YOUR CORPORATE CLIENT IS FACING CIVIL AND CRIMINAL INVESTIGATIONS FOR SUSPECTED FINANCIAL STATEMENT FRAUD – WHAT SHOULD YOU DO?

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The recent indictment of Arthur Andersen and the very public criminal and civil financial fraud investigations of Enron and other former high-flying companies have corporate America on edge. Small issues that in the past may have been dismissed as not material are now being carefully examined at the highest levels. Corporate insiders are worried that any accounting mistake may lead to an investigation by the enforcement staff of the Securities & Exchange Commission ("SEC" or "Commission") or by federal criminal prosecutors or both. For most companies, that prospect is terrifying, at least in part because the procedures and rationale of law enforcement can seem opaque to those who have never been exposed to them.

Because financial statement fraud can happen at any company, it is important for companies and their counsel to understand how the SEC and criminal prosecutors evaluate cases against corporations.[1] Understanding that evaluation process will permit a company that has discovered a financial statement fraud rationally to assess the likelihood that it will end up as a defendant in an enforcement or criminal action and to formulate a strategy to minimize that risk or to mitigate any punishment that the government might wish to meet out.

Both the SEC and the Department of Justice have published materials that shed substantial light on their approach to corporate liability: for the Department of Justice it is "Bringing Criminal Charges Against Corporations," a memorandum from the Deputy Attorney General, dated June 16, 1999, and available on the internet at www.usdoj.gov/criminal/fraud/policy/chargingcorps.html ("DAG Memo"); and for the SEC it is "Relationship of Cooperation to Agency Enforcement Decisions," a report issued pursuant to Section 21(a) of the Securities Exchange Act of 1934, dated October 23, 2001, available on the internet at www.sec.gov/litigation/investreports/34-44969.htm ("21(a) Report").[2]

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[1] This paper addresses enforcement actions against companies. Counsel who represent individual officers and employees in SEC and criminal investigations will have somewhat different issues to consider. The course of action that is best for the corporation is not necessarily the most advantageous for individual officers and employees.

[2] The SEC and the Department of Justice (generally acting through a local U.S. Attorney's Office) independently decide whether each will pursue an investigation or prosecution in any particular

The two documents are addressed to somewhat different issues: the 21(a) Report addresses the relationship of cooperation to the Commission's enforcement decisions whereas the DAG Memo addresses all aspects of prosecuting corporations and treats reward for cooperation as just one aspect of the larger issue.[3] Although the two documents are different in scope, they articulate generally similar principals of prosecution and generally similar factors that will mitigate (or aggravate) the agencies' charging decisions as well as the punishment to which each might agree in settlement of an action.

When determining a strategy for dealing with the SEC and criminal authorities, it is helpful to divide the problem into three parts: (1) an assessment of the seriousness of the fraud; (2) advice to the company on its course of action after it has discovered a fraud; and (3) formulating arguments for leniency based on the likely future of the company.

1. <u>Assessing the Seriousness of the Fraud</u>

Both the 21(a) Report and the DAG Memo make clear that the guiding factor for both agencies in determining how to exercise prosecutorial discretion will always be the agency's obligation to protect the public. Some violations will be assessed by them to be so egregious that no degree of cooperation or other mitigating factors will be sufficient to outweigh the need for an enforcement action or criminal prosecution to vindicate law enforcement's interest in protecting the public. Nevertheless, the Commission has substantial discretion, even when it decides an enforcement action should be brought, to determine what charges it will pursue (scienter-based fraud charges v. non-scienter based fraud charges v. charges that do not include fraud), the venue in which it will pursue the charges (federal district court v. an administrative proceeding), the remedy it will seek (injunction v. cease and desist order v. censure) and the level of civil penalty it will seek. In contrast, criminal authorities have more limited discretion. There are few federal misdemeanors, leaving prosecutorial discretion largely in the realm of bringing a felony charge or no charge at all.[4] Once the decision is made that a corporation should be charged, standard federal prosecutorial policies require the corporation to be charged with the "most serious offense that is consistent with the nature of the defendant's conduct and that is likely to result in a sustainable conviction." DAG Memo at 11.

