New York Law Journal

MONDAY, JULY 18, 2005

WHITE-COLLAR CRIME

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Not the Usual Suspects

As scrutiny of accounting irregularities continues, a wider net is being cast to catch collaterally liable parties.

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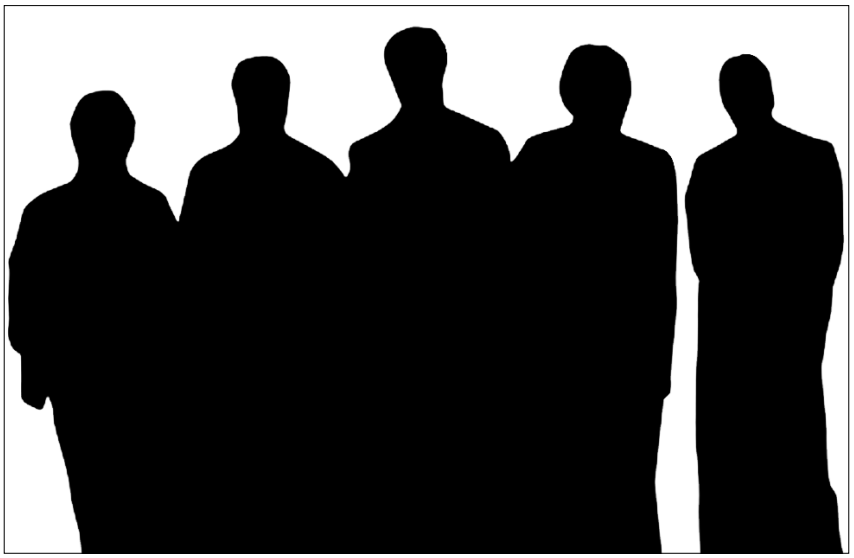

NYLJ ART

AS GOVERNMENT scrutiny of corporate accounting irregularities gets its second wind, the potential criminal and civil exposure of American businesses has continued to expand in both kind and degree. While the Supreme Court's reversal of the Arthur Andersen conviction may have led people to believe that aggressive corporate prosecution was a thing of the past, the widespread crackdown on blue-chip companies such as Royal Ahold NV, WorldCom, and most recently Bristol-Myers Squibb, indicates otherwise.

This is the result of a government effort to increase standards of corporate vigilance by defining a wider net of collaterally liable parties. Authorities have broadened their target to encompass those parties whose "deliberate indifference" has aided or abetted another party's accounting fraud, and such a move has been supported by a new framework of criminal and civil sanctions, most notably the use of deferred prosecution agreements that hold companies accountable for prior wrongdoing without exacting the ultimate Andersen-style punishment on their shareholders and employees.

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So how does a company protect itself in the current environment?

Audit committees must enhance their prophylactic safeguards against fraud and train their employees. And when law enforcement knocks, companies must be prepared to manage the investigative process and pre-empt government-imposed sanctions by addressing the concerns of the prosecutors voluntarily. If handled proactively, companies can resolve government investigations of accounting improprieties with less public fanfare and a diminished risk of spillover civil litigation.

Understand the Liabilities

It is crucial to comprehend the array of liability facing today's corporations and executives in order to anticipate, deter and, if necessary, manage such government inquiries.

There has been general awareness since Enron of the perils for companies that directly engage in fraudulent accounting practices to mislead the public markets about the efficacy of their own books and records. Since that time, there has been a trend toward criminal prosecution of secondary participants as well, namely those who have facilitated others' manipulation of their financial statements.

Government attention has increasingly focused on whether companies "look over the fence" to see how their counterparties or clients are accounting for transactions, and prosecutors and regulators are no longer willing to accept the "don't ask, don't tell" standard of conscious avoidance that permeated corporate America in decades past.

This heightened scrutiny has resulted in criminal and civil charges against

companies and officers that were insulated from such liability historically as long as they kept their own financial statements in check.

Five months ago, the United States Attorney's Office in the Southern District of New York filed criminal charges against nine individuals employed by suppliers of a Royal Ahold NV subsidiary for signing false audit confirmation letters with alleged knowledge that the revenue amounts therein had been artificially inflated by more than $800 million.

