

SEC INVESTIGATIONS AND ENFORCEMENT  
ACTIONS:

AN OVERVIEW AND DISCUSSION OF RECENT  
TRENDS IN ACCOUNTING FRAUD INVESTIGATIONS

PRACTISING LAW INSTITUTE

SECURITIES LITIGATION 2001

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## I. INTRODUCTION

### A. Restatements, Earnings Management, and Other Financial Statement Problems Have Prompted An Onslaught of SEC Investigative Activity

In the last few years, we have witnessed an enormous number of new and highly visible accounting debacles visited upon public companies, including the well-told stories of accounting fraud at Cendant, Waste Management, Livent, Rite-Aid, Microstrategy, Oxford Health, Informix, McKesson HBOC, Boston Scientific, and similar "poster children." As reported by the Financial Executives Research Foundation ("FEI"), the losses in market capitalization caused by these accounting scandals is staggering. The market cap loss for Microstrategy alone was \$11.9 *billion*, and for McKesson it was \$8.8 *billion*. Boston Scientific was a more modest \$1.7 *billion*. 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*. This latest group of "bad" restatement cases is only the most recent—but by far the most attention-grabbing due in part to the sheer magnitude of the frauds, and the impunity of some of the conduct involved.

Not surprisingly, these scandals have led to a rigorous new effort by the SEC Enforcement Division to combat accounting fraud. The Commission 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.<sup>1</sup> 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 has announced the creation of a Financial Fraud Task Force, which will focus on companies, their management and auditors, where the Staff believes that the financial

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<sup>1</sup> "SEC List of Accounting Fraud Probes Grows," *Wall Street Journal*, July 6, 2001.

statements may reflect improper earnings management or other GAAP violations.<sup>2</sup>

To what can we attribute this sudden explosion of enforcement activity? The major cause and effect seems to be the fact that many companies have been restating their financial results due to the sudden 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,<sup>3</sup> the trend of restatements has been troubling to the SEC. It is believed that in addition to continuing to aggressively pursue issuers and their directors and officers who commit fraud, the Commission now will begin targetting the customers, distributors and other third parties who often are involved in the sales or other activity that is at the heart of these accounting manipulations—and bring enforcement actions against them as "aiders and abettors."<sup>4</sup>

Most recently, Congress has indicated that the House financial services committee will hold hearings on this topic, with a possible eye towards expanding the Commission's budget and resources by 200-300% in order to further combat financial fraud. As well, at the request of Rep. John Dingell, the General Accounting Office will study whether there needs to be a full-time self regulatory organization for the accounting profession.<sup>5</sup>

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<sup>2</sup> Remarks of Lynn E. Turner, SEC Chief Accountant, 39th Annual Corp. Counsel Institute (Oct. 12, 2000)

<sup>3</sup> 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, and add back some of the amounts that had been previously written down. In 1999, this accounted for 57 known restatements, in addition to the 150 "other" restatements reported that year.

<sup>4</sup> E., McDonald and D. Kruger, "Aiding and Abetting", *Forbes Magazine* (April 2, 2001)

<sup>5</sup> "SEC List of Accounting Fraud Probes Grows," *Wall Street Journal* (July 6, 2001)

With this upsurge in enforcement activity comes many perils for public companies, their officers and directors, and in some cases for these companies' non-officer personnel. As the Enforcement Division has declared on more than one occasion, the Division is particularly focussed on wrongdoing by senior management personnel, and on situations where senior management has aggressively pushed subordinates to violate accounting rules in order to achieve analysts' expectations, or to mask adverse trends in the business, or to otherwise manage earnings. As well, the possibility of a criminal investigation has become more prevalent, as the Commission not infrequently carries out its investigations in parallel with the U.S. Attorney's office.<sup>6</sup>

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.<sup>7</sup>

#### **B. Recent SEC Rulemaking May Give Rise to Yet Another Generation of Enforcement Inquiries Directed to the Conduct of Audit Committees, and Companies' Relationships with Their Outside Auditors**

Besides the new emphasis within the Enforcement Division on combatting financial fraud, the Commission also has promulgated new rules and regulations designed to impose greater accountability on audit committees of public companies, and to insure the independence of outside auditors. While this topic is beyond the scope of this paper, these rules are important to defense counsel, since they may define the standards of conduct by which the Commission will judge whether, in addition to punishing a company for accounting manipulations, it should also punish the members of the audit

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<sup>6</sup> See, e.g., "SEC Goes Criminal on Fraud", National Law Journal (May 1, 2001) (reporting on the SEC's efforts to cooperatw with U.S. Attorneys nationwide)

<sup>7</sup> PricewaterhouseCoopers LLP 2000 Securities Litigation Study (June 2001).

committee for inadequate supervision of the company's accounting policies and practices. Chief among these new rules are the new rules on audit committees announced in December 1999.<sup>8</sup> 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.<sup>9</sup> Defense lawyers will be watching the implementation of these new rules closely, and monitoring the degree to which the Commission invokes them as a basis for future enforcement activity.

**C. New Staff Accounting Bulletins May Impose Heightened Materiality Standards on Public Companies, and Tighter Revenue Recognition Policies and Practices**

In the last two years, the Commission's accounting staff also has been active, and promulgated several important accounting bulletins that are viewed by many practitioners as "raising the bar" on public companies in their efforts to comply with GAAP, and to satisfy increasingly pointed inquiries by the outside auditors in connection with quarterly reviews, which traditionally had been subjected to only limited reviews. Among the new accounting pronouncements that are most noteworthy are:

- SAB No. 99—*Materiality*
- SAB No. 100—*Restructuring and Impairment Charges*
- SAB No. 101—*Revenue Recognition*

Besides these SEC pronouncements, the AICPA also has issued new accounting guidelines that will have an impact on public companies that fail to book adjustments to their financial statements recommended by their auditors. Previously, many companies would deem these proposed

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<sup>8</sup> SEA Release No. 34-42266, 17 CFR Parts 210, 228, 229, 240.

<sup>9</sup> 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).

adjustments to be immaterial, according to a quantitative "rule of thumb" that amounts below approximately 5% of earnings were too small to require booking. Both SAB No. 99 and recent guidance from the AICPA do away with this notion of quantitative materiality. As well the AICPA now requires that management must provide the auditors with a *written representation* that any "passed adjustments" (i.e., those not booked) are not material under SAB No. 99—a requirement that will put enormous pressure on management to make the right accounting call.

In light of these perils and pitfalls, it is important, perhaps, first to review basic aspects of SEC investigations, and the typical remedies imposed in SEC enforcement actions. This paper also will look at selected recent enforcement actions involving "high profile" restatements and other alleged financial irregularities. We then will offer some practical advice on dealing with SEC investigations.

## II. SEC INVESTIGATIONS

### A. What Prompts an SEC Inquiry

Nothing more than official curiosity is required for the SEC to start an investigation. This is not to say, however, the investigations are started for no reason. Usually some event prompts the SEC to begin an inquiry. Examples of areas which may lead to investigations are the following:

1. Review of periodic filings and registrations statements by the Division of Corporation Finance.
2. Review of Forms 8-K. The SEC reviews every Form 8-K dealing with adverse events and with changes in auditors.
3. Referrals from the stock exchanges. Sometimes the NASD, the NYSE or AMEX has begun an informal investigation, found troubling facts, and refers the matter to the SEC for more rigorous investigation.
4. Newspaper and other media reports.

**5. Disgruntled investors and market professionals frequently complain to the SEC. Sometimes these complaints come from professional short-sellers.**

**6. Anonymous informants or disgruntled employees. Many of the SEC's cases start with an anonymous tip from an unknown person, frequently an employee of the company who is dissatisfied with the manner in which management is accounting for its assets.**

**7. Competitors. On occasion, corporations believe that they are competing against a company which has been falsely stating its performance. They may complain to the SEC.**

**8. Plaintiff's Lawyers. It is not unusual for the plaintiffs in private civil actions to assert that the SEC should get involved in the same issues which are the subject of its lawsuit.**

**While the SEC staff attempts to view complaints made to it with appropriate skepticism, many of these complaints are taken seriously and on occasion are proven to be well founded.**

**B. Types of SEC Investigations.**

**1. Informal Inquiries.**

**a. Frequently, SEC investigations begin with a request for informal cooperation by corporation in providing information to the SEC staff. While a corporation and its employees are under no obligation to comply with such a request, it is usually in the company's interest to do so. First, voluntary cooperation will put the company in the best light in the consideration of the issues posed by the investigation. Secondly, voluntary cooperation may encourage the SEC staff not to seek a formal order of private investigation and may possibly reduce the company's requirement to disclose the investigation in its periodic filings. Third, voluntary cooperation gives the issuer some greater degree of control over the scope of the investigation.**

b. In addition, and as more fully discussed below, cooperation may enable the company to make an earlier presentation to the staff with regard to the underlying basis for its decisions.

2. Formal Investigations.

a. The securities laws permit the SEC to issue subpoenae to compel the production of documents by company or by individuals and to compel witnesses to appear and to testify under oath in connection with investigations of possible violations of the federal securities laws. The commissioners do not, of course, conduct these investigations themselves. Thus, they delegate their authority to issue subpoenae to identified members of the staff. This delegation is accomplished by the issuance of a "formal order of private investigation" which recites the factual predicate for issuing the order, the statutory sections which may have been violated, and which authorizes designated Commission employees to issue subpoenae and compel witnesses to appear under oath.

A formal order is not a finding of a fact nor a form of adjudication. It is akin to a corporate board resolution. Nevertheless, it is a document which asserts the possibility of a violation of law by the issuer, and it may include within its scope a wide variety of persons.

b. Typically, SEC investigations commence with a broad request for the production of documents covering an arbitrarily selected time period. This request can be narrowed by negotiation in order to prevent an undue burden and the production of irrelevant documents.

c. Once documents are collected, if the SEC staff continues to have questions, it will frequently call witnesses to appear to testify regarding the matters at issue. In a financial disclosure case, witnesses from a company usually include its controller, its chief financial officer and other accounting and finance personnel.

d. Because financial disclosure investigations frequently turn on the treatment of transactions between the issuer and third parties, the SEC will likely issue subpoenae to other relevant persons. Depending upon the nature of the case, these may include the following:

- (1) The company's independent auditors;
- (2) customers, vendors, and suppliers;
- (3) business or strategic partners; and
- (4) financial analysts.

e. The SEC takes the position that it is not required to give the company notice of the persons to whom the subpoenae are issued; thus, one of the frequent side effects of an SEC investigation is the fact that it will cause persons with whom the company does business to receive a surprise subpoena in the investigation, with concomitant effects upon the company's reputation and business relationships.

### 3. Concluding Investigations.

After gathering documents and taking testimony, the staff typically makes a collaborative decision as to whether or not a particular company or individual should be charged with a violation of the federal securities laws, which laws are believed to have been violated and the nature of the relief to be sought. In virtually every case other than those requiring emergency relief, the staff will contact counsel for the prospective defendant and advise counsel of its conclusion and, in summary form, the basis for the conclusion. Counsel and the individual then have an opportunity to meet with the staff to discuss the basis for its conclusions, attempt to persuade the staff that the basis is not appropriate, and to submit a brief, usually called a "Wells" submission, which sets forth the reasons of fact or law as to why an enforcement action may not be appropriate.

The ultimate decision of whether or not to institute an enforcement proceeding is the Commission's, based upon the staff's recommendation. That recommendation is usually a collaborative one. Thus, in a financial disclosure case, attorneys from the SEC's Division of Enforcement will typically solicit the views of the Office of the Chief Accountant, the Division of Corporation Finance, and all recommendations are reviewed for consistency and for compliance with Commission policy and statute by the Office of the General Counsel.

Meetings with and Wells submissions to the staff are frequently fruitful. Often times, the staff will not be aware of significant facts known to counsel or to the issuer which may change its recommendation. Moreover, even if the recommendation itself is not ultimately changed, counsel and the issuer may be successful in persuading the staff that some defendants should be excluded altogether or that the number of charges should be reduced.

If this process of discussion is unsuccessful, then the staff will send its recommendation, which is in the form of a memorandum together with the Wells submission of the proposed defendant, to the Commissioners for their decision. The Commissioners meet in a closed meeting, which is open to the staff but not open to the public or to the prospective defendants, to determine whether or not an enforcement action should be commenced. Once that decision is made, counsel is usually advised of that decision and afforded a brief opportunity within which to determine whether to negotiate a resolution of the case or to contest it.

Most SEC enforcement proceedings are resolved by negotiation and by settlement. There are several reasons for this result. First, an adverse finding in a judicial proceeding against a respondent in a case brought by the SEC may be held to be binding on the company in connection with all other litigation dealing with the same matter. Since the issues in SEC investigations are often the same as those in private actions, this could have a significant effect on a company's liability for damages. Second, litigation against the government can be an expensive and time consuming burden, both in out-of-pocket costs and in distraction of management from business efforts. Therefore, business considerations may dictate a resolution with the government rather than litigation. Third, the SEC, like other government agencies, is dependent upon its ability to resolve cases without litigation in order to maximize its enforcement resources. Therefore, in many cases, the government is prepared to offer less than the full relief it could conceivably obtain in order to settle a case without litigation.

### **III. SEC ENFORCEMENT PROCEEDINGS**

If the Staff believes that securities law violations have occurred, they will recommend to the Commission that an enforcement action be brought, following the process described above. If approved, the Staff will be

authorized to commence an enforcement action, usually in a federal district court.

**A. Remedies**

**1. Civil Injunctions**

The SEC may obtain a civil injunction prohibiting any person or corporation from future violations of the federal securities laws based upon a showing that the person or enterprise has violated or is about to violate the federal securities laws. Injunctions are issued by a federal district judge after commencement of a lawsuit by the SEC and a trial pursuant to the Federal Rules of Civil Procedure. The standard for issuing an injunction requires that the SEC show a reasonable likelihood of future violations. Courts usually look to four factors:

- a. The nature of the conduct;
- b. The degree of scienter (bad intent) involved;
- c. The defendant's ability to violate the law in the future; and
- d. The degree to which the defendant has recognized the wrongfulness of his conduct.

**2. Ancillary Relief**

Even if a court does not issue an injunction prohibiting future violations of the law, it may award the SEC "ancillary" relief. Common forms of ancillary relief include:

- a. **Disgorgement.** The SEC will frequently seek to have the defendant "disgorge" or repay money obtained as a result of alleged violations of the federal securities laws. Such improper gains may include, for example, profits from alleged insider trading; proceeds obtained from allegedly illegal securities distributions; bonuses based upon allegedly improperly recognized revenues; and assets that were allegedly misappropriated. The SEC will seek prejudgment interest on these sums.

b. Corrective Disclosure. The SEC may also seek an order requiring that the issuer restate previously issued annual or quarterly financial statements to correct alleged accounting errors or to correct other previously filed 10K's, 10Q's or disclosure documents.

c. Corporate Governance. On occasion, the SEC will seek an order requiring a structural change in a business, such as the adoption of internal controls, the establishment of an audit or other committees, or, in extreme cases, the appointment of a receiver to take control of the enterprise.

d. Civil Money Penalties. As a result of the 1990 Securities Law Enforcement and Penny Stock Reform Act, the SEC also has the authority to obtain civil money penalties from issuers of securities and persons associated with issuers. The amounts which the SEC can obtain are based upon the nature of the violation and whether or not the defendant is an individual or a organization.

### 3. Bar Upon Service as an Officer or Director

The 1990 Remedies Act also permitted the SEC to obtain an order from a district court prohibiting an individual from serving in the future as an officer or director of a public company. Such orders require a showing of egregious misconduct and are generally been sought in circumstances where the individual has misappropriated corporate assets.