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matter. While they may coordinate their investigative activity and may consult with one another, neither's decision to investigate or prosecute a particular case is binding on the other.

[3] The DAG Memo obviously deals with policy issues surrounding the full range of federal crimes, not just securities fraud. This article will focus, however, on the DAG Memo only as it would inform a prosecutor's actions in a securities fraud case.

[4] Another possibility is a deferred prosecution, in which the corporation acknowledges responsibility for the crime and the prosecutor agrees not to prosecute so long as the corporation abides by various conditions for a period of time. If the period of time lapses without the corporation violating the terms of the agreement, no charges will be brought.

The 21(a) Report and the DAG Memo provide guidance on the criteria the SEC and criminal authorities are likely use in evaluating the seriousness of a particular fraud. These criteria include: the harm to the public from the misconduct; the pervasiveness of wrongdoing within the corporation, including whether corporate management condoned or was complicit in the wrongdoing; the motivation for the misconduct, including whether it resulted from inadvertence or willfulness; whether management sets a tone of lawlessness or lawfulness; the presence or absence of compliance procedures to prevent misconduct; the duration of the fraud; and whether the corporation has a history of similar misconduct. DAG Memo at 3; 21(a) Report at 2-3.

Put somewhat differently, both agencies' initial assessment of seriousness will be guided by evaluating where on the continuum a situation falls between a corporation that is essentially lawless with pervasive employee and officer misconduct that has caused substantial harm and a good corporate citizen with a rogue employee that has caused minimal harm. Recognizing that most cases fall somewhere in the middle, the goal of counsel is to critically examine the facts to determine where on that continuum the facts really fall.

In a financial statement fraud case, usually, though not always, the fraud is publicly disclosed when the company announces a restatement.[5] Perhaps the single most critical factor for assessing the seriousness of the offense is the market's reaction to the restatement. The sharper the share price drops, the more likely the fraud is to be viewed as serious. Other obviously critical facts include how many quarters or years of financial statements are being restated.

In assessing the seriousness of the offense, counsel should also evaluate the company's compliance program. As the DAG Memo acknowledges, "no compliance program can ever prevent all criminal activity by a corporation's employees, [so] the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives." DAG Memo at 8. See also 21(a) Report at 2 ("What compliance procedures were in place to prevent the misconduct now uncovered? Why did those procedures fail to stop or inhibit the wrongful conduct?") While the presence of a good compliance program that is actually enforced will not guarantee that a corporation will not be charged, it is a significant mitigating factor.

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[5] Although there is no requirement that corporations do so, when a significant restatement is going to be announced, counsel may wish to consider alerting the SEC (either enforcement staff in Washington or in the appropriate regional office) in advance of the announcement. By providing a courtesy call in advance, counsel can begin the process of cooperating with the Commission – assuming that is the chosen strategy.

Other facts should also be evaluated critically. Competent investigators are not likely to impute venality to officers where none is present, but blanket denials of knowledge from managers who were in a position to observe red flags are not likely to be credited. Other facts that will influence law enforcement's assessment of the seriousness of the fraud include whether documents have been destroyed; whether officers have personally benefited through bonuses or otherwise from the fraud; whether officers have sold stock during the pendency of the fraud; and whether upon discovery of the fraud, the company promptly disclosed the fraud to the public and to relevant regulatory agencies.[6] The more serious the fraud, the more important the corporation's post-discovery conduct will be in determining how it will be treated by law enforcement.

2. Conduct After Discovery of the Fraud

The next factors that will significantly affect how a company will be treated by the DOJ and the Commission are largely within the control of the company and its counsel: regardless of whether the company is a good corporate citizen or a rogue, how does it react once the wrongdoing is discovered?

Of critical importance is that the company promptly conduct an internal investigation designed and executed to discover the full extent of the misconduct and make rapid disclosure to appropriate regulators and to public shareholders.

The 21(a) Report lists five factors that the Commission will consider in evaluating a company's post-discovery conduct: speed of response; nature of the response; processes followed to resolve the issues and ferret out the facts; thoroughness and independence of the internal investigation; and level of cooperation with the Commission's enforcement staff. 21(a) Report at 3. Similarly, the DAG Memo points to "the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its [officers and employees], including, if necessary, the waiver of the corporate attorney-client and work product privileges," DAG Memo at 3, as important factors in determining whether to charge the company.