David Kelley, United States Attorney for the Southern District of New York and a member of President Bush's Corporate Fraud Task Force, noted that such "assistance" has severe ramifications in today's climate. "Those who do not respond fully and truthfully, or who willfully turn a blind eye to protect a profitable business relationship, will face the risk of criminal prosecution and conviction."[1]

Parallel civil proceedings, such as the SEC charges filed against the defendants in that case, have become increasingly common as criminal prosecutors coordinate with their regulatory enforcement counterparts to pursue those who enable fraud. Indeed, the level of potential fines that accompany civil charges and exposure to costly third-party lawsuits may now pose the greatest threats to big companies.

In March of this year, the SEC slapped Time Warner with a $300 million penalty for overstatement of its own revenues as well as its role in aiding and abetting three other companies in doing the same, and the shareholder class action suits against WorldCom, and more recently the Enron bank defendants, have seen settlements in the billions.

This extension of criminal and civil liability to secondary actors who facilitated the fraudulent accounting activity of others has exposed many additional parties who previously went unnoticed. Such outside parties have included independent auditors, business partners along the supply chain, transaction counterparties and underwriters. While only Andersen collapsed due to its indictment in the Enron scandal, all of the remaining Big Four accounting firms have been subject to investigation, with three of them paying millions in SEC fines or settlements.

Canadian Imperial Bank of Commerce (CIBC) was prosecuted by the government in 2003 for its role in disguising several transactions with Enron, in which it structured hefty loans as "asset sales" so that the extent of Enron's debt would go undetected. The bank was forced to settle by accepting a three-year government-imposed monitorship under the terms of a deferred prosecution agreement, a fine in the amount of $80 million, and the related civil litigations seeking billions of dollars are still pending.

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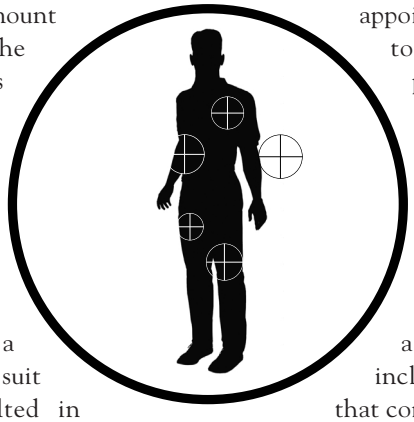

Several investment banks that had underwritten WorldCom bond offerings prior to its bankruptcy were also named as defendants in a shareholder class action suit that has already resulted in billions of dollars in settlements. The plaintiffs there alleged that banks such as JPMorgan, Chase and Citigroup had failed to detect WorldCom's accounting irregularities and disclose the information to shareholders.

In a noteworthy opinion last December, District Judge Denise Cote wrote: "Underwriters function as the first line of defense with respect to material misrepresentations," and as a result, "courts must be particularly scrupulous in examining their conduct." *In re WorldCom, Inc. Securities Litigation*, 346 F.Supp.2d 628, 662 (S.D.N.Y. 2004).

The government is continuing to make an example of aiders and abettors whose "willful blindness" is treated as knowledge and intent with disastrously costly consequences. In this environment of enhanced liability, strict compliance with government regulations has become a top priority for American businesses.

The Government's Methods

While numerous companies like Enron, WorldCom and Andersen have learned their lessons the hard way, federal prosecutors and the SEC are now seeking ways to compel companies to reform their internal corporate controls without forcing them into bankruptcy.

The mechanism of choice has been the deferred prosecution agreement, in which an allegedly offending company agrees to swiftly undertake corrective action in exchange for a "deferral" of prosecution for its alleged violations. A set time period is established during which the organization must be on good behavior, and an independent monitor is appointed by the government to oversee the reform process and report on any problems.

This mechanism grants companies a second chance at righting past wrongs under the real threat of imminent legal action, and typically also includes a significant fine that compensates injured shareholders while sending out a strong deterrence message.

An increasing number of large corporations are being subjected to this type of government-imposed monitorship. Just a month ago, pharmaceutical giant Bristol-Myers Squibb signed on to a two-year deferred prosecution agreement following allegations that it had used a channel-stuffing scheme to inflate its sales and earnings.

By giving wholesalers incentives to purchase more prescriptions than necessary, the company faced criminal charges of conspiracy to commit securities fraud. However, by entering into a deferred prosecution agreement, Bristol-Myers was given the opportunity to pay a fine, revamp its internal controls, and if all goes smoothly over the next 24 months, the charges will ultimately be dropped.