## B. Administrative Remedies

1. Cease and Desist Orders. Prior to 1990, the SEC had relatively little jurisdiction in administrative proceedings over public companies and their officers. In 1990, as part of the Remedies Act, Congress gave the SEC the authority to seek cease and desist orders against public companies and their officers. The Remedies Act authorizes the SEC to issue its own order against persons who have violated the securities laws "a cause" of another persons violation. For example, the cease and desist order may compel an issuer to state its financial reports in accordance with GAAP and forbid the CFO from being a "cause" of the issuer's violation. Since 1990, hundreds of cease and desist orders have been issued. The SEC contends that

it may obtain an order upon a lesser showing that a "reasonable likelihood of future violation" as was required for civil injunctions.

a. Cease and desist proceedings are tried before an administrative law judge, a full-time Commission employee, with a right of appeal to the Commission and from there to the United States Court of Appeals. Thus, the trial is entirely an "in-house" proceeding with far more restricted rights of discovery and of appeal than in a standard civil trial.

b. Disgorgement. The SEC may also issue orders compelling disgorgement of ill-gotten gains and ancillary relief in administrative proceedings. It may not, however, obtain a civil order requiring the payment of a civil money penalty from an issuer or person affiliated with an issuer.

2. Professional Discipline.

a. In addition to injunctive actions and administrative proceedings seeking a cease and desist order, the SEC may also take action against professionals. These actions arise under the Rule 102(e) of the SEC's Rules of Practice, and which permits the Commission to limit the ability of a professional who has engaged in improper professional conduct or who has violated the federal securities laws to practice and appear before the Commission.

b. Rule 102(e) proceedings clearly extend to outside professionals, such as accountants and lawyers. Rule 102(e) proceedings in this context commonly deal with the question of whether previously issued financial statements were audited in accordance with generally accepted auditing standards or whether professionals, such as lawyers, violated the federal securities laws in connection with the preparation of prospectuses, registration statements or other disclosure documents.

(1) The Commission takes the position that practice before the Commission includes advice by a lawyer on the application of the federal securities laws.

(2) The Commission has also taken the position that Rule 102(e) extends to inside management professionals within a corporation, such as chief financial officers, controllers and in-house counsel. Thus, an order prohibiting a professional from practicing and appearing before the commission may preclude a professional from assisting in the preparation of financial statements to be filed with the Commission, even if the professional is not associated with an outside firm.

(3) Rule 102(a) proceedings are also decided by administrative law judges.

### C. Criminal Cases

The SEC does not have independent authority to prosecute criminal cases. On the other hand, any willful violation of the federal securities laws can be prosecuted as a crime. Because of the large dollars often involved, securities offenses are popular among federal criminal prosecutors. Thus, the SEC has a close working relationship with federal prosecutors and frequently refers more egregious violations of the federal securities laws to them.

1. In addition to securities law offenses, prosecutors frequently will charge the following:

- a. Mail and wire fraud;
- b. False statements to the government, such as those contained in SEC filings, under 18 U.S.C. § 1001;
- c. Money laundering; and
- d. RICO cases.

2. The most commonly prosecuted areas of securities laws violations are insider trading, financial fraud, unregistered securities offerings. While not always pursued for garden variety financial disclosure cases, criminal prosecutions are frequent where there has been wide-spread misappropriation of assets or the sale of stock by insiders who know that the financial statements are false.

**D. Legal Bases For Enforcement Actions And Penalties Involving Accounting Fraud**

**1. Enforcement actions involving accounting disputes or financial statement manipulations almost always involve one or both of three types of conduct:**

**a. causing accounting improprieties that render a company's financial statements false and misleading (and thereby also rendering public statements by the company to the investment community false and misleading);**

**b. failing to implement an adequate system of internal accounting controls; and**

**c. making false and misleading statements the company and/or its officers to the company's independent auditor.**

**2. The Commission has a variety of statutory and/or regulatory weapons in its arsenal which frequently are invoked in enforcement actions involving accounting issues:**

**a. Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 promulgated thereunder prohibit any person from knowingly or recklessly making any material misstatement or omission in connection with the purchase or sale of securities registered under Section 12 of the Exchange Act.**

**b. Section 17(a) of the Securities Act of 1933 ("Securities Act") prohibits the use of any "device, scheme, or artifice to defraud" in the offer or sale of any securities (Section 17(a)(1)), as well as any "untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" (Section 17(a)(2), (3)). Scierter is an element only of claims based on the "device, scheme, or artifice to defraud language of Section 17(a)(1), and is not a required element of claims brought under other provisions of Sections 17(a)(2) and 17(a)(3).**

c. Section 13(b)(2)(A) of the Exchange Act requires that each issuer of securities registered pursuant to Section 12 of the Exchange Act make and keep books, records, and accounts that accurately and fairly reflect the dispositions of its assets.

d. Section 13(b)(2)(B) of the Exchange Act requires that each issuer of securities registered pursuant to Section 12 of the Exchange Act to devise and maintain a system of sufficient internal accounting controls.

e. Section 13(b)(5) of the Exchange Act prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account.

f. Rule 13b2-1, promulgated under Section 13(b)(5) of the Exchange Act, prohibits any person, whether directly or indirectly, from falsifying or causing to be falsified any book, record or account.

g. Rule 13b2-2, promulgated under Section 13(b)(5) of the Exchange Act, states that "[n]o director or officer of an issuer shall . . . [m]ake or cause to be made a materially false or misleading statement, or [o]mit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in the light of the circumstances in which they were made, not misleading to an accountant in connection with (1) any audit or examination of the financial statements of the issuer . . . or (2) the preparation or filing of any document or report required to be filed with the Commission. . . ."

h. Section 20(a) of the Exchange Act states that "[e]very person who, directly or indirectly controls any person liable under any provision of [the Exchange Act] . . . shall also be liable jointly and severally with . . . such controlled person, *unless* the controlling person acted in good faith. . . ." This provision generally has been interpreted to mean that a "controlling person," such as a senior corporate executive, can be liable for violations committed by subordinates either where the controlling person caused the subordinate to commit the violation or knew of the

subordinate's propensity to violate the securities laws and failed to take reasonable steps to prevent future violations by that subordinate.

i. Section 21C of the Exchange Act prohibits any person from causing a violation of any other provision of the Exchange Act to occur. Under Section 21C, a person is a cause of a violation of the provisions of the Exchange Act if the violation occurs because of an action or omission that the person knew or should have known would contribute to such a violation.

j. Rule 12b-20 requires that, "[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under they are made, not misleading."

3. Penalties for violations of one or more of these sections frequently include:

- a. civil and criminal fines and penalties;
- b. injunctions and/or cease and desist orders against future violations of the securities laws;
- c. orders requiring the issuer to restate its financial statements;
- d. orders barring individuals from serving as an officer or director of any company whose securities are traded over a national securities exchange; and
- e. orders barring individuals from serving as an accountant before the Commission (that is, barring an accountant from serving in any position requiring that person to make or certify statements by a corporation or accounting firm to the Commission).

#### **IV. RECENT SEC ENFORCEMENT ACTIONS**

**Following are just a few of the recent high profile financial fraud cases launched by the Commission in the last two years. In the Appendix, we set forth a number of additional cases involving accounting fraud claims against technology companies in recent years.**

##### **A. 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 Drabinski, 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 Drabinski, 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.**

**B. 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 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.<sup>10</sup>

**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 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.

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<sup>10</sup> One of the former officers of Informix is represented by the author in connection with the Commission's on-going investigation.

**Additionally, in fiscal years 1996 and 1997, CUC management inflated income by ignoring the impairment of certain CUC assets.**

**The CUC management scheme was eventually uncovered following CUC's merger with HFS Incorporated. Management of the surviving company (Cendant) discovered the fraud in April 1998. Cendant announced the need for restatement of financial reports on April 15, 1998. In the three days following the April 15, 1998 announcement, Cendant lost over \$11 billion in market value.**

**Predictably, the SEC responded vigorously to Cendant's announcement. Cendant entered into a cease-and-desist agreement with the SEC. The Commission brought civil actions against former CUC CEO Forbes and former CUC President and COO Shelton, seeking cease-and-desist orders, disgorgement, civil money penalties, and permanent bars against either person serving as officers of public company.**

**Criminal actions were commenced against CUC's former CFO Corigliano, former Controller Pember, and former Vice President of Accounting. All three pled guilty to wire fraud and conspiracy to commit wire fraud. Sabatino also 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, the Grand Jury also indicted the top two officers of Cendant, Walter Forbes and Kirk Shelton, the CEO and COO respectively.**

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

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.

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 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.

**E. 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 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 Gilberston 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.

**F. 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 manufacturers. 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.**

**G. 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 one of the outside audit partners of Sunbeam from Arthur Andersen.

**H. In the Matter of Waste Management Inc., SEA Release No. 34-42968, June 1, 2000**

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 brought enforcement actions against top officers of Waste Management, including; [describe individual resolutions]

In recent related proceedings, 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 Cercavski, Edward G. Maier, and Robert E. Allgyer, Lit. Release No. 17039, June 19, 2001, 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 an accounting firm in more than 20 years, and the largest ever civil penalty (\$7 mil) against a Big % 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."

**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 \$100 million restatement in April 2000, 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, one of whom has subsequently pled guilty. The criminal cases against the former CEO and CFO are still pending.<sup>11</sup>

**J. Conclusions?**

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<sup>11</sup> The author of this paper represented Aurora Foods in the related securities class action and derivative litigation brought by the company's investors and bondholders, and worked with the independent counsel to the company's Special Committee to help resolve the SEC matter.

Clearly, these examples should give pause to any public company, or any officer of a public company, who believes the SEC is not serious about combatting financial fraud. The aggressive enforcement efforts now underway should serve as a warning that financial statement manipulations will be met with the most severe penalties.

## V. WHAT TO DO WHEN THE SEC CALLS

### A. Take Your Time

The SEC's initial contact with an issuer or individual is often out of the blue and without warning. Many issuers and individuals feel a compulsion to provide answers instantly without reflection or research. This is almost invariably a mistake.

It is crucial when giving information to the government to insure that the information is accurate and complete. Hasty decisions to provide information frequently cause issuers or individuals to make assumptions about key facts and to inadvertently provide the government with erroneous information. Mistakes are devastating to credibility. No one is compelled to provide information on the spot. It is always worthwhile to pause, to reflect, to consult with counsel and then to decide on a course of conduct.

### B. Hire a Lawyer

Securities compliance, accounting and related legal and factual issues are frequently complex, and companies are well advised to retain counsel to advise them on the consequences and implications of an SEC or securities exchange request for information. In addition, involving outside counsel can insure that business information remains confidential, and candid communications with a lawyer are protected from disclosure by the attorney-client privilege.

### C. Assess the Nature of the Problem

**While the SEC will not usually disclose why it is asking for information or its source of concern, one can usually find the cause of the inquiry from other business issues that have arisen or other sources of information. Usually, there is some underlying reason why the SEC requests information. It is crucial to understand at an early stage what the underlying problem is and to understand whether it creates a bigger business problem for the company, such as inaccurately reported financial statements, difficult business conditions, employee or other misconduct or third party litigation. Prompt and thorough internal investigation, preferably done under the supervision of counsel, is a valuable investment.**

**In a financial misstatement situation, it will be important to have extremely competent consulting experts who are familiar with the financial and accounting matters that are involved in the investigation. Forensic experts can mobilize quickly and provide invaluable early guidance on the nature of the accounting issues, and the potential magnitude of the problem. They also may serve as important contributors in interviews of key personnel, and in discussions with the audit committee and the outside auditors.**

**D. Fix the Problem**

**If, in fact, there is an underlying business or financial statement problem to which the SEC inquiry relates, such as a potential misstatement, a misleading disclosure, or potential "tipping" by corporate insiders, then it is important to correct that problem at the earliest possible time. Such corrections not only make good business sense, they may insulate the corporation from several forms of liability to the government as a "controlling person." Officers and directors of public companies owe a duty to their shareholders to take such corrective action.**

**Moreover, early corrective action will be a demonstration of the issuer's good faith and may negate an inference by the government that enforcement action against the company is warranted in order to prevent future violations. Early corrective action also may blunt the Commission's ultimate demands for injunctive or other ancillary relief—in effect, the company will be in a better position to argue that sweeping remedies are unnecessary since the company took prompt remedial action already.**

**In fixing the problem, defense counsel would be well advised to make early contact with the outside auditors to request their assistance in the evaluation of and adoption of various remedial efforts, particularly if the SEC inquiry relates to accounting issues that might implicate the integrity of any audited financial statement—and perhaps even if it implicates a review engagement. Very frequently the Staff will request documents from the outside auditor in any event, so there is little reason to believe that in a financial statement investigation, the audit firm will not become apprised of the investigation at some point in any event.<sup>12</sup> The Big 5 audit firms have gained enormous experience in dealing with financial restatements, and their active participation in many circumstances helps solve the problem. By contrast, not much good normally will come by attempting to shield the auditors from what is going on.**

**E. Decide on a Strategy**

**Once the problem is understood and, if necessary, corrective actions are taken, it is important to develop the strategy for dealing with the investigation. In those circumstances where all of the relevant facts may be gathered quickly, a thorough factual investigation is conducted, and it appears likely that there is no liability, then an early presentation of the corporation's views to the SEC may enable the government to make a decision more quickly, reduce the cost of the investigation, and lead it to a prompt and confidential conclusion. Moreover, if the company is in registration for a new issue of securities or has an important transaction, then an early resolution may also be desirable.**

**Such presentations carry significant risks. The government may not agree with the conclusions that the issuer has reached. Moreover, voluntary disclosure of information to the government may accelerate the investigation and lead to an *adverse* outcome more quickly than would**

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<sup>12</sup> In cases involving alleged illegal acts, Section 10A of the PSLRA already imposes a statutory duty on the outside auditor to satisfy itself that the company has taken, or is taking, prompt remedial action to solve the problem. Thus, a company's early efforts also may avoid the risk of a Section 10A report being lodged with the SEC by the outside auditors.

otherwise be the case. Other tactical issues relating to the attorney client privilege, discussed below, also may come into play.

A second alternative may be to be more reactive than proactive. The persons who are subject to an SEC investigation need to understand that, in some circumstances, they cannot "push on a string" and obtain an early resolution of the investigation. The SEC is professionally skeptical and will not necessarily "take the corporation's word for it". Rather, the staff will want to independently test and verify facts given by corporation and come to its own conclusion as to the nature of the conduct and the potentially responsible persons. This may take time, and patience is essential.

**F. Worry About the Attorney-Client and "Joint Defense" Privileges**

**1. Is There a Privilege to Begin With?**

Not infrequently, an SEC investigation will delve into issues related to the adequacy of SEC disclosures, or disclosures made in conference calls with analysts, and the like. The Staff may argue that such disclosure-related issues do not afford any attorney-client privilege as to lawyer communications in connection with a matter that is to be publicly disclosed. In general, the Staff has shown more willingness to push hard on companies' blanket assertions of privilege, and refuse to acquiesce in a claim of privilege. In at least one pending investigation, the Staff took the extraordinary position that communications between lawyers and a forensic consultant hired by the law firm to help investigate an accounting problem may not be privileged, and insisted on taking the testimony of the consultant as to the investigative steps he pursued at the request of counsel. Clearly there is no guarantee that the SEC with what defense counsel believes is "off limits" to its investigation.

**2. Are the Individual Officers and Employees Protected by the Privilege?**

Any serious inquiry by the Commission will cause counsel to interview many company employees in order to understand the facts. The casual belief that these communications are all privileged needs to be critically examined. Counsel may not have clearly communicated with and

agreed with the affected individual that an attorney-client relationship exists, and any resulting memoranda or other work product may not be privileged. Conversely, counsel may have determined that a particular individual may have engaged in wrongdoing, and would have a conflict in purporting to represent that individual. Counsel may also find him/herself disqualified later on for having purported to jointly represent the individual, only to later conclude that that individual needs separate counsel—only after having received highly confidential communications with the now-former client.