Upon discovery of a financial fraud, most companies conduct an internal investigation. In the 21(a) Report, the SEC laid out the criteria it would use to assess the quality of an internal investigation:

> "Did the company identify what additional related misconduct is likely to have occurred?"

[6] Self disclosure is viewed by both the SEC and the DOJ as a mitigating factor but it alone will not guarantee immunity. See DAG Memo at 6-7.

> "…What processes did the company follow to resolve many of these issues and ferret out necessary information? Were the Audit Committee and the Board of Directors fully informed? If so, when?"
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> "…Did [the company] do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior? Did management [or independent directors] oversee the review? [Who performed the review and were any scope limitations placed on it?]"[7]
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> "…Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? … Did the company voluntarily disclose information [SEC] staff did not directly request and otherwise might not have uncovered?"

21(a) Report at 3.

In short, the Commission expects the company to conduct a thorough, independent review of the situation so that all misconduct is uncovered. Further, both DOJ and SEC expect a company to deal appropriately with employees who have engaged in misconduct. While every set of facts is unique and there are always many circumstances to consider, as a general rule, the higher in the organization a culpable employee is and the greater the employee's culpability, the less likely a company can justify to the Commission or DOJ retaining the employee – even in a different position.

In addition to making personnel decisions based on the results of its independent investigation, a company must also determine whether to accept the government's invitation to share the results of the internal investigation with their investigators. Ideally, the government would like for whomever conducts the independent investigation to produce a "probing written report detailing the findings of its review," 21(a) Report at 3, and to share that report with law enforcement investigators.[8] There can be adverse collateral consequences to taking

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[7] An independent investigation does not have to be conducted by attorneys; in fact, the 21(a) Report refers to outside "persons" conducting the investigation. As a practical matter, however, the vast majority of internal investigations are conducted by attorneys who hire, as necessary, forensic accountants and other experts to facilitate the investigation. In this way, the company has the option, notwithstanding other considerations, to assert certain privileges and immunities with respect to the results of the investigation.

[8] "In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness … to disclose the complete results of its internal investigation, and to waive the attorney-client and work product privileges." DAG Memo at 6.

that step (including waiver of the attorney-client and work product privilege)[9], but it is, unquestionably, the best way for a corporation to gain favor with an investigator. After all, having the results of a well conducted internal investigation can cut months off of the government's investigation. Given chronic personnel shortages, the government is generally willing to reward such help.[10]

Because of the adverse collateral consequences of sharing the results of an internal investigation, counsel may also wish to consider taking steps short of full disclosure of the internal report that may be viewed favorably by the government and may redound to the company's benefit – although not to the same degree as providing the full report of the internal investigation. Without revealing the contents of the internal investigation, counsel can, for example, direct the investigators to those employees who have relevant information and can encourage those employees to cooperate with the investigation.

Regardless of whether the company provides the SEC or U.S. Attorney's Office its internal investigation, it should not protect culpable employees. In the eyes of law enforcement,

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[9] In most financial fraud cases, class action securities fraud cases and derivative actions are being filed contemporaneously with the pendency of the SEC and criminal investigations. Rational counsel may be willing to waive attorney-client and work product privilege vis-à-vis the government but only if doing so does not result in a waiver for the private litigation as well. The SEC is somewhat sympathetic to litigants on this issue and has recently filed an amicus brief arguing that providing privileged material to SEC staff pursuant to a confidentiality agreement should not effect a waiver as to third parties. See McKesson HBOC, Inc. v. Adler, 2002 WL 460318 (Ga. App. 2002). Nevertheless, most courts that have considered the issue have decided that it would be a waiver, particularly if the report is provided without obtaining a confidentiality agreement from the government. See, e.g., United States v. Billmyer, 57 F.3d 31 (1st Cir. 1995) (voluntary disclosure of privileged material to the government waives the privilege); In re Steinhardt Partners, L.P., 9 F.3d 230, 235 (2d Cir. 1993) (voluntary production to the SEC of attorney work product waives the privilege in later civil discovery); Westinghouse v. Republic of the Philippines, 951 F.2d 1414 (3d Cir. 1991) (voluntary disclosure to investigating agency waives privilege).

