales of the poultry vaccine. The manipulation purportedly was achieved by failing to write off defective or destroyed inventory, improperly back-dating sales to prior periods, and failing to record and process sales credits in a timely manner.

In March of 1998, IGI engaged an accounting firm to provide financial advisory services in conjunction with an internal investigation concerning these an related inventory and accounting issues. On March 31, 1998, trading in IGI's stock was suspended due to the company's failure to file a Form 10-K for 1997. When trading resumed on September 8, 1998 after IGI filed its 1997 10K and announced material restatements of its financial results for 1995, 1996, and the first three quarters of 1997, the stock price dropped from $3.13 to $2.00 per share, nearly 40 percent. From 1995 to 1997, the period during which the fraud was allegedly occurring, IGI stock traded between $4.00 and $10.00 per share.

As a result of the internal investigation, Gallo and other members of senior management were terminated and new internal controls were instituted. During the ensuing Commission investigation of IGI, the company cooperated fully with Commission staff, voluntarily providing the complete results of its internal investigation and waiving attorney-client privilege with respect to documents and communications. On March 12, 2002, the Commission instituted and settled cease-and-desist proceedings against the company, imposing no monetary penalties.[34] On March 13, 2002, the Commission filed an action in federal court in New Jersey against Gallo, seeking civil monetary penalties, disgorgement of all compensation and profits derived from the accounting manipulation, and a lifetime bar against Mr. Gallo serving as an officer or director of

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[33] *See generally*, Remarks of Stephen M. Cutler, *supra* nn. 9, 21.

[34] *See* Admin. Proc. No. 3-10722; Exchange Act Rel. No. 45553; Accounting and Auditing Enforcement Rel. No. 1520 (Mar. 12, 2002).

any public company.[35] In related actions, the Commission instituted and settled an antifraud injunctive action, a civil penalty proceeding, and cease-and-desist proceedings against other former IGI employees involved in the fraud.

In short, it remains to be seen how the Section 21(a) Report will be internalized by public companies, and how it will affect the enforcement outcomes in specific cases. It can reasonably be predicted, however, that the Report is intended to put a serious "stake in the ground" with companies and their counsel when an issuer is on the receiving end of an enforcement inquiry.

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[35] *See* Litigation Rel. No. 17410; Accounting and Auditing Enforcement Rel. No. 1521 (Mar. 13, 2002).