3. Even if the Privilege Attaches, Will It Be Waived?

Increasingly, the Commission has sought to have the company waive its applicable privileges as part of any voluntary resolution of an investigation or enforcement action. This puts both the company and individual officers and employees in some jeopardy, since lawyer memos or other work product may have been generated that, if handed over to the Enforcement Division, will increase the potential exposure of one or more individuals. Defense counsel should consider the possibility that otherwise privileged documents at some point may be handed over to the government, and act appropriately.

4. How Will Disclosures to the SEC Affect Discovery in Related Civil Proceedings?

Often, an SEC investigation takes place in parallel with a securities class action case. Documents disclosed to the SEC, except in rare situations, are discoverable in the civil action. Thus, defense counsel need to consider how far the company's cooperation with the Staff should extend where, for example, the Staff asks for specially-prepared summaries, indices, or similar documents. Counsel need to be aware that in the name of cooperation, they may be creating a "roadmap" for plaintiffs' counsel in the civil cases.

5. The "Joint Defense" Privilege May Give Rise to a Disqualifying Conflict if One of the Participants Becomes a Witness for the Government

The company and its officers, some of whom may be separately represented, sometimes enter into formal or informal "joint defense" agreements for the purpose of exchanging facts and information during the course of an investigation. Recently, this privilege has led to unforeseen difficulties when one of the participants decides to settle with the government, and in exchange agrees to testify against the remaining members of the "joint defense." *See, e.g., United States v. Henke*, 222 F.3d 633 (9th Cir. 2000) (holding that defense counsel properly concluded that he must withdraw from representation of his client where, by virtue of a joint defense agreement, he obtained confidential information from another former defendant who became a government witness. The court agreed that a conflict of interest was created, due to counsel's inability to use the confidential information to cross-examine the former defendant when he testified at trial). Defense counsel need to proceed with caution in entering into a "joint defense agreement", and consider the later complications it will create if the matter is likely to go to trial.

**G. Secure the Company's Records, For Better or For Worse.**

While sometimes unfortunate documents will have been generated, it would be potentially as damning in the eyes of the Enforcement Division for the company to have allowed important evidence to have been lost or destroyed. Take steps to secure both paper and electronic evidence as soon as practicable. Be sure to have a procedure in place to deal with departing employees involved in the subject matter of the investigation, so that their computer files (including hard drives) are not inadvertently wiped clean. And keep a clear record of where critical documents—good or bad—are coming from, since the question of who within the company may have been aware of certain facts at particular times may have an enormous impact on the disposition of the investigation.

**H. Cooperate, Cooperate, Cooperate**

Except in the rarest of cases, the better advice is always to cooperate with the Commission and meet the Staff's reasonable requests for information. An important asset of the company in resolving any SEC inquiry on favorable—or at least neutral—terms is to establish credibility, honesty and integrity. Assisting the Staff in providing summaries or

overviews of the facts sometimes will earn "bonus points" with the Staff in building credibility.

**I. Admonish Key Employees Not to Engage in Uncontrolled Discussions Regarding the Merits**

One of the questions the SEC will ask of each testifying witness is whether they have had communications with other individuals involved in the investigation. There is usually no need for potential witnesses to "compare notes" on the underlying events and circumstances, and counsel usually will be able to do this in a more controlled and privileged manner. Defense counsel only puts his or her witnesses in harm's way by not strongly advising these individuals to cease all such communications while the investigation is pending.

**J. Make Appropriate Public Disclosure**

While an investigation is pending, defense counsel often wrestle with the issue of when the company needs to disclose the fact of the investigation. Since the Staff is not required to reveal that it is investigating any particular claim against a particular person, many companies conclude that it would be premature to make a disclosure of the investigation until a more formal event, such as a Wells Notice indicating the Commission's intent to pursue a claim against the company or one of its officers, occurs. There is no single answer to this question—it is entirely dependent on the facts and circumstances of the individual investigation. Nevertheless, it is no uncommon practice to make public disclosure of the pending investigation, at least where the Commission has decided to take testimony from employees, and there are other early indicators that the Staff believes that wrongdoing has occurred.

## APPENDIX OF REPRESENTATIVE SEC ENFORCEMENT ACTIONS INVOLVING TECHNOLOGY COMPANIES AND THEIR OFFICERS

### 1. Violations of Revenue Recognition Provisions of GAAP

- a. In **In the Matter of James R. Bryan**, Exchange Act Rel. No. 34-39077, 1997 WL 578260 (Sept. 15, 1997), who was Chief Financial Officer for Digitran, Inc., engaged in a fraudulent scheme with Digitran's Chief Executive Officer to overstate Digitran's sales, assets, shareholders' equity, and earnings for its 1992 fiscal year and portions of 1993. Specifically, the Commission alleged that Bryan participated in a scheme to file false financial statements with the Commission, misrepresentations of the existence of agreements for the sale or lease of computer simulators by Digitran, failures to disclose the cancellation of agreements to purchase or lease computer simulators, and improper recognition of revenue on several sale and lease transactions. According to the Commission, this conduct led Digitran to overstate its revenue by 46% in 1992 and by 93% in 1993.

The Commission also alleged that Bryan sold approximately 6000 shares of Digitran stock while in possession of this material, nonpublic information concerning Digitran's sales and finances. Bryan consented to the entry of a judgment barring him from serving as an officer or director of a publicly traded company, enjoining future violations of the securities laws, and containing civil fines and interest of approximately \$20,000 in connection with his alleged insider trading activities. Digitran previously consented to the entry of a judgment relating to the same conduct, which enjoined Digitran from future violations of the securities laws.

- b. In **In the Matter of Scientific Software-Intercomp**, Litig. Rel. No. 15485, 1997 WL 561753 (Sept. 11, 1997), the Commission filed and simultaneously settled a financial fraud action alleging, among other things, that Scientific Software Intercomp violated Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B), and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13, by materially overstating its revenue and earnings for 1993, 1994 and 1995. Specifically, the Commission alleged that SSI backdated or misdated contracts, booked revenue without contracts, overaccrued project revenues, and provided side letters to customers modifying

payment obligations. According to the Commission, as a result of these practices, SSI recognized revenues on contracts to resellers that included confidential side-letters either excusing payment to SSI until the reseller received payment from a third-party, or rendering the contract ineffective and cancelable until a specified future event, normally the sale of SSI's software to the reseller's customer. SSI consented to the entry of an order permanently enjoining future violations of the antifraud, reporting, internal control, and books and records provisions of the federal securities laws, and, in addition, agreed to restate its financial statements for 1993, 1994 and 1995.

- c. In **In the Matter of PMSC**, Litig. Rel. No. 15417, 1997 WL 411683 (July 23, 1997), the Commission announced that it had filed a complaint against Policy Management Systems Corp. and five of its current and former officers, alleging that each had engaged in a number of improper accounting practices, including the use of side letters to modify the terms of contracts granting customers rights of return, an undisclosed billing arrangement with one customer, undisclosed prebilling arrangements with other customers, and various practices which had the effect of holding the books open beyond the end of several reporting periods. According to the Commission, each of these practices resulted in the recognition of revenue (1) on the sale of products that had not been shipped, (2) on the sale of products for which a right of return existed, or (3) on contracts that had been entered into only after the end of the company's reporting period. The Commission's complaint alleges violations of Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act, and of Rules 13a-1, 13a-13, and 12b-20, and seeks an order pursuant to which PMSC would pay a civil penalty of \$1 million, and each individual defendant a civil penalty of \$20,000, as well as injunctive relief barring future violations of certain provisions of the federal securities laws.
- d. In **In the Matter of Spectrum Information Technologies, Inc.**, Exchange Act Rel. No. 34-38774, 64 S.E.C. 2030 (June 25, 1997), the Commission brought and simultaneously settled an enforcement action alleging violations of Sections 5 and 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and Rules 10b-5, 13a-13 and 12b-20. The Commission alleged that between May and October, 1993, Spectrum entered into a series of transactions to create the illusion that a license of its technology was worth millions of dollars. Specifically, the Commission alleged that Spectrum persuaded a series of companies to agree to

pay Spectrum large fees to license its patented technology by promising those same parties payments that would substantially offset their fees by funneling the fees back in the form of offsets for advertising expenses incurred by those parties. Thus, according to the Commission, Spectrum violated the securities laws by (1) filing periodic disclosures with the Commission and issuing press releases that materially misstated Spectrum's revenue, and (2) failing adequately to disclose material information concerning the substance of its licensing transactions and to discuss in the management discussion and analysis section of the company's periodic reports the effect of those transactions on its cash flows. Spectrum agreed to the entry of a consent judgment against it, including a cease and desist order barring further violations of the federal securities laws.

- e. In **S.E.C. v. Joseph C. Allegra, et al.**, Litig. Rel. No. 15384, 64 S.E.C. Docket 1951 (June 11, 1997), the Commission announced that it had commenced and simultaneously settled an enforcement action against the former chief executive officer, former chief financial officer, former chief operating officer, and former executive vice president of T2 Medical, Inc., alleging that the four former executives inflated T2's net income for the quarters ended December 31, 1992 and March 31, 1993 by engaging, and directing their subordinates to engage, in fraudulent accounting practices. These fraudulent practices included prematurely recognizing revenue, deferring bad debt write-offs past the end of the fiscal quarter in which the write-offs were required to be recorded, recorded revenue from an asset sale that actually occurred in the following quarter, reclassifying as assets certain period expenses, and making fictitious accounting entries in connection with T2's acquisition of certain companies that had the effect of pushing some bad debt expense back to prior periods. In addition, the Commission's complaint alleges that the former COO engaged in illegal insider trading. Each of the defendants agreed to the entry of an order permanently enjoining them from future violations of the securities laws, and each agreed to pay a civil fine, ranging from \$20,000 to \$150,000.
  
- f. In **In the Matter of Ronald H. Hoffman**, Exchange Act Rel. No. 34-38494, 64 S.E.C. Docket 648 (Apr. 10, 1997); **In the Matter of Lynn K. Blattman**, Exchange Act Rel. No. 34-38493, 1997 WL 186886 (Apr. 10, 1997); **In the Matter of Richard J. LaJoie, Jr.**, Exchange Act Rel. No. 34-38559, 64 S.E.C. Docket 1186 (Apr. 30, 1997); and **In the Matter of Philip S. Present II and William J. Scanlon**, Exchange Act Rel. No. 34-38494, 64 S.E.C. Docket 648 (Apr. 10, 1997), the Commission brought and simultaneously settled enforcement

actions against five persons associated with Structural Dynamics Research Corporation ("SDRC"): Ronald H. Hoffman (SDRC's Chief Financial Officer), Richard J. LaJoie, Jr. (SDRC's Controller), Lynn K. Blattman (SDRC's Assistant Controller), and Philip S. Present II and William J. Scanlon (both partners with SDRC's outside auditor, KPMG Peat Marwick LLP).

In each of these actions, the Commission alleged that the defendants knew or were reckless in not knowing that SDRC had recognized material amounts of revenue on the basis of purchase orders containing conditional language during 1993 and the first half of 1994. Specifically, the Commission alleged that, beginning in 1992 and continuing through September 14, 1994, SDRC had inflated revenues and earnings by recognizing both premature and fictitious revenue. This fraudulent scheme allegedly was carried out by certain SDRC executives. According to the Commission, a material amount of the improperly recognized revenue was based on purchase orders containing conditional language. On January 17, 1995, SDRC restated its financial statements in order to correct for the improper recognition of revenue. For 1993, revenue was restated downward by 38.7 million (21%).

With respect to each of the SDRC insiders, the Commission alleged that each had omitted to state certain material information to SDRC's auditors in connection with their audit of SDRC's 1993 financial statements.

The Commission also alleged that SDRC's outside auditors knew that SDRC recorded certain revenue based on conditional purchase orders in violation of GAAP, but had not required SDRC to omit amounts attributable to such purchase orders from revenue reported in its 1993 financial statements, despite the fact that explanations from SDRC personnel did not address the fact that the purchase orders were conditional. Further, the Commission alleged that the auditors were aware at the time of the 1993 audit that there were material risk factors associated with SDRC that increased the risk of material financial errors, such as the adoption of aggressive revenue recognition policies, weak internal controls, and high write offs of accounts receivable. The Commission alleged, for example, that the auditors failed adequately to verify the underlying cause of the large write-offs and revenue reversals. As part of the consent judgment, Present consented to the entry of an order barring him from practicing as an accountant before the Commission, and Scanlon consented to an order of censure.

g. In **In the Matter of Midisoft Corp.**, Exchange Act Rel. No. 34-37847, 63 S.E.C. Docket 110 (Oct. 22, 1996), the Commission brought and simultaneously settled charges against Midisoft Corp. arising out of a scheme by Midisoft's officers fraudulently to inflate the company's 1994 revenue. Specifically, the Commission alleged that Midisoft improperly recognized revenue on goods that the company did not ship prior to the end of the company's 1994 fiscal year, failed adequately to reserve for product returns, and misled its outside auditors concerning the level of both its sales and product returns.

The Commission alleged that Midisoft violated GAAP and materially overstated 1994 revenues by overstating revenues by approximately 16.8%, mostly as a result of a scheme whereby Midisoft recognized revenue when the product left the company's premises, rather than when the product actually was shipped to distributors. In this regard, Midisoft allegedly implemented a "ship and hold" scheme, pursuant to which product was held by a freight forwarding company rather than by the company itself, thereby creating the impression that the product had been shipped to customers. The Commission noted that evidence existed that officers discussed storing inventory in an employee's garage for purposes of creating an appearance that such inventory had been shipped to customers.

The Commission also alleged that Midisoft had created contingent purchase orders (that is, purchase orders based on the understanding that Midisoft would not deliver the products ordered unless and until the company received further instructions from the respective customers) and received phony shipping documents from the freight forwarding company, thereby creating the impression that the goods held by the freight forwarding company actually had been shipped to the customer. In addition to contributing to the publication of materially false financial statements in violation of Section 10(b), the Commission found that these practices reflected a failure by Midisoft to implement appropriate internal accounting controls, as required by Section 13(b)(2) of the Exchange Act.

The Commission also brought enforcement actions against Midisoft's Chief Executive Officer (**In the Matter of Raymond J. Bily**, Exchange Act Rel. No. 34-38296, 63 S.E.C. Docket 2166 (Feb. 18, 1997)), its Chief Financial Officer (**In the Matter of Calvin M. Dyer**, Exchange Act Rel. No. 34-37848, 63 S.E.C. Docket 114 (Oct. 22, 1996)), its Controller (**In the Matter of Alan G. Lewis**, Exchange Act Rel. No. 34-37879, 63 S.E.C. Docket 242 (Oct. 28, 1996)), and its National Sales Manager (**In the Matter of William D. Kyle**, Exchange Act Rel. No. 34-

38876, 1997 WL 417629 (July 28, 1997)). The Commission found that each of these persons violated (1) Section 21C of the Exchange Act by causing Midisoft improperly to recognize revenue relating to contingent purchase orders, (2) Section 13(b)(2) of the Exchange Act by failing to cause Midisoft to make and keep books, records and accounts that fairly reflected the material transactions relating to those purchase orders, (3) Section 13(b)(5) and Rule 13b2-1 by failing to implement a system of accounting controls sufficient to prevent the inclusion of revenues relating to contingent purchase orders, (4) Rule 13b2-2 by issuing a false management representation letter to Midisoft's outside auditors in connection with the company's fiscal year 1994 audit, and/or Section 10(b) of the Exchange Act by causing Midisoft to file false and misleading periodic reports with the Commission. Despite the nature of the allegations, each of the individual enforcement actions were settled by the Commission pursuant to agreements in which defendants agreed only to the entry of a cease and desist order.