Computer Associates, which was charged civilly by the SEC and criminally by the Justice Department for fraudulent revenue recognition, agreed to an SEC consent judgment and deferred prosecution agreement in September 2004 that subjected it to a stringent 18-month review by an outside monitor. Other major corporations have also settled charges in recent years using deferred prosecution agreements, as well as companion civil enforcement judgments, including mortgage financier Freddie Mac, banking powerhouse CIBC, and tech firm Symbol Technologies.

An Alternate Response

There are, however, serious risks that attend a company's entry into a deferred prosecution agreement and government-imposed monitorship, beyond the substantial financial penalties that generally accompany such settlements.

A violation of the government-imposed protocol during the deferral period can trigger prosecution. Even if the monitorship proceeds without incident, the public nature of the sanction necessarily draws the attention of potential plaintiff firms with appetites for costly shareholder derivative suits.

Accordingly, the legal and market risks of deferred prosecution agreements typically extend far beyond the monitorship period. It is therefore preferable for a company to handle its potential liability proactively, by responding to a government inquiry of prior improprieties with a plan to institute a self-initiated, rather than government-imposed, review process in accordance with established guidelines.

Pre-emptive institution of a voluntary monitorship that establishes policies and procedures addressing the accounting concerns implicated by a government inquiry may avert criminal prosecution and civil regulatory penalties, and cloak the remedial action in a confidentiality that reduces the likelihood of costly third-party litigation.

The Department of Justice's Thompson memo issued in January 2003,[2] echoing principles set forth in the 1999 Holder memo,[3] and the new federal sentencing guidelines advise companies how to implement comprehensive remedial programs to avoid imposition of a deferred prosecution agreement, public monitorship or full-scale criminal prosecution.

Among other factors, these guidelines note the significance of a company's internal and external compliance efforts in the Department's decision whether or not to bring criminal charges. The SEC's Seaboard memo of 2001[4] similarly highlights the importance of establishing a code of ethics, whistleblower policies, and strict internal controls that would immediately work to rectify illegal conduct.

While these government pronouncements merely provide guidance and do not mandate specific procedures, they collectively set forth a framework for the type of private, voluntary monitorship that may insulate a company from criminal and civil liability. While companies may resist adopting such security systems in the absence of government scrutiny, they will likely recognize their value when striving to thwart the far more severe criminal and civil penalties that are likely to result from an aggressive enforcement action.

Companies facing accounting inquiries are thus well advised to quickly retain outside law firms and auditing firms to revise their accounting controls and monitor their operations. Such outside advisors, working with the organization's internal audit group, should conduct a fraud risk assessment based on the nature of the business and the government's inquiry, and based on that assessment, develop a credible sampling methodology focused on the high risk areas.

With interim safeguards in place including appropriate discipline of individual wrongdoers, a company is well positioned to then approach government prosecutors and regulators and request, in lieu of indictment or the filing of civil charges, an opportunity to implement better internal controls, train its personnel, and retain a private monitor to review and revise its compliance protocol over a period of time.

Volunteering to root out misconduct and devise remedial controls within a specified time frame is an offer that federal prosecutors are unlikely to refuse. And when granted a respite from enforcement action, a company can mandate heightened review of quarter- and year-end transactions, and employees can be trained to identify and elevate questionable business practices to assigned compliance personnel or through an anonymous hotline.

A private monitor, retained at the company's expense for a period of time acceptable to the government, can systematically review outlier transactions without the tag of a government sanction and the shareholder derivative actions that inevitably follow such disclosures.

By offering the government its endgame—a rigorous model for good corporate behavior, companies under scrutiny for accounting irregularities can avoid criminal prosecution and devastating civil penalties. Apart from being the right way to run a business, strategic engagement of a private monitor is the most effective way to pre-empt a criminal enforcement action and reduce the civil liability risks that accompany any form of public sanction.

1. U.S. Attorney's Office, S.D. New York, Press Release (Jan. 13, 2005), available at http://www.usdoj.gov/usao/nys/Press%20Releases/JANUARY05/Ahold%20vendor%20press%20release.pdf

2. Memorandum from Larry D. Thompson, "Principles of Federal Prosecution of Business Organizations" (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/business_organizations.pdf

3. Memorandum from Eric H. Holder, Jr., "Bringing Criminal Charges Against Corporations" (June 16, 1999), available at http://www.usdoj.gov/criminal/fraud/fcpa/Appendices/Appendix%20K.pdf

4. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (Oct. 23, 2001), available at http://www.sec.gov/litigation/investreport/34-44969.htm