[10] In all likelihood, however, neither the staff attorney for the SEC nor an Assistant U.S. Attorney conducting a criminal investigation will commit at the outset that it will not prosecute the corporation in return for that level of cooperation. Generally, defense counsel will be told that the investigators will evaluate the extent and value of the corporation's cooperation at the end of the investigation and will not provide any commitments at the outset. The prospect of simply having to trust that the SEC staff attorney or the Assistant U.S. Attorney will provide a good faith evaluation of the corporation's cooperation can be extremely scary to corporations. It is worth attempting to negotiate a cooperation agreement with the criminal authorities, in which the Assistant U.S. Attorney agrees at the outset there will be no prosecution of the corporation in exchange for its full cooperation, see DAG Memo at 6, but defense counsel should not be shocked if those attempts are not successful. Staff of the SEC have historically been unwilling to entertain such negotiations.

"protection of culpable employees" includes advancing attorneys fees,[11] retaining employees without sanction for the misconduct and sharing information about the government's investigation pursuant to a joint defense agreement. DAG Memo at 7. The situation frequently arises during the course of an investigation that an employee will refuse to testify based on his or her Fifth Amendment privilege against self-incrimination. While the employee is fully within his or her constitutional rights to do so, the government can also justifiably conclude that a company that retains as an employee someone who will not testify absent immunity is not being fully cooperative with the government.

Finally, while neither the SEC nor the criminal authorities will expressly condition its disposition on the corporation settling private litigation brought by harmed shareholders, the corporation's willingness to pay restitution to those who have been harmed is viewed by both agencies as evidence of "acceptance of responsibility" that will redound to the company's favor. DAG Memo at 9-10; 21(a) Report at 3 ("Did the company appropriately recompense those adversely affected by the conduct?").

3. Future of the Company

The final considerations that will influence both the SEC and DOJ are miscellaneous factors that generally focus on the future of the company and the likelihood it will violate the law in the future. The 21(a) Report talks in terms of the likelihood of recurrence and the identity of the company. To the extent the company has fired all culpable employees and has voluntarily adopted better internal controls and a better compliance program, those changes will redound to its favor. See also DAG Memo at 10 ("although inadequacy of a corporate compliance program is a factor to consider when deciding whether to charge a corporation, that corporation's quick recognition of the flaws in the program and its efforts to improve the program are also factors to consider."). If the company has fundamentally changed through merger or reorganization, that may also mitigate possible punishment.

The DAG Memo directs prosecutors to consider the collateral consequences of a corporate criminal conviction and whether non-criminal alternatives to prosecution exist that will adequately "deter, punish and rehabilitate a corporation that has engaged in wrongful conduct."

As the indictment of Arthur Andersen makes clear, collateral consequences standing alone, even if devastating, will not necessarily result in a decision not to indict. Nevertheless, the issue of collateral consequences and the availability of non-criminal alternatives permit a company that is facing a joint criminal-SEC investigation to argue that the criminal authorities should defer to the Commission, where sanctions can include injunctions against future

[11] If state law requires the corporation to pay the legal fees of officers until there has been a formal determination of guilt, the DOJ will not view advancing legal fees as a failure to cooperate. DAG Memo at n.3.

misconduct and substantial fines. Because a corporation cannot be imprisoned, as a practical matter a civil fine has the same fiscal impact as a criminal fine and an injunction is likely to be as effective in deterring future misconduct as probation. Of course, the more egregious the fraud and the more pervasive the misconduct, the less likely the criminal authorities are to defer to the SEC.

CONCLUSION

Any corporation that discovers a financial statement fraud – particularly in the current environment – can expect to be investigated by the government and therefore needs to consider carefully the strategy it wants to pursue. At base, the best strategy for a public company in dealing with the government is to accept responsibility for the wrongdoing that occurred and to take such steps as are necessary to give law enforcement comfort that the misconduct will not be repeated. While there is no guarantee that strategy will yield the ideal resolution from the corporation's perspective, it will best position the corporation to argue for leniency.

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