- h. In **In the Matter of Cambridge Biotech Corp.**, Exchange Act Rel. No. 34-37833, 63 S.E.C. Docket 2, (Oct. 17, 1996), the Commission brought -- and defendant settled -- an enforcement action alleging improper accounting practices. According to the Commission, between June 1991 and December 1992, CBC improperly recognized revenue from a series of nine sales and license transactions that did not meet the revenue recognition requirements of GAAP. Specifically, the Commission alleged that the transactions included shipments of product with no expectation of payment, premature recognition of license fee revenues, and use of corporate funds to resolve outstanding receivables by creating the false appearance that CBC had purchased unrelated goods and services when, in fact, CBC simply had bought its own product back. According to the Commission, each of these transactions caused CBC to overstate revenue and to understate the company's net loss in its Form 10-Q and Form 10-K Reports in violation of Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act, and Section 17(a) of the Securities Act. Pursuant to a settlement with the Commission, a cease and desist order was entered against the company.
- i. In **In the Matter of Aura Systems, Inc.**, Exchange Act Rel. No. 34-37776, 62 S.E.C. Docket 2563 (Oct. 2, 1996), the Commission brought enforcement actions against Aura Systems, Inc., its Chief Executive Officer, Chief Financial Officer, and Chief Accounting Officer, alleging that each of the defendants had caused to be filed with the Commission false and misleading quarterly and annual reports. According to the Commission, the defendants made material false and misleading

statements in its Form 10-Q and Form 10-K Reports in that Aura reported certain unusual transactions as income, without disclosing that such transactions had nothing to do with its proprietary electromagnetic technology business. Specifically, the Commission found that Aura and/or the individual defendants violated Sections 10(b), 13(a), 13(b)(2), and 13(b)(5) of the Exchange Act and Section 17(a) of the Securities Act by failing to disclose that it had recorded as current revenue two transactions that were not related to Aura's business. In the first transaction, Aura purchased and resold computer monitors "under circumstances [defendants] understood would generate little or no profit." In the second transaction, Aura entered into a sham agreement with a dry wall installation contractor, ostensibly for the provision of "engineering services" to the contractor, but which in reality were provided by another service provider. The effect of both transactions was to artificially inflate Aura's reported revenues. The Commission determined that neither transaction should have been reported as income, and that both should have been disclosed and discussed in Aura's disclosure documents.

- j. In **In the Matter of 3Net Systems, Inc.**, Exchange Act Rel. No. 34-37746, 1996 WL 557069 (Sept. 30, 1996), the Commission filed and simultaneously settled claims that 3Net's former management, which had been ousted by 3Net's shareholders only one year after the company's August, 1992 initial public offering, had materially misled investors by (1) making false and misleading statements concerning 3Net's primary software product in its offering materials, and (2) reporting materially inflated revenue for 3 Net's 1991 fiscal year, as well as for certain portions of 1992. Specifically, the Commission alleged that 3Net falsely represented in its offering materials that 3Net had successfully installed its software for a specific customer, and also misleadingly had failed to disclose that it had encountered significant problems and delays in developing the same software product.

In addition, the Commission alleged that 3Net improperly recognized over \$1 million of revenue in both 1991 and 1992, resulting in overstated revenue of 57% and 48%, respectively, by misrepresenting to its outside auditors the degree to which certain work had been completed under existing contracts. In this regard, the Commission noted that GAAP outlines two different methods for recognizing contract revenue. According to the Commission, the "percentage of completion method" applies "only when management can reliably estimate progress toward completion of the contract. Thus, management must be able to reliably estimate

the total costs required to complete the contract." The "completed contract" method is required when management cannot reliably estimate progress toward completion, and requires the company to postpone recognizing revenue until the contractual obligations have been met. Although 3Net's outside auditors had determined that 3Net could recognize revenue for certain contracts under the percentage of completion method, the Commission alleged that the auditor's approval was based on false statements by 3Net concerning the costs associated with each contract and, in fact, "lacked the systems necessary to estimate and track progress" under the contracts.

See also In the Matter of William T. Manak, Exchange Act Rel. No. 34-38251, 63 S.E.C. Docket 1910 (Feb. 6, 1997) (consent judgment ordering defendant, the former President and Chief Executive Officer of 3Net, to cease and desist from further violations of the reporting requirements of the federal securities laws); In the Matter of Lawrence M. Gress, Exchange Act Rel. No. 34-37745, S.E.C. Docket 2543 (Sept. 30, 1996) (consent judgment ordering defendant, a consultant to 3Net and then its Chief Financial Officer, to cease and desist from further violations of the reporting requirements of the federal securities laws).

- k. **In the Matter of Cypress Bioscience, Inc.**, Exchange Act Rel. No. 34-37701, 62 S.E.C. Docket 2286 (Sept. 19, 1996), the Commission simultaneously brought and settled an action against both Cypress and its Chief Financial Officer. The Commission alleged that Cypress filed a false and misleading Form 10-Q Report for the third quarter of its 1993 fiscal year by: (1) including financial statements that materially overstated revenue and materially understated losses by improperly recognizing revenue from purported "bill and hold" transactions; (2) failing to disclose that Cypress had changed its accounting policies to recognize revenue on goods that had not been shipped; (3) failing to disclose that the increase in revenues between the third quarter of 1992 and the third quarter of 1993 was primarily attributable to the purported bill and hold transactions; and (4) failing to discuss the impact the purported bill and hold transaction were likely to have on future revenue.

These violations resulted from two events. First, the company had moved to new manufacturing facilities in November, 1992, but had not yet received approval from the Food and Drug Administration and, therefore, could not legally fill customer orders under FDA regulations. During this period, Cypress nevertheless recognized revenue on product that had been ordered by its customers and that

would have been shipped but for the FDA prohibition. Second, in the spring of 1993, Cypress implemented a volume discount program pursuant to which customers were not required to accept immediate delivery of goods, but could take delivery at any time within 11 months, with a full right to return unopened goods within 14 days of receiving delivery. Cypress allegedly recognized revenue to be received pursuant to volume discount sales, despite the existence of the right of return. According to the Commission, both practices violated GAAP and resulted in the filing by Cypress of false and misleading financial statements in the company's periodic reports in violation of Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act, and Rules 10b-5, 12b-20 and 13a-13 promulgated thereunder. Similarly, the Commission alleged that Cypress' CFO violated Sections 10(b) and 13(b)(5) of the Exchange Act, and Rules 10b-5, 13b2-1 thereunder, and aided and abetted Cypress' violation of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). Both Cypress and its CFO consented to the entry of a cease and desist order and, in addition, Cypress' CFO consented to the entry of an order barring him from practicing before the Commission as an accountant.

1. In **In the Matter of Advanced Medical Products, Inc.**, Exchange Act Rel. No. 34-37649, 62 S.E.C. Docket 1964 (Sept. 5, 1996), the Commission alleged that AMP overstated its revenues in the 18.65%, 29.89%, 5%, and 30.86% in its Forms 10-Q for AMP's third and fourth quarters of 1991 and third and fourth quarters of 1992, respectively. Specifically, the Commission alleged that AMP engaged in five different practices leading to the improper recognition of revenue: (1) the recognition of revenue when product had been shipped to AMP's field representatives for installation, rather than when product actually had been received by the customer, as required by GAAP; (2) improperly recording in its books shipments of "soft sales" (sales for which customers had expressed interest, but had not yet committed); (3) improperly holding open accounting periods to record additional end-of-the quarter sales; (4) improperly recognizing revenue for a sale that was not properly shipped during the quarter; and (5) improperly recognizing revenue on equipment that was on backorder, often with partial shipments. In addition, in those instances in which AMP eventually wrote-off soft sales that previously had been recorded as revenue but that, in fact, never materialized, AMP consistently accounted for the write offs in a manner that resulted in an overstatement of revenue.

The Commission's enforcement action alleged that AMP and two of its officers violated Section 17(a) of the Securities Act and Sections 10(b) and 13(b)(2) of the

Exchange Act, as well as Rules 13b2-1 and 13b2-2 thereunder by filing false and misleading periodic reports with the Commission, failing to keep accurate books and records, and making materially false or misleading statements to AMP's outside auditor. Each of the defendants consented to the entry of a cease and desist order.

- m. In **In the Matter of Platinum Software Corp., John F. Keane and William B. Falk**, Exchange Act Rel. No. 34-37185, 61 S.E.C. Docket 2217 (May 9, 1996), the Commission announced that it had filed and simultaneously settled (with some defendants), and enforcement action alleging that Platinum Software Corp. ("PSC") and certain of PSC's officers violated Sections 10(b), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1 and 13b2-2, by devising and perpetrating a scheme to overstate PSC's revenues and cash receipts. In particular, the Commission alleged that certain officers of PSC made false accounting entries in PSC's books and records that caused PSC improperly to recognize revenue on sales that were undelivered or the subject of license agreements that were unsigned, subject to cancellation or other significant uncertainty about customer acceptance, or that were subject to significant remaining obligations on the part of PSC. In addition, the Commission alleged that PSC held its books open past the end of certain reporting periods, in order to recognize revenue received after the end of such periods and, in this regard, arbitrarily reclassified accounts receivable as cash.

Although PSC and two of PSC's vice presidents of sales consented to the entry of orders requiring them to cease and desist violations of the federal securities laws, PSC's chief financial officer, Jon R. Erickson, was fined \$100,000 and permanently barred from practicing as an accountant before the Commission. See In the Matter of Jon R. Erickson, Exchange Act Rel. No. 34-37269, 62 S.E.C. Docket 181 (June 3, 1996). In addition, PSC's controller was temporarily barred from practicing as an accountant before the Commission. See In the Matter of Mark S. Tague, Exchange Act Rel. No. 34-37270, 62 S.E.C. Docket 182 (June 3, 1996).

- n. In **In the Matter of Kurzweil Applied Intelligence, Inc.**, Exchange Act Rel. No. 34-36021, 59 S.E.C. Docket 2138 (July 25, 1995), the Commission brought, and Kurzweil Applied Intelligence, Inc. ("KAI") simultaneously settled, an enforcement action alleging violations of Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and Rules 10b-5, 12b-20, 13a-13

and 13b2-1. Specifically, the Commission alleged that four former officers of KAI devised and carried out a scheme to falsify corporate sales records in order to report steadily increasing revenues and earnings, both prior to and after KAI's initial public offering in August, 1993. According to the Commission, as part of the scheme, KAI routinely recognized revenue from transactions that had not been completed.

The Commission explained that in order to create a false appearance that transactions were complete, the former executives and certain other employees forged signatures on sales quotes, created "side letters" which negated any obligation on the part of the purchaser to pay for goods, and recognized revenue from contingent distributorship agreements where the distributor did not have the intent or ability to pay absent resales of the goods. In addition, the Commission alleged that goods were shipped to an off-site independent warehouse for storage to create the false appearance that products had been sold and shipped to the customer. Moreover, the Commission alleged that in order to avoid detection during the audit of KAI's 1994 financial statements, the former executives and other employees attempted to deceive the company's outside auditors by forging and falsifying accounts receivable and inventory audit confirmations, altering and shredding documents reflecting sales contingencies and moving approximately twenty pallets of stored inventory to secret locations to evade the auditor's detection. These practices resulted in overstated revenue of \$2.76 million (25%) for 1993, and \$5.74 million (76%) for the first nine months of 1994.

Although KAI agreed to the entry of an injunction against future violations of the securities laws, the individual defendants received much stiffer penalties. Bernard F. Bradstreet, who had served as KAI's President and Co-Chief Executive Officer, and Thomas E. Campbell, who had served as KAI's Vice President of Sales, were convicted of five counts of conspiracy, securities fraud and falsification of corporate books and records in violation of Sections 10(b) and 13(b)(5) of the Exchange Act and Rule 10b-5. Bradstreet and Campbell were sentenced to 33 and 18 months in prison, respectively. In addition, Bradstreet was ordered to pay restitution of \$2.3 million. Finally, Bradstreet and Campbell, together with Debra J. Murray, another former KAI executive, agreed to settle the civil enforcement action brought by the Commission, agreeing to the entry of injunctions against future violations of the securities laws and barring each of them from serving as an officer or director of any public company. A fourth executive, David R. Earl, did not consent to judgment, and the SEC's enforcement action against him is

pending in the United States District Court for the District of Massachusetts. United States v. Bradstreet, Litig. Rel. No. 15187, 63 S.E.C. Docket 1123 (Dec. 16, 1996).

- o. In **S.E.C. v. Telematics International, Inc.**, Litig. Rel. No. 14293, 57 S.E.C. Docket (Oct. 7, 1994), the Commission announced the entry of a consent judgment against Telematics, its Chief Executive Officer and its Chief Financial Officer. According to the Commission, each of the defendants engaged in violations of Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B), and Rules 10b-5, 13b2-1 and 13b2-2 by employing improper revenue recognition practices, resulting in the filing of materially false and misleading periodic reports with the Commission in 1986, 1987, 1988, and 1989. Specifically, the Commission alleged that Telematics improperly had booked and recorded sales (1) without receipt of a purchase order or other sales authorization, (2) when ultimate acceptance by the customer was contingent upon a future event, (3) when product was shipped on consignment or loan to a customer, and/or (4) when rights of return existed.
  
- p. In **S.E.C. v. Gupta, et al.**, Litig. Rel. No. 15097, 1996 WL 565283 (Sept. 30, 1996), the Commission alleged that three senior executives of California Micro Devices Corporation ("Cal Micro") fraudulently inflated Cal Micro's publicly reported revenue by directing employees to falsify documents in order to create the appearance that certain goods had been shipped to customers when, in fact, the goods had not been shipped or, in most cases, even manufactured. The Commission alleged that, as a result of this conduct, net sales for the second and third fiscal quarters were overstated by 95% and 117%, respectively. The Commission also alleged that two defendants engaged in illegal insider trading by selling Micro Devices stock while in possession of material, nonpublic information concerning the true state of Micro Devices finances. The Commission alleged that defendants violated Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, 13b2-2, and/or 16a-3. In addition, on September 17, 1997, a federal grand jury handed down a criminal indictment against each of the same three defendants. See United States v. Desaignouard, No. CR 97 20120 (N.D. Cal., filed Sept. 17, 1997), discussed below at Section II.C.3.a; J. Rae-Dupree, "Ex-execs of Cal Micro indicted," San Jose Mercury News, Sept. 18, 1997, at C1.

- q. In **S.E.C. v. Network Equipment Technologies, Inc.**, Litig. Rel. No. 14946, 62 S.E.C. Docket 383 (June 12, 1996), the Commission announced that the United States District Court for the Northern District of California had entered a final judgment against Network Equipment Technologies, Inc. ("NET") that, among other things, enjoined NET from future violations of Sections 13(a), 13(b)(2)(A), 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-13 promulgated thereunder. The Commission had alleged that NET had materially misstated revenues, net income and related items for the periods ended September 31, 1989 and December 31, 1989. Specifically, the Commission alleged that NET's materially inaccurate financial reports resulted from an inadequate internal accounting control system that improperly gave substantial authority and control over revenue recognition to the company's sales department, allowing the company to recognize revenue on shipments for which there were no purchase orders, no binding contracts, and no authorization for shipment by the customer.
- r. In **In the Matter of Software Toolworks, Inc.**, Exchange Act Rel. No. 13813, 55 S.E.C. Docket 307 (Sept. 30, 1993), the Commission brought and simultaneously settled (against four of five defendants) an enforcement action alleging that Software Toolworks misled investors in connection with the company's July 1992 \$82 million secondary offering. Specifically, defendants' alleged misrepresentations and omissions concerned, among other things, deteriorating sales of Nintendo software, offering of millions of dollars of price concessions to the company's customers to stimulate sales, and shipment of millions of dollars of the company's Nintendo product to certain customers as conditional or fictitious sales. Perhaps most significantly, the Commission alleged as a basis for the enforcement action the alleged "failure to maintain a functioning audit committee to monitor the company's financial performance and to safeguard against accounting improprieties. In addition, each of the four individual defendants was alleged to have sold substantial amounts of Software Toolworks stock during the same period in which they were alleged to have misled the market concerning the company's financial condition.
- s. See also In the Matter of Harry C. Berridge, Exchange Act Rel. No. 34-35444, 58 S.E.C. Docket 2456 (Mar. 6, 1996); In the Matter of Ronald A. Romito, Exchange Act Rel. No. 34-36803, 61 S.E.C. Docket 524 (Feb. 1, 1996); In the Matter of Fenando Cappuccio, Exchange Act Rel. No. 34-36670, 60 S.E.C. Docket 2757 (Jan. 3, 1996); In the Matter of Florio Fiorini, Exchange Act Rel. No. 34-36669, 60 S.E.C. Docket 2753 (Jan. 3, 1996); In the Matter of Roger D. Gnowles,

Exchange Act Rel. No. 34-36244, 60 S.E.C. Docket 652 (Sept. 18, 1995); In the Matter of Duane V. Midgley, Exchange Act Rel. No. 34-36229, 60 S.E.C. Docket 547 (Sept. 14, 1995); In the Matter of John J. French and Brent Jones, Exchange Act Rel. No. 34-36053, 59 S.E.C. Docket 2406 (Aug. 3, 1995); S.E.C. v. Curtis A. Younts, Jr., et al., Litig. Rel. 14547, 59 S.E.C. Docket 1752 (June 27, 1995); In the Matter of James Edward Palmer and John Louis Thonet, Exchange Act Rel. No. 34-35385, 58 S.E.C. Docket 2152 (Feb. 16, 1995); In the Matter of Thomas Milo Somers, Exchange Act Rel. No. 34-35386, 58 S.E.C. Docket 63288 (Feb. 16, 1995).

## 2. Misleading Statements to Auditors

- a. In In the Matter of PMSC, Litig. Rel. No. 15417, 1997 WL 411683 (July 23, 1997) (discussed in greater detail above), the Commission filed a complaint against Policy Management Systems Corp. and certain of its officers, including its General Counsel. The Commission alleged, among other things, that PMSC's general counsel had made false statements to the company's outside auditors that two contracts PMSC had included as revenue in the period ended December 31, 1992, had been completed in December, 1992, despite the fact that the contracts had not been finally negotiated and signed until January, 1993. The Commission seeks a \$1 million civil penalty against PMSC, a \$20,000 civil penalty against the General Counsel, and injunctive relief barring PMSC and the General Counsel from future violations of certain reporting provisions of the federal securities laws.
- b. In In the Matter of William T. Manak, Exchange Act Rel. No. 34-38251, 63 S.E.C. Docket 1910 (Feb. 6, 1997), and In the Matter of Lawrence M. Gress, Exchange Act Rel. No. 34-37745, 62 S.E.C. Docket 2543 (Sept. 30, 1996), the Commission brought and simultaneously settled enforcement actions against 3Net Systems, Inc.'s president and chief executive officer, and against its chief financial officer, respectively, alleging that each had violated Rule 13b2-2 by making materially false and misleading statements to the company's outside auditors regarding the status of work performed by the company under certain contracts. (See discussion of In the Matter of 3Net Systems, Inc., *supra*).
- c. In S.E.C. v. Earl V. Young, Litig. Rel. No. 14981, 62 S.E.C. Docket 1033 (July 16, 1996), the SEC announced that it had filed an enforcement action Earl Young, who was a member of the Audit Committee of the ATM's Board of Directors of Automated Telephone Management Systems, Inc. ("ATM"). In its Litigation

Release, the Commission alleged that Young either knew or was reckless in not knowing that ATM's financial statements materially misstated ATM's revenues for the company's 1993 fiscal year, and failed to notify ATM's independent auditors of the improper revenue recognition. In a previous action, the Commission had alleged that certain of ATM's officers had engaged in a fraudulent scheme to inflate ATM's 1993 revenues by arranging for a third party to sign a fictitious sales contract valued at approximately \$1.3 million (25% of ATM's 1993 revenue). The Commission further alleged that these ATM officers "concealed inventory, created fictitious invoices, and backdated ATM internal documents to conceal the fraud from ATM's auditors." The prior action resulted in default judgments against the officer defendants and the entry of permanent injunctions, civil and criminal penalties, and orders barring each of the officers from serving as officers of any reporting company.

- d. See also In the Matter of James R. Bryan, Exchange Act Rel. No. 34-39077, 1997 WL 578260 (Sept. 15, 1997); In the Matter of Raymond J. Bily, Exchange Act Rel. No. 34-38296, 63 S.E.C. Docket 2166 (Feb. 18, 1997); In the Matter of Alan G. Lewis, Exchange Act Rel. No. 34-37879, 63 S.E.C. Docket 242 (Oct. 28, 1996); In the Matter of Calvin M. Dyer, Exchange Act Rel. No. 34-37848, 63 S.E.C. Docket 114 (Oct. 22, 1996); In the Matter of Advanced Medical Products, Inc., Exchange Act Rel. No. 34-37649, 62 S.E.C. Docket 1964 (Sept. 5, 1996); In the Matter of Kurzweil Applied Intelligence, Inc., Exchange Act Rel. No. 34-36021, 59 S.E.C. Docket 2138 (July 25, 1995); S.E.C. v. Telematics International, Inc., Litig. Rel. No. 14293, 57 S.E.C. Docket (Oct. 7, 1994).

**3. Persons Who "Cause" Violations of SEC Regulations**

- a. In the Matter of William J. Kyle, Exchange Act Rel. No. 34-38876, 1997 WL 417629 (July 28, 1997).
- b. In the Matter of Raymond J. Bily, Exchange Act Rel. No. 34-38296, 63 S.E.C. Docket 2166 (Feb. 18, 1997).
- c. In the Matter of Alan J. Lewis, Exchange Act Rel. No. 34-37879, 63 S.E.C. Docket 242 (Oct. 28, 1996).

**4. Failure To Implement Adequate Internal Controls**

- a. In the Matter of James R. Bryan, Exchange Act Rel. No. 34-39077, 1997 WL 578260 (Sept. 15, 1997).

- b. In the Matter of William J. Kyle, Exchange Act Rel. No. 34-38876, 1997 WL 417629 (July 28, 1997).
- c. In the Matter of Spectrum Technologies, Inc., Exchange Act Rel. No. 34-38774, 64 S.E.C. Docket 2030 (June 25, 1997).
- d. In the Matter of Alan J. Lewis, Exchange Act Rel. No. 34-37879, 63 S.E.C. Docket 242 (Oct. 28, 1996).
- e. In the Matter of Mark S. Tague, Exchange Act Rel. No. 34-37270, 62 S.E.C. Docket 182 (June 3, 1996).
- f. In the Matter of Software Toolworks, Inc., Exchange Act Rel. No. 13813, 55 S.E.C. Docket 307 (Sept. 30, 1993) (citing as grounds for enforcement action the company's alleged "failure to maintain a functioning audit committee to monitor the company's financial performance and to safeguard against accounting improprieties").

## **C. Remedies**

### **1. Orders Barring Individuals From Serving As An Officer Or Director Of Any Publicly Traded Company**

- a. In the Matter of James R. Bryan, Exchange Act Rel. No. 34-39077, 1997 WL 578260 (Sept. 15, 1997).
- b. S.E.C. v. Joseph C. Allegra, Inc., Litig. Rel. No. 15384, 64 S.E.C. Docket 1951 (June 11, 1997).
- c. United States v. Bradstreet, Litig. Rel. No. 15187, 63 S.E.C. Docket 1123 (Dec. 16, 1996).
- d. S.E.C. v. Earl V. Young, Litig. Rel. No. 14981, 62 S.E.C. Docket 1033 (July 16, 1996).
- e. S.E.C. v. Kendall Square Research Corp., et al., Litig. Rel. No. 14895, 61 S.E.C. Docket 2142 (Apr. 29, 1996).

f. In the Matter of Software Toolworks, Inc., Exchange Act Rel. No. 13813, 55 S.E.C. Docket 307 (Sept. 30, 1993).

**2. Orders Barring Accountants From Practicing Before The Securities And Exchange Commission**

a. In the Matter of Ronald H. Hoffman, Exchange Act Rel. No. 34-38560, 64 S.E.C. Docket 1187 (Apr. 30, 1997).

b. In the Matter of Richard J. LaJoie, Jr., Exchange Act Rel. No. 34-38559, 64 S.E.C. 1186 (Apr. 30, 1997)

c. In the Matter of Philip S. Present II and William J. Scanlon, Exchange Act Rel. No. 34-38494, 64 S.E.C. Docket 648 (Apr. 10, 1997).

d. In the Matter of Karl G. Wassmann III, Exchange Act Rel. No. 34-37938, 63 S.E.C. Docket 449 (Nov. 12, 1996).

e. In the Matter of Aura Systems, Inc., Exchange Act Rel. No. 34-37776, 62 S.E.C. Docket 2563 (Oct. 2, 1996).

f. In the Matter of Cypress Bioscience, Inc., Exchange Act Rel. No. 34-37701, 62 S.E.C. Docket 2286 (Sept. 19, 1996).

g. In the Matter of Mark S. Tague, Accounting Enforcement Act Rel. No. AE-788, 62 S.E.C. Docket 182 (June 3, 1996).

h. In the Matter of Mark S. Tague, Exchange Act Rel. No. 34-37270, 62 S.E.C. Docket 182 (June 3, 1996).

i. In the Matter of Jon R. Erickson, Exchange Act Rel. No. 34-37269, 62 S.E.C. Docket 181 (June 3, 1996).

**3. Civil and Criminal Fines and Penalties**

a. United States v. Desaigouadar, No. CR 97 20120 (N.D. Cal., filed Sept. 17, 1997) (criminal indictment of three former senior executives of California Micro Devices, Inc., and alleging that defendants conspired to and did fraudulently

inflate the revenues and earnings of Cal Micro and that two of the defendants also engaged in illegal insider trading).

- b. S.E.C. v. Joseph C. Allegra, et al., Litig. Rel. No. 15384, 64 S.E.C. Docket 1951 (June 11, 1997) (announcing consent judgments against former executives of T2 Medical, Inc., including civil fines).
- c. In the Matter of Pierce Lowrey, Jr. and Richard Estrin, Litig. Rel. No. 14952, 62 S.E.C. Docket 503 (June 19, 1996) (announcing the entry of consent judgments against two officers of Information Management Technologies Corp., including consent to the entry of permanent injunctions barring future violations of the securities laws and the payment of \$50,000 and \$25,000 civil penalties, respectively).
- d. S.E.C. v. Kendall Square Research Corp., et al., Litig. Rel. No. 14895, 61 S.E.C. Docket 2142 (Apr. 29, 1996) (ordering former president and chief executive officer of Kendall Square Research Corp. to pay \$1.1 million in civil penalties, including disgorgement of losses avoided from sales of KSR stock based on material nonpublic information of \$804,000, with credit for \$750,000 already paid to plaintiffs in a shareholder class action, \$804,000 in civil fines under the Insider Trading Sanctions Act, and a civil penalty of \$242,000).
- e. In the Matter of Thomas J. MacCormack, Exchange Act Rel. No. 34-37147, 61 S.E.C. Docket 2068 (Apr. 29, 1996) (ordering employee of Kendall Square Research Corp. to disgorge \$26,800 plus prejudgment interest, of profits made trading in KSR stock on the basis of material, nonpublic information).
- f. In the Matter of Mark S. Tague, Accounting Enforcement Act Rel. No. AE-788, 62 S.E.C. Docket 182 (June 3, 1996).
- g. In the Matter of James R. Bryan, Exchange Act Rel. No. 34-39077, 1997 WL 578260 (Sept. 15, 1997).
- h. In the Matter of Jon R. Erickson, Exchange Act Rel. No. 34-37269, 62 S.E.C. Docket 181 (June 3, 1996).

#### 4. Orders Requiring Restatement of Financial Statements

In the Matter of Scientific Software-Intercomp, Inc., Litig. Rel. No. 15485, 1997 WL 561753 (Sept. 11, 1997).

**5. Injunctions And/Or Cease And Desist Orders**

- a. In the Matter of James R. Bryan, Exchange Act Rel. No. 34-39077, 1997 WL 578260 (Sept. 15, 1997).
- b. In the Matter of Scientific Software Intercomp, Inc., Litig. Rel. No. 15484, 1997 WL 561753 (Sept. 11, 1997).
- c. In the Matter of William D. Kyle, Exchange Act Rel. No. 34-38876, 1997 WL 417629 (July 28, 1997).
- d. In the Matter of Spectrum Information Technologies, Inc., Exchange Act Rel. No. 34-38774, 64 S.E.C. Docket 2030 (June 25, 1997).
- e. In the Matter of Lynn K. Blattman, Exchange Act Rel. No. 34-38493, 1997 WL 186886 (Apr. 10, 1997).
- f. In the Matter of Raymond J. Bily, Exchange Act Rel. No. 34-38296, 63 S.E.C. Docket 2166 (Feb. 18, 1997).
- g. In the Matter of William T. Manak, Exchange Act Rel. No. 34-38251, 63 S.E.C. Docket 1910 (Feb. 6, 1997).
- h. In the Matter of Karl G. Wassmann III, Exchange Act Rel. No. 34-37938, 63 S.E.C. Docket 449 (Nov. 12, 1996).
- i. In the Matter of Alan G. Lewis, Exchange Act Rel. No. 34-37879, 63 S.E.C. Docket 242 (Oct. 28, 1996).
- j. In the Matter of Midisoft Corp., Exchange Act Rel. No. 34-37847, 63 S.E.C. Docket 110 (Oct. 22, 1996).
- k. In the Matter of Cambridge Biotech Corp., Exchange Act Rel. No. 34-37833, 63 S.E.C. Docket 2 (Oct. 17, 1996).

- l. In the Matter of Aura Systems, Inc., Exchange Act Rel. No. 34-37776, 62 S.E.C. Docket 2563 (Oct. 2, 1996).
- m. In the Matter of 3Net Systems, Inc., Exchange Act Rel. No. 34-37746, 1996 WL 557069 (Sept. 30, 1996).
- n. In the Matter of Lawrence M. Gress, Exchange Act Rel. No. 34-37745, S.E.C. Docket 2543 (Sept. 30, 1996).
- o. In the Matter of Cypress Bioscience, Inc., Exchange Act Rel. No. 34-37701, 62 S.E.C. Docket 2286 (Sept. 19, 1996).
- p. In the Matter of Advanced Medical Products, Inc., Exchange Act Rel. No. 34-37649, 62 S.E.C. Docket 1964 (Sept. 5, 1996).
- q. In the Matter of Jon R. Erickson, Exchange Act Rel. No. 34-37269, 62 S.E.C. Docket 181 (June 3, 1996).
- r. In the Matter of Mark S. Tague, Accounting Enforcement Act Rel. No. AE-788, 62 S.E.C. Docket 182 (June 3, 1996).
- s. S.E.C. v. Kendall Square Research Corp., et al., Litig. Rel. No. 14895, 61 S.E.C. Docket 2142 (Apr. 29, 1996).
- t. In the Matter of Ronald A. Romito, Exchange Act Rel. No. 34-36803, 61 S.E.C. Docket 524 (Feb. 1, 1996).
- u. In the Matter of Kurzweil Applied Intelligence, Inc., Exchange Act Rel. No. 34-36021, 59 S.E.C. Docket 2138 (July 25, 1995).

**6. Orders Requiring Implementation Of Corporate Policies**

In the Matter of Software Toolworks, Inc., Exchange Act Rel. No. 13813, 55 S.E.C. Docket 307 (Sept. 30, 1993) (as part of consent judgment entered to settle enforcement action, company agreed to "maintain a properly functioning audit committee and . . . take reasonable steps to assure that [company's] officers, directors and other employees do not purchase or sell [the company's] securities while in possession of material nonpublic information concerning [they company]").

## 7. Recent Representative Cases Against Chief Financial Officers

a. *SEC v. Solucorp Industries Ltd.*, Litigation Release No. 16388, AAER No. 1213, December 13, 1999 (<http://www.sec.gov/enforce/litigrel/lr16388.htm>): The SEC filed a civil injunctive action against Solucorp Industries Ltd., a company which develops, markets and licenses soil decontamination products. Also charged were several of the company's officers and directors, including Victor Herman, the former CFO of two of Solucorp's subsidiaries. Herman was also responsible for preparing Solucorp's consolidated financial statements. The Commission alleged that defendants defrauded investors over a four year period by releasing false information in ten press releases, an annual report, a shareholders letter, and SEC regulatory filings. Defendants falsely reported having contracts worth \$350 million when such contracts were either nonexistent or subject to undisclosed contingencies. Defendants also overstated revenues from existing contracts by \$4 million and failed to announce the termination or postponement of other contracts in a timely fashion. The company's financial statements included as revenue license fees which were subject to contingencies, resulting in revenue overstatements between 28% and 55% in five separate SEC filings. Herman and others were also charged with selling Solucorp securities while aware of the company's financial fraud.

Also named in the complaint were Solucorp itself, the company's President, two VPs, and a consultant (former an officer and director of Solucorp). The SEC seeks to enjoin all five defendants from violating §10(b) of the Securities Exchange Act and Exchange Act Rule 10b-5. The Commission asked that Solucorp be further enjoined from violating §§13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-10, and 13a-13. It requested that the company's consultant be enjoined from violating §17(a) of the Securities Act, §16(a) of the Securities Exchange Act, and Exchange Act Rules 16a-2 and 16a-3; be required to pay civil penalties and disgorge funds earned by insider trading (plus prejudgment interest); and be barred from serving as an officer or director of a public company. The Commission seeks to enjoin Solucorp's President from violating §17(a) of the Securities Act, §§13(b)(5) and 16(a) of the Exchange Act, and Exchange Act Rules 13b2-1, 13b2-2, 16a-2, and 16a-3. Civil penalties, disgorgement and prejudgment interest were also sought, as well as an order barring him from serving as officer or director of a public company. The SEC seeks civil penalties against the two Vice Presidents, and an injunction against one

prohibiting him from violating §16(a) of the Exchange Act and Exchange Act Rules 16a-2 and 16a-3. Two other directors of Solucorp (one a Senior Vice President) were also named in the complaint; the Commission requested that they be enjoined from violating §16(a) of the Exchange Act and Exchange Act Rules 16a-2 and 16a-3. The SEC also asked that a civil penalty be assessed against the Senior Vice President.

The SEC's investigation is ongoing, and the matter has not been settled.

b. *SEC v. Goldinger* and *SEC v. Strauch*, Litigation Release No. 16347, AAER No. 1203, November 8, 1999 (<http://www.sec.gov/enforce/litigrel/lr16347.htm>): PairGain Technologies, Inc., a designer, manufacturer, and distributor of telecommunication products, was charged along with its former CEO and CFO with failing to account for and timely disclose thefts by the company's money manager, S. Jay Goldinger. Goldinger mingled the funds of his clients and then shifted tens of millions of dollars from some clients to others in order to generate commissions, fees and income for himself. In this fashion, he engaged in securities-futures trading misallocation which cost PairGain \$15.9 million over the course of two years. Although PairGain was aware during this time period that its trading account statements revealed substantial losses, it never verified these amounts or investigated the situation; rather, PairGain accepted Goldinger's explanations at face value. The company instructed Goldinger to attempt to recoup some of its losses; meanwhile, it failed to account for or disclose these losses in two quarterly SEC filings. PairGain also falsely asserted that its funds were held in investment grade securities. The Commission charged that PairGain's former CFO knew or was reckless in not discovering that PairGain had lost significant sums of money in bad investments and that the company's remaining funds had been invested in high-risk options.

PairGain's former CFO was charged with violations of §§10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5, 12b-20, 13a-13, and 13b2-1. He was enjoined from violating or aiding and abetting or causing violations of the above sections and was ordered to pay \$25,000 in civil penalties. An identical injunction and order was entered against PairGain's former CEO.

Goldinger, PairGain's former money manager, was enjoined from violating or aiding and abetting or causing violations of §17(a) of the Securities Act, §§10(b), 13(a), 13(b)(2)(A), 13(b)(5), and 15(c)(1)(A) of the Securities Exchange Act, and Exchange Act Rules 10b-5, 12b-20, 13a-13, and 13b2-1. Goldinger was also

ordered to pay disgorgement plus prejudgment interest and civil penalties. He was further barred from associating with any securities broker or dealer, and later charged with commodities fraud and four felony counts of wire fraud in a related criminal action.

PairGain itself was ordered to cease and desist from violations of §§10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 10b-5, 12b-20, and 13a-13. The company also plead guilty to felony charges for failing to maintain internal accounting controls and accurate books and records.

c. *SEC v. Q.T. Wiles et al.*, Litigation Release No. 16250, AAER No. 1152, August 11, 1999 (<http://www.sec.gov/enforce/litigrel/lr16250.htm>): The SEC alleged that the former CFO of MiniScribe Corporation, a disk drive manufacturer, participated in a financial fraud scheme and concealed MiniScribe's dire financial situation from investors and outside auditors. No further details regarding the activities of the former CFO, Owen Taranta, were provided. Taranta consented to entry of a permanent injunction prohibiting him from violating §10(b) of the Exchange Act and Exchange Act Rules 10b-5, 13b2-1, and 13b2-2. Taranta also paid a civil penalty of \$10,000, apparently reduced because of his inability to pay more, and was barred for five years under rule 102(e) from practicing as an accountant before the SEC. The entry of judgment against Taranta concluded this matter.

In a related action, Q.T. Wiles, a former officer of MiniScribe, was convicted of one count of securities fraud, one count of wire fraud, and one count of making false statements to the government. *See U.S. v. Wiles*, 106 F.3d 516 (10<sup>th</sup> Cir. 1997).

d. *SEC v. Kahn et al.*, Litigation Release No. 16297, AAER No. 1167, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16297.htm>); *In re Zemaitis*, No. 34-41924, 1999 WL 766090 (S.E.C. September 28, 1999): The Commission filed complaints against two employees and three officers of First Merchants Acceptance Corporation ("FMAC"), a sub-prime auto lender. One defendant, Thomas Ehmann, was FMAC's CFO. Defendants allegedly orchestrated efforts to alter payment and balance information on thousands of FMAC's delinquent and uncollectable accounts to make them appear current. Ehmann, although not originally party to the scheme, discovered it and took action to further and conceal the fraud.

The SEC charged that FMAC “vastly understated” the number of delinquent and uncollectable accounts it carried, allowing it to under reserve its allowance for credit losses and overstate its net income in SEC filings signed by Ehmann and the company’s former President/CEO.<sup>13</sup> These erroneous figures were disseminated as a press release and filed in Forms 8-K and 10-K with the Commission. Ehmann and FMAC’s former CEO were also alleged to have misled the company’s outside auditors in an attempt to conceal the fraud. The SEC deemed the scheme a fraud on the market for FMAC common stock in violation of §§10(b), 13(a), 13(b)(2), and 13(b)(5) of the Exchange Act. Defendants were also charged with violations of Rules 10b-5, 12b-20, 13a-1, 13a-11, 13b2-1, and 13b2-2 promulgated thereunder.

Charged along with Ehmann were FMAC’s former President/CEO and VP of Strategic Planning. All three were charged with violations of the statutory provisions listed above, and the Commission is seeking disgorgement (including performance bonuses) and civil penalties from each. The matter has not yet been concluded.

In a related action, the Commission instituted cease and desist proceedings against two former employees of FMAC pursuant to §21(c) of the Securities Exchange Act. The two had altered customer account balances and payment dates at the direction of the company’s officers and were charged with violations of §§10(b), 13(a), 13(b)(2), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-11, and 13b2-1 promulgated thereunder. Defendants were ordered to cease and desist from all future violations of the above statutory sections.

e. *SEC v. FastComm Communications Corp.*, Litigation Release No. 16310, AAER No. 1187, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16310.htm>): The Commission filed civil injunctive actions against FastComm Communications Corporation, a telecommunications company, and FastComm’s former VP of Contracts and Administration. In a related action, FastComm’s former CFO and former CEO were both indicted on charges arising out of the same events. Fastcomm, with the participation of the individual defendants, improperly recognized \$185,000 in revenue on a sale of products that were not fully assembled or functional as shipped; several of these products were shipped after the close of the fiscal quarter for which they were reported and documents were backdated to conceal this fact.

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<sup>13</sup> In its 1996 financial statements, FMAC apparently understated credit losses by \$43.4 million (252.6%) and overstated net income by \$76.7 million (729%).

The company also improperly recognized \$579,000 in revenue during a different quarter, accounting for one-third of its sales for that time period. In that transaction, unfinished product was shipped to a freight-forwarders warehouse because finished product was not available for shipment to the customer. Some or all of this product was shipped after the end of the fiscal quarter for which it was reported. The sale was also contingent upon a letter of credit from the customer (which never arrived) and a resale of the product by the customer to an end-user. FastComm later reversed this transaction.

FastComm's CFO was held responsible for the company's violations of the Exchange Act's reporting, books and records and internal controls requirements. He consented to entry of a judgment ordering him to cease and desist from future violations of Exchange Act §§13(a), 13(b)(2)(A), and 13(b)(2)(B), and requiring him to pay \$20,000 in civil penalties.

Also charged were FastComm itself, along with its CEO and former VP of Contracts and Administration. The company's CEO consented to entry of a judgment identical to that entered against the CFO. FastComm was enjoined from future violations of §§10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act. Since FastComm had recently emerged from reorganization proceedings, it was not assessed civil penalties. The company's former VP of Contracts and Administration was permanently enjoined from future violations of §10(b) of the Exchange Act, and enjoined from aiding and abetting violations of Exchange Act §13(a) and Exchange Act Rules 12b-20, 13a-1 and 13a-13. He was also assessed a civil penalty of \$20,000.

f. *SEC v. Ickovics* and *SEC v. Cankes*, Litigation Release No. 16309, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16309.htm>); *In re Model Imperial, Inc.*, No. 34-41932, 1999 WL 760643 (S.E.C. September 28, 1999); *In re Schwartz*, No. 34-41933, 1999 WL 760642 (S.E.C. September 28, 1999): The Commission filed charges against the Stephen Kesh, former CFO of Model Imperial, Inc., alleging that he and others had falsified the company's financial statements and fraudulently inflated its revenues and net income. Model Imperial, based in Florida, is a wholesale distributor of cosmetics and fragrances. During 1994 and 1995, defendants were said to have recorded \$1.3 million in revenues from a barter transaction which "lacked economic substance," reported revenues from consignment shipments, logged customer returns as purchases of goods, and created fraudulent receivables through a series of sham sales transactions. Gross retail sales profits were overstated, and the defendants paid bribes to a supplier to

ensure his continued service while recording nonexistent purchases to conceal this activity. Defendants also filed false and misleading reports with the SEC during 1994 and 1995.

Also charged was Model Imperial's President, CEO, and Chairman, Harold Ickovics. Ickovics and Kesh, the former CFO, consented to a final judgment which enjoined each of them from violating or aiding and abetting violations of §10(b), §13(a), and §13(b)(5) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13, 13b2-1 and 13b2-2 thereunder. Kesh was assessed a civil penalty of \$25,000; Ickovics was fined \$200,000. Kesh was also permanently barred from practicing as an accountant before the SEC.

In related actions, three other individuals were charged and proceedings were initiated against Model Imperial itself. In *SEC v. Cankes*, the president of the fragrance supplier to which Model Imperial paid bribes was charged with aiding and abetting Model Imperial's President/CEO in violations of Exchange Act Rule 13b2-2. Cankes falsely claimed to have been unaware of the payoffs made to his company, failed to disclose the payments to his auditors, and assisted Model Imperial in misleading its independent accountants. Cankes consented to entry of a final judgment permanently enjoining him from violating or aiding and abetting in violations of Exchange Act Rule 13b2-2 and requiring him to pay \$50,000 in civil penalties.

A separate case, *In re Schwartz*, involved two partners of a retail fragrance shop with whom Model Imperial did business. The pair, Schwartz and Steinberg, cashed checks for Model Imperial in exchange for a three percent fee. The cash thus acquired by Model Imperial was used to make payoffs to Cankes's outfit, but was fraudulently reported as spent on purchases from Schwartz and Steinberg's shop. Defendants provided Model Imperial with invoices for these nonexistent. The Commission found that Schwartz and Steinberg had directly violated Rule 13b2-1 of the Exchange Act and had caused Model Imperial's violations of §§10(b) and 13(a) of the Exchange Act and Rules 10b-5, 13a-1 and 13a-13 promulgated thereunder. Defendants were ordered to cease and desist from violating §§10(b) and 13(a) of the Exchange Act and Exchange Act Rules 10b-5, 13a-1, 13a-13, and 13b2-1. They were also ordered to pay \$14,500 in disgorgement and nearly \$7,000 in prejudgment interest.

In the final related matter, the Commission instituted public administrative proceedings to determine whether to revoke Model Imperial's common stock SEC registration. Model Imperial filed for Chapter 11 protection in July, 1996, and all of its common stock was later purchased by a private company. The SEC alleged

that Model Imperial, while its common stock was registered, failed to file annual 10-K reports or quarterly 10-Q reports and thereby violated §13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13. Model Imperial, in violation of §13(a) of the Exchange Act and Exchange Act Rules 13a-1, 13a-13, and 12b-20, also overstated the value of its revenues and gross profits in filings with the SEC during 1994 and 1995. The matter has not yet been concluded, but a public hearing is to be scheduled.

g. *SEC v. C.E.C. Industries Corp.*, Litigation Release No. 16299, AAER No. 1169, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16299.htm>): The Commission filed a securities fraud action against Marie Levine, principal financial officer of C.E.C. Industries Corporation during 1996 and 1997. Although the SEC's Litigation Release does not specify C.E.C.'s principal line of business, other information available online indicates that the company provides transportation services. See <http://www.sec.gov/Archives/edgar/data/54175/0000054175-97-000016.txt>. C.E.C. is alleged to have fraudulently overstated its assets and revenues in public filings and statements concerning fiscal years ending in March 31, 1996 and March 31, 1997. C.E.C. engaged in asset exchange transactions by acquiring non-cash assets in exchange for company stock or other non-cash assets previously acquired in the same fashion. C.E.C. filed delinquent reports with the SEC and has failed to file any reports since July 1998; the company also published false and misleading information on the Internet. The SEC has determined that Levine was directly responsible for the company's misdeeds.

Charged along with Marie Levine was Gerald Levine, C.E.C.'s CEO. The pair were charged with violations of §17(a) of the Securities Act of 1933, §10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. C.E.C. was charged with violating the reporting and bookkeeping requirements of §13 of the Exchange Act and the rules thereunder; both individual defendants were charged with violations of Exchange Act §13(b)(5) and Rule 13b2-1 for failing to implement internal accounting controls and falsifying books and records.

The matter has not been concluded, but the SEC is seeking permanent injunctions against all defendants, civil penalties against both individual defendants, and an order barring either from serving as an officer or director of any other public company. The Commission has also requested a restatement of past financial records and seeks to compel C.E.C. to file current information. The case is still under investigation.

h. *SEC v. Tendler*, Litigation Release No. 16298, AAER No. 1168, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16298.htm>): The SEC initiated proceedings against the former CFO of WIZ Technology, Inc, among others, for financial fraud and insider trading. WIZ is a software manufacturer and wholesaler based in Southern California. *See* <http://www.toydirectory.com/WizTechnology/index.htm>. The SEC alleged that defendants used accounting gimmicks, sham sales, and backdated agreements to inflate the company's publicly reported sales, income and assets. Financial misrepresentations were made in four reports filed with the SEC and three press releases made during 1995, 1996, and 1997. The company's former CFO, along with the other defendants, was said to have overstated the company's revenue, income and assets during the 1996 fiscal year.<sup>14</sup> WIZ counted barter transactions involving obsolete products as sales, claimed to have sold a nonexistent distributorship, backdated agreements, and reported expenses as assets in an effort to boost sales revenue figures. Defendants filed false financial statements in its Form 10-QSB reports for the first, second, and third quarters of 1996, as well as the second quarter of 1997. The complaint also alleged that defendants engaged in insider trading by selling thousands of shares of common stock; Billie Jolson, WIZ's former CFO, earned \$63,183 in profit from these transactions.

Also charged in the case were WIZ's CEO/Chair of the Board of Directors and the company's President. The two continued to engage in financial fraud in 1997, after the CFO's participation ceased.

The Commission charged all three defendants with violations of §17(a) of the Securities Act of 1933, §§10(b), 13(a), 13(b)(a)(A), 13(b)(2)(B), 13(b)(5), and 16(a) of the Securities and Exchange Act of 1934, and Rules 10b-5, 12b-20, 13a-13, 13b2-1, and 16a-3 promulgated under the same statute. Although the matter is not yet settled, the SEC has requested that defendants be permanently enjoined from further violations of the statutory provisions listed above, be required to disgorge the losses they avoided through insider trading, and be assessed civil penalties. The SEC is also seeking officer and director bars against each defendant.

i. *SEC v. Itex Corp.*, Litigation Release No. 16305, AAER No. 1175, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16305.htm>): Itex

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<sup>14</sup> WIZ was accused of overstating income by \$154,214 (63%) in the first quarter of 1996, \$379,855 (31%) in the second quarter, \$596,190 (26%) in the third quarter, and \$450,000 (45%) in the fourth quarter. Losses were understated by 193% in the third quarter of 1996.

Corporation, a barter exchange company, and five of its former officers and/or directors were charged with materially inflating revenues and earnings in financial statements filed with the SEC and disclosures made to the public between December 1993 and February 1998. Although the SEC's Litigation Release fails to specify the offices held by individual defendants, it appears that one of the defendants, Joseph Morris, was at least nominated to serve as CFO of ITEX in 1996. *See* <http://www.sec.gov/Archives/edgar/data/860518,0001025894-97-000034.txt>. The complaint alleged that defendants "implemented a broad-ranging fraudulent scheme" by failing to disclose suspect and sham barter deals between ITEX and offshore entities related to and/or controlled by ITEX's founder. Defendants were charged with defrauding investors by bartering worthless assets and by describing ITEX assets and transactions in "trade dollars" rather than their lower U.S. dollar values in financial statements. Defendants also arranged bogus barter deals by substantially inflating the value of goods and services on the ITEX Exchange, and subsequently reported these inflated revenues as income and/or assets in public filings. ITEX and its subsidiary, the Swiss-based Associated Reciprocal Traders, reported significant earnings from sham barter transactions; such barter transactions accounted for 56% of ITEX's revenue in 1994, 56% in 1995, 43% in 1996, and 60% in 1997. The SEC also alleged that nearly all of these barter transactions, typically involving difficult-to-value assets, were either inside deals orchestrated by the company's founder or deals involving patently bogus assets. Had these transactions not been reported as earnings, ITEX would have been forced to report losses rather than profits during fiscal years 1994 through 1997. During this same time period, the company's stock value rose from \$2.25 to \$12.50 per share and Morris exercised stock options to earn \$45,000 in profit.

Since ITEX was actually losing money, the company sold its common and preferred stock to pay operating expenses. Most of the shares, the sale of which generated \$11.7 million, were initially purchased at a substantial discount by offshore investors controlled by ITEX's founder. The shares were later sold back into the U.S. stock market, earning ITEX and its founder an additional \$10.7 million.

Although Joseph Morris was indicted by the S.E.C. in this action, the primary target seems to have been Terry Neal, ITEX's founder. The complaint alleges further wrongdoing that only Neal is said to have participated in. Also charged were Michael Baer, Graham Norris, and Cynthia Pfaltzgraff; Baer and Norris served on the Board of Directors. *See* <http://www.sec.gov/Archives/edgar/data/860518,0001025894-97-000034.txt>. Norris may also have served as President and CEO, although I could not confirm

his appointment to either post. *See id.* No specific information was available concerning Pfaltzgraff.

The SEC alleged that all defendants, including Morris, violated §17(a) of the Securities Act of 1933, §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Defendants were also charged with violating unspecified reporting, internal controls, and record-keeping provisions of federal securities law. IteX and Neal were also charged with violations of the securities registration provision of §5 of the Securities Act of 1933. Neal and Baer were charged with violations of §13(d) of the Securities Exchange Act of 1934, and Neal was additionally alleged to have violated §16(a) of the same Act.

Although the matter is not yet concluded, the SEC is seeking injunctive relief, civil penalties, and disgorgement from and officer and director bars against Neal, Baer and Morris.

j. *SEC v. Walker*, Litigation Release No. 16300, AAER No. 1170, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16300.htm>): The SEC filed a civil injunctive action against two former officers of Unison HealthCare Corporation, owner and operator of more than 50 nursing homes nationwide. Defendants, one of them the company's former CFO and a member of the Board of Directors, were alleged to have made false adjustments to Unison's quarterly net income throughout 1996 to ensure that the company met publicly announced earnings estimates. Unison's former CFO, Craig Clark, instructed the company's controller to make substantial false adjustments to the company's revenue and expenses for the third quarter of 1996. These adjustments allowed Unison to meet its own publicly released earnings estimates, and press releases were issued containing the inflated earnings figures. The same false information was included in two SEC quarterly reports filed in 1996. Unison did not disclose, in either its press release or its Form 10-Q, how its third quarter earnings had been derived; neither the press release nor Form 10-Q disclosed deficiencies in the company's books and records.

The SEC seeks an injunction against Clark, prohibiting him from violating §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1. It has also requested that Clark be enjoined from aiding and abetting violations of §13(a) of the Exchange Act and Exchange Act Rule 13a-13. The Commission is also seeking civil penalties.

Charged along with Clark was the company's former CEO/President, Jerry Walker. Walker both participated in the fraud with which Clark was also charged, and instructed the company's controller to make similar adjustments to earnings

reports for the second quarter of 1996. Walker also led Unison's auditors to believe that the second quarter's financial statements had been prepared in accordance with generally accepted accounting principles. The Commission sought an order enjoining Walker from violating §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5, 13b2-1, and 13b2-2, and from aiding and abetting violations of Exchange Act §13(a) and Exchange Act Rule 13a-13. It also sought to impose civil penalties. Walker consented to entry of a final judgment, consisting of the proposed injunction described above and a civil penalty of \$15,000. Walker also consented to entry of an order under Rule 102(e) barring him from appearing or practicing before the SEC as an accountant, with the right to reapply after five years. This matter is not yet settled with respect to Clark, Unison's former CFO.

In a related settled proceeding, Lisa Beuche, Unison's former controller, and Unison's successor corporation were charged with similar violations of securities laws. Raintree HealthCare Corporation, Unison's successor, agreed to cease and desist from violating §13(a) of the Exchange Act and Exchange Act Rule 13a-13. Beuche consented to entry of a cease and desist order prohibiting her from committing or causing violations of §13(b)(5) of the Exchange Act and Exchange Act Rules 13b2-1 and 13b2-2. She was also ordered to cease and desist from causing any violations of §13(a) of the Exchange Act and Exchange Act Rule 13a-13. Beuche was barred from appearing or practicing as an accountant before the SEC pursuant to Rule 102(e) of the Rules of Practice, but will be allowed to apply for readmission after two years.

k. *SEC v. Villares*, Litigation Release No. 16301, AAER No. 1171, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16301.htm>): The SEC charged three executives of Pepsi-Cola Puerto Rico Bottling Company, including the company's Director of Finance, with accounting fraud. Defendants were said to have fraudulently overstated the company's financial figures by understating sales discounts, allowances and operating expenses during the first two quarters following Pepsi-Cola P.R.'s IPO in 1995. These false adjustments allowed the company to report a profit rather than a loss in the first quarter of FY 1996 and to understate the company's loss during the second quarter.

Pepsi-Cola P.R.'s Director of Finance consented to entry of a final judgment permanently enjoining him from future violations of §§10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 10b-5, 12b-20, 13a-13, and 13b2-1. He was also assessed a \$10,000 civil penalty and barred from

practicing or appearing before the SEC as an accountant, with the right to apply for reinstatement after five years.

Charged along with the Director of Finance were the company's General Manager and Controller, who were additionally alleged to have organized and participated in an unsuccessful revenue recognition scheme. Pepsi-Cola P.R.'s General Manager consented to entry of an order permanently enjoining him from future violations of §§10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 10b-5, 12b-20, 13a-13, 13b2-1, and 13b2-2. Because of his inability to pay, the General Manager was not assessed a civil penalty. The company's Controller agreed to entry of an order permanently enjoining him from future violations of §§13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-13, and 13b2-1.

1. *In re Fink*, No. 34-41934, 1999 WL 760647 (S.E.C. September 28, 1999): The Commission instituted proceedings against Fink, the former CFO and later, CEO, of Photran Corporation, a manufacturer of film-coated glass. Photran filed for Chapter 7 bankruptcy in 1999. Fink is alleged to have violated the antifraud and books and records provisions of the securities laws by preparing and signing fraudulent financial statements for Photran and directing that false information be entered into the company's financial records. Fink orchestrated a premature revenue recognition scheme and instructed other employees to backdate documents and report false shipment dates. He also allowed nonexistent and premature revenues to be recorded without supporting documentation, in violation of Photran's internal accounting controls.

Photran is said to have reported fictitious sales and prematurely recognized revenue in its financial statements from December 1995 through the third quarter of 1996. Such fraudulent reporting allowed the company to avoid reporting losses in its financial records and financial statements filed with the SEC. The Commission characterized Photran's second and third quarter reports in 1996 as "materially false and misleading." Fink, who served as CFO from February 1996 to August 1997, signed the registration statement and periodic SEC filings when he either knew or was reckless in not knowing that earnings and revenues had been substantially overstated. The Commission alleged that he "ignored obvious red flags" and recurring conduct that indicated that the company's internal accounting controls had been circumvented. Fink took no steps to determine the validity of the fraudulent transactions or to reinstitute proper accounting procedures. He misled Photran's outside auditor when he signed a letter affirming that revenue had been properly

reported. In at least one instance, Fink himself backdated documents to correspond with the premature revenue recognition scheme.

Photran prematurely recognized revenue in the first quarter of 1996, just prior to the company's IPO, on a sale that actually took place in the second quarter. Documents were backdated by Photran's employees and freight forwarder and revenue from the shipment was recorded in March despite the fact that the transaction was not completed until April. Photran's first quarter 1996 revenues were thus inflated by \$168,000 (15%), and the premature recognition of this sale enabled the company to show a profit prior to its IPO.

Revenue was also reported during the first quarter of 1996 for two fictitious transactions, notwithstanding the fact that neither was accompanied by supporting documentation. Both transactions were reversed on the day after quarterly earnings were posted, and the inclusion of these sales in quarterly earnings artificially inflated revenues by 26%. Fink made no effort to determine why the transactions were reversed.

A similar fictitious sale worth over \$300,000 was reported in the third quarter of 1996, and although Fink was suspicious of the transaction, he allowed the revenue to be reported without any documentation. While he declined to sign a management representation letter for Photran's auditors during the company's third quarter review, he did not share his suspicions with Photran's audit committee or its external auditors. As a result, third quarter revenue was artificially inflated by 15%.

Photran also prematurely recognized revenue from consignment inventory in the second quarter of 1996, although the merchandise was not sold until the third and fourth quarters of the year. None of the consignment sales had accompanying documentation, and Fink failed to request any despite later sales reversals.

Photran's quarterly net income and earnings were misstated in financial statements included in the company's registration statement and second and third quarter periodic SEC filings. Revenue for FY 1995 was inflated by \$951,000 (28%), first quarter 1996 revenue was overstated by \$460,491 (40%), second quarter revenues inflated by \$417,944 (25%), and third quarter revenues overstated by \$329,539 (16%). While the company reported a profit of \$391,000 during the first three quarters of 1996, later financial restatements revealed a loss of over \$1 million. Fink was alleged to be responsible (either intentionally or through recklessness) for the company's financial misstatements and failure to conform to generally accepted accounting practices. He was also accused of actively falsifying financial records, backdating shipping documents, and requesting that Photran's

freight forwarder backdate its bill of lading to correspond with other falsified documents.

The SEC alleges that Fink violated §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5, 13b2-1, and 13b2-2. It further alleged that Fink engaged in improper professional conduct, as defined in Rule 102(e) of the Rules of Practice. Proceedings have been instituted against Fink and a public hearing on the matter was scheduled. The matter has not yet been settled.

m. *In re Pace*, No. 34-41929, 1999 WL 766095 (S.E.C. September 28, 1999); *SEC v. Tarkenton*, Litigation Release No. 16306, AAER No. 1179, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16306.htm>); *In re Drews*, No. 34-41928, 1999 WL 766093 (S.E.C. September 28, 1999); *In re Mathes*, No. 34-41927, 1999 WL 766094 (S.E.C. September 28, 1999); *In re Chamberlain*, No. 34-41926, 1999 WL 766089 (S.E.C. September 28, 1999): The Commission instituted proceedings against KnowledgeWare, Inc., a software marketing firm<sup>15</sup>, and several of its officers for violation of the antifraud, periodic reporting, books and records, and internal accounting controls requirements of the securities laws. Throughout FY 1994, KnowledgeWare posted artificially inflated revenue and net income in its own financial records and in filings with the SEC by fraudulently recognizing revenue from contingent sales transactions secured by secret side agreements. Because of this improper revenue recognition, the company filed false information in Forms 10-Q filed for the third and fourth quarters of 1993 and the first quarter of 1994. KnowledgeWare falsely reported a profit for the first quarter of 1994 and the previous nine months, despite the fact that it had been operating at a loss. The company reported over \$8 million in sham software sales during FY 1994.

KnowledgeWare's improper revenue recognition stemmed from sales transactions with resellers of computer software. The officers charged either granted or authorized their subordinates to grant resellers the right to return their products; they also agreed or authorized their subordinates to agree to contingent payment terms, relieving resellers of their obligation to pay KnowledgeWare until the products had been resold. The company's purchase orders, however, failed to reflect these modified contractual terms; instead, they contained the company's standard unconditional requirement that resellers pay for items received. These

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<sup>15</sup> Although not indicated in the SEC Litigation Releases, KnowledgeWare's Internet homepage suggests that the company is a technology management consulting group.

purchase orders were reported as sales revenue in KnowledgeWare's financial records. Separate letters were sent to resellers confirming the altered terms of agreement, but such side letters were never sent or disclosed to the company's order administration department. Transaction approval forms were prepared for certain reseller transactions, but none of them alluded to the side letters as required by the company's policies. The side agreements were never disclosed to the order administration department or the company's accountants, and KnowledgeWare continued to recognize revenue on these contingent sales. The resellers never paid for their products, and the company was forced to reverse \$20 million in sales during July and August, 1994. Even at this juncture, however, KnowledgeWare denied any wrongdoing in these events and instead claimed that the restatement was required because of difficulties encountered when trying to collect from resellers.

Named in the SEC's complaint was Gossett, KnowledgeWare's CFO. Gossett was named as one of the architects of the fraud, and was charged with making fraudulent statements to purchasers of the company's stock and to KnowledgeWare's auditors. Gossett consented to entry of judgment against him, permanently enjoining him from violating §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5, 13b2-1, and 13b2-2. He was also enjoining from engaging in conduct as a controlling person that would subject him to liability under §20(a) of the Exchange Act for violations of §§13(a) and 13(b)(2) of the Exchange Act or Exchange Act Rules 12b-20, 13a-1, and 13a-13. He was ordered to pay \$25,000 in civil penalties and disgorge \$2,812 plus prejudgment interest (the amount of his 1994 bonus).

The SEC also filed charges in this matter against Pace, an Area VP; Tarkenton, the CEO/Chairman of the Board; Addington, the President and Chief Operating Officer; Fontaine, the Manager of Financial Reporting; Hammersla, the VP for Direct Sales in the Northeastern U.S.; Alvarez, a District Sales Manager; Welch, another District Sales Manager; Drews, VP for Reseller Channel Sales; Mathes, a District Sales Manager; and Chamberlain, an Area VP.

Pace consented to entry of a judgment against him, requiring him to cease and desist from violations of §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1. He was further ordered to disgorge \$9,944 (representing his 1994 bonus plus prejudgment interest).

Tarkenton was among those held responsible for orchestrating the fraud and making false statements to investors and auditors. He consented to entry of an order permanently enjoining him from violating §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5 and 13b2-1. He was

also enjoined from engaging in conduct which would subject him, as a controlling person, to liability under §20(a) of the Exchange Act for violations of §§13(a) and 13(b)(2), as well as Exchange Act Rules 12b-20, 13a-1, and 13a-13. Tarkenton was assessed \$100,000 in civil penalties and was ordered to disgorge \$54,187 (the amount of his 1994 bonus plus prejudgment interest).

Addington was also among those held responsible for orchestrating the fraud and making false statements to investors and auditors. He consented to entry of an order permanently enjoining him from violating §17(a) of the Securities Act, §§10(b) and §13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5 and 13b2-1. He was also enjoined from engaging in conduct that would subject him to liability, as a controlling officer, under §20(a) of the Exchange Act for violations of §§13(a) and 13(b)(2) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13. Addington was assessed a civil penalty of \$100,000 and was ordered to disgorge \$54,187 (the amount of his 1994 bonus plus prejudgment interest).

Fontaine was charged with preparing the fraudulent financial statements and quarterly reports. He consented to entry of a judgment permanently enjoining him from violating §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1. He was also ordered to pay \$10,000 in civil penalties.

Hammersla was charged with creating the sham software sales and engaging in insider trading. He consented to entry of an order permanently enjoining him from violating §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5 and 13b2-1. He was ordered to disgorge \$51,356, representing his 1994 bonus and the losses he avoided through insider trading. He paid civil penalties in the amount of \$21,575, including penalties for both financial fraud and insider trading.

Proceedings against Alvarez and Welsh are still pending.

Drews was ordered to cease and desist from committing or causing violations of §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1. She was also ordered to disgorge \$45,983, the amount of her 1994 bonus plus prejudgment interest.

Mathes was ordered to cease and desist from committing or causing violations of §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1. He was also ordered to disgorge \$10,959, the amount of his 1994 bonus plus prejudgment interest.

Chamberlain was ordered to cease and desist from committing or causing violations of §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules

10b-5 and 13b2-1. He was also ordered to disgorge \$22,584, the amount of his 1994 bonus plus prejudgment interest.

n. *SEC v. Computone Corporation*, Litigation Release No. 16307, AAER No. 1178, September 28, 1999 (<http://www.sec.gov/enforce/litigrel/lr16307.htm>); *In re Montgomery*, No. 34-41931, 1999 WL 7690646 (S.E.C. September 28, 1999); *In re Barkley*, No. 34-41923, 1999 WL 760640 (S.E.C. September 28, 1999): Officers of Computone Corporation, a computer software and hardware designer/manufacturer/seller, were charged with intentionally overstating the company's income from October 1993 to October 1997. Defendants allegedly improperly recognized revenue in approximately 240 transactions; orders had not been placed, products were not shipped, products were shipped before customers had asked for delivery, and orders were contingent on the resale of the product. The company also failed to promptly record product returns or account for expenses. Computone filed false reports with the SEC, issued false press releases, maintained inaccurate corporate financial records, and failed to maintain an effective internal accounting control system.

Among those charged by the Commission was Gregory Alba, Computone's former Controller and CFO. Alba is alleged to have disregarded the facts of certain transactions he recorded in Computone's financial statements, falsified financial statements and accounting records, misled the company's auditors, and circumvented internal accounting controls. The proceedings are pending, and the Commission has requested that a permanent injunction be entered and that Alba be required to pay civil penalties.

Also charged were Barkley, the company's former accounting manager; Anderson, Computone's former President/CEO; Pearce, former VP of Finance and Principal Accounting Officer; Hume, VP of International Sales; Kretschman, VP of Sales; Montgomery, Director of Sales; Auerbach, National Sales Manager; and Glaser, President of CYMA Systems, a customer of Computone.

Anderson was the primary target of the SEC's investigation. He was charged with orchestrating the fraud, directing others to falsify financial statements and accounting records, and falsifying records himself in some instances. He was also said to have misled auditors and circumvented internal accounting controls. Proceedings against Anderson are still pending, but the SEC is seeking a permanent injunction, civil penalties, disgorgement plus prejudgment interest, and an officer and director bar against him.

Pearce disregarded factual issues concerning certain transactions he recorded; he also allowed the company to record sales where purchase orders had not been received, customers were unable to pay, sales were contingent, or customers retained the right to return the product. Proceedings against Pearce are pending, and the Commission requested that a permanent injunction be entered against him and that he be assessed civil penalties.

Kretschmann created false documents, altered existing documents, instructed his subordinates to alter documents, and misled auditors as to the accuracy of a particular purchase order. Proceedings against him are pending, and the Commission requested entry of a permanent injunction and an order requiring him to pay civil penalties.

Hume altered a purchase order to artificially inflate Computone's income and then attempted to convince the customer in question to sign a false confirmation request. He also misled auditors about the transaction. Proceedings against him are pending, and the SEC has asked that a permanent injunction be entered against him and that he be assessed civil penalties.

Barkley, Computone's Accounting Manager from June 1993 to July 1994, shared responsibility with the CFO for ensuring that revenues and expenses were recorded in accordance with generally accepted accounting principles.<sup>16</sup> During the second quarter of 1994, Barkley allowed the company to record and include as revenue three sales for which no purchase orders were issued and no payments were received. These sales artificially inflated Computone's second quarter continuing operations income by \$186,459, and allowed the company to report \$465,000 in profits in this category instead of \$261,141. In the third quarter of 1994, Barkley included as revenue a consignment sale worth \$69,670 to a customer who was unable to pay for the product. He failed to conduct any inquiry into the customer's financial condition, and the customer returned all products after the end of the quarter. Barkley was also aware that Computone had recorded approximately sixty transactions, worth \$189,848, as "bill and hold" sales on the last day of the quarter. As a result, third quarter continuing operations revenues were inflated by \$259,518, and the company claimed \$62,000 net in this category rather than reporting \$197,518 in losses. During the fourth quarter, Barkley allowed Computone to

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<sup>16</sup> Given that Barkley shared responsibility with Computone's CFO (Alba), the transactions described with respect to Barkley may be the same as those Alba is eventually held accountable for. The SEC's litigation release specifically referring to Alba does not, however, provide a more detailed account of his involvement in this fraud.

record \$158,961 in sales which were not shipped until the following quarter. In the first quarter of 1995, he failed to ensure that the company's new cost recording system comported with generally accepted accounting practices; the new system allowed Computone to understate its cost of goods sold during this quarter by \$81,261. Also during the first quarter of 1995, Barkley allowed the company to record a sale on the last day of the quarter without a purchase order or shipment of the product in question. This oversight artificially inflated first quarter continuing operations revenues by \$159,314 and allowed Computone to report \$123,000 in income from continuing operations instead of a loss of \$36,314.

Barkley assisted in the preparation of Computone's quarterly Forms 10-Q, which included these artificially inflated figure. He also signed management representation letters for the company's auditors, averring that Computone's financial statements had been prepared in conformity with generally accepted accounting practices.

Barkley was ordered to cease and desist from committing or causing violations of §§13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act, as well as Exchange Act Rules 12b-20, 13a-13, 13b2-1, and 13b2-2.

Montgomery allegedly accepted a contingent purchase order to enable Computone to meet its quarterly sales target, causing the company to understate its first quarter 1996 loss from continuing operations by \$544,400. He also falsely denied knowledge of this transaction when questioned by the company's auditors. The Commission alleges that Montgomery caused Computone to violate §§10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Exchange Act Rules 10b-5, 13a-13, and 13b2-1. He was also alleged to have personally violated §13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1. Proceedings are pending, and a public hearing has been scheduled.

Auerbach created a fictitious purchase order which was later recognized as a valid transaction in Computone's third quarter 1997 continuing operations income report. As a result, income was overstated by \$75,830 in this category. The Commission alleges that Auerbach caused Computone to violate §§10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Exchange Act Rules 10b-5, 13a-13, and 13b2-1. He was also alleged to have personally violated §13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1. Proceedings are pending, and a public hearing has been scheduled.

Glaser collaborated with Computone to mislead the company's auditors in regards to a particular consignment order. As a result, Computone overstated its FY 1995 continuing operations income by \$124,684. The Commission alleges that Glaser

caused Computone to violate §§10(b) and 13(a) of the Exchange Act, as well as Exchange Act Rules 10b-5 and 13a-1. Proceedings are pending, and a public hearing has been scheduled.

o. *SEC v. American Telephone + Data, Inc.*, Litigation Release No. 16232, AAER No. 1148, August 2, 1999

(<http://www.sec.gov/enforce/litigrel/lr16232.htm>): The SEC filed charges for financial fraud and theft of investor funds against two officers and the acting CFO of American Telephone + Data (“AT+D”), a telecommunications company. During 1993, the company’s two controlling officers filed false financial statements with the SEC; these financial statements included nonexistent assets, which led to the of AT+D’s total assets by between 74% and 87%. The pair also stole more than \$900,000 in corporate funds, generated by the sales of AT+D warrants and common stock, to pay personal expenses. From October 1993 to January 1994, the two engaged in insider trading and realized \$400,000 in profits. During the same time period, the company’s financial statements fraudulently overstated AT+D’s assets.

The two officers were charged with violations of §§10(b) and 13(b)(5) of the Exchange Act and Exchange Act Rules 10b-5 and 13b2-1. AT+D itself is alleged to have violated §§10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, as well as Exchange Act Rules 10b-5, 13a-1, 13a-11, 13a-13, and 12b-20. The matter has not yet settled, and the SEC seeks to enjoin all three parties from future violations of the above provisions, to bar the two officers from serving as officers or directors of public companies, and to require the two to disgorge all illegal profits plus prejudgment interest.

Also charged in the complaint was AT+D’s acting CFO, Daniel Kratochvil, from November 1993 to January 1994. The Commission alleged that the former CFO had filed false quarterly reports that fraudulently inflated AT+D’s assets. Kratochvil consented to entry of a judgment permanently enjoining him from violating 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

Administrative proceedings have been initiated to determine whether AT+D’s registration should be revoked.

p. *SEC v. Sutton*, Litigation Release No. 16164, May 27, 1999 (<http://www.sec.gov/enforce/litigrel/lr16164.htm>): The SEC charged three former officers of Happiness Express, Inc., including its former CFO, with fraudulently inflating the company’s sales and net income. Happiness Express, before its bankruptcy in 1996, designed, developed and manufactured toys.

The Complaint alleged that the company's President/CEO/Chairman of the Board, its Executive VP/Chief Operating Officer, and its CFO falsified sales and net income figures prior to the company's IPO and in financial reports filed with the SEC between March 1995 and February 1996. The three overstated sales and earnings for the quarter ending June 30, 1994 in order to justify \$675,000 in payments made to the President/CEO and the Executive VP/Chief Operating Officer. They also overstated sales and net income for the year ending March 31, 1995 and the subsequent three quarters, enabling Happiness Express to meet projected earnings. While the company reported earning \$7.5 million in profits for the year ending March 31, 1995, it was actually operating at a loss of \$1 million.

Michael Goldberg, the company's former CFO, was also charged with engaging in insider trading (generating \$310,000 in illicit profits) and with providing nonpublic information about Happiness Express's financial condition to two friends. Goldberg's friends were also indicted for having shorted the company's common stock and sold off other shares to avoid losses. Goldberg consented to entry of a judgment permanently enjoining him from violating §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5, 13b2-1, and 13b2-2. Goldberg was also enjoining from engaging in conduct which would subject him to liability under §20(a) of the Exchange Act for violations of §13(b)(2) by an issuer of securities. He consented to entry of an order barring him from serving as an officer or director of a public company for ten years, requiring him to disgorge \$310,350 plus \$67,882 prejudgment interest, obligating him to pay a civil penalty of \$150,000, and permanently barring him under Rule 102(e) from practicing as an accountant before the Commission.

Against the other former officers of Happiness Express, the SEC seeks permanent injunctions (including a cease and desist order under §20(a)), disgorgement of illicit profits, civil penalties and officer and director bars. The Commission also seeks disgorgement plus prejudgment interest from the two men who benefited from Goldberg's insider stock tips.

q. *SEC v. Barton*, Litigation Release No. 16068, AAER No. 1112, February 23, 1999 (<http://www.sec.gov/enforce/litigrel/lr16068.htm>): The SEC filed charges against Robert Barton, the former CFO of Bio Clinic Corporation ("BCC"). BCC is a subsidiary of Sunrise Medical Inc., a manufacturer and distributor of medical devices. Barton was alleged to have fraudulently inflated Sunrise Medical's 1994 earnings by 16% and its 1995 earnings by 40% in order to qualify for a performance bonus worth \$25,000. During 1994 and 1995, Barton fraudulently

understated BCC's expenses by nearly \$20 million by reporting nonexistent assets and falsely understating liabilities. Barton also avoided losses of \$32,000 by insider trading, selling stocks which he was aware that the company's publicly released financial statements were materially false.

Barton agreed to entry of an order enjoining him from violating §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act rules 10b-5 and 13b2-1. Because of his inability to pay, Barton was not required to disgorge his illicit profits and was not assessed a civil penalty.

Barton's plans were aided by BCC's Controller, Accounting Manager, Information Systems Manager, and outside computer consultant. The four were variously ordered to cease and desist from committing or causing violations of §17(a) of the Securities Act, §§10(b) and 13(b)(5) of the Exchange Act, and Exchange Act Rules 10b-5 and 13b2-1. One defendant was also required to disgorge her 1994 annual bonus.

Sunrise Medical was also ordered to cease and desist from committing or causing violations of §13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-13.