Fraud Traps For The Unwary

by Gary S. Matsko

Are you committing board fraud? Of course not, is your immediate response. Yet, according to SEC policy, directors may be guilty of fraud for corporate actions they not only never approved, but never knew about. Missing a danger "red flag" may be all that is needed.

In the business world, being invited to serve on the board of directors of a public company can be quite enticing. However, accepting a directorship can open a Pandora's box. Every, year many business people put themselves at risk of public accusations of fraud, under circumstances that would surprise many, by agreeing to join a public company board.

Few events are as damaging to a businessperson as public accusations of fraud, particularly in the age of the Internet, where accusations can circle the globe instantly and can be readily found. When the accuser is the Securities and Exchange Commission, the accusations can be particularly devastating.

The circumstances in which a director can be charged with fraud can be quite innocuous, the process of a SEC investigation painful, and even a good result can be unsatisfying. Despite the risks, many people are not aware of simple missteps that can result in fraud charges. An understanding of what the SEC might consider as fraudulent behavior, and how the SEC comes to a determination of fraud, can significantly lessen a director's chances of being ensnared in the SEC's crosshairs. Stopping short of declining an invitation to serve on a board, there are active ways directors can keep their guard up.

Following on Congress's adopting Sarbanes Oxley, the head of the SEC's Division of Enforcement announced that the SEC would bring civil fraud charges against corporate directors who were neither directly involved in nor had actual knowledge of their corporation's fraudulent activities. Under the announced policy, such charges would be brought if the SEC concluded that there were clear warnings, or "red flags" of fraudulent activities, and the directors failed to respond appropriately to such warnings.

Furthermore, board members with particular expertise, such as accountants or financial analysts who failed to respond appropriately to less obvious "yellow flags" in their areas of expertise, might be treated equally harsh. Fraud charges would be asserted in an SEC-enforced proceeding, which could be either a civil suit filed in an appropriate Federal District Court, or an administrative proceeding conducted before an SEC Administrative Law Judge, with an appeal to the SEC Commissioners.

Even though a director is not aware a filing with the SEC is false, the Commission can claim that other information available to the director should have raised suspicions.

It is not remarkable that the SEC has determined to make disengaged directors the objects of enforcement proceedings. What is remarkable is the remedy the SEC has chosen—to assert fraud charges. These charges are usually reserved for *intentional* misconduct, and carry with them many collateral consequences, including severe limitations on future business activities. Moreover, no matter what the ultimate resolution, severe damage to reputation nearly always follows.

A director's signature on a document filed with the SEC is the most likely way to find he or she is in jeopardy of fraud charges. For example, the director signs an annual report or Form 10-K that contained statements proved to be false. The SEC concludes that, even though the director was not aware that the statements were false, other information available to the director should have caused heightened scrutiny. SEC fraud charges are then likely to be sought by the SEC against directors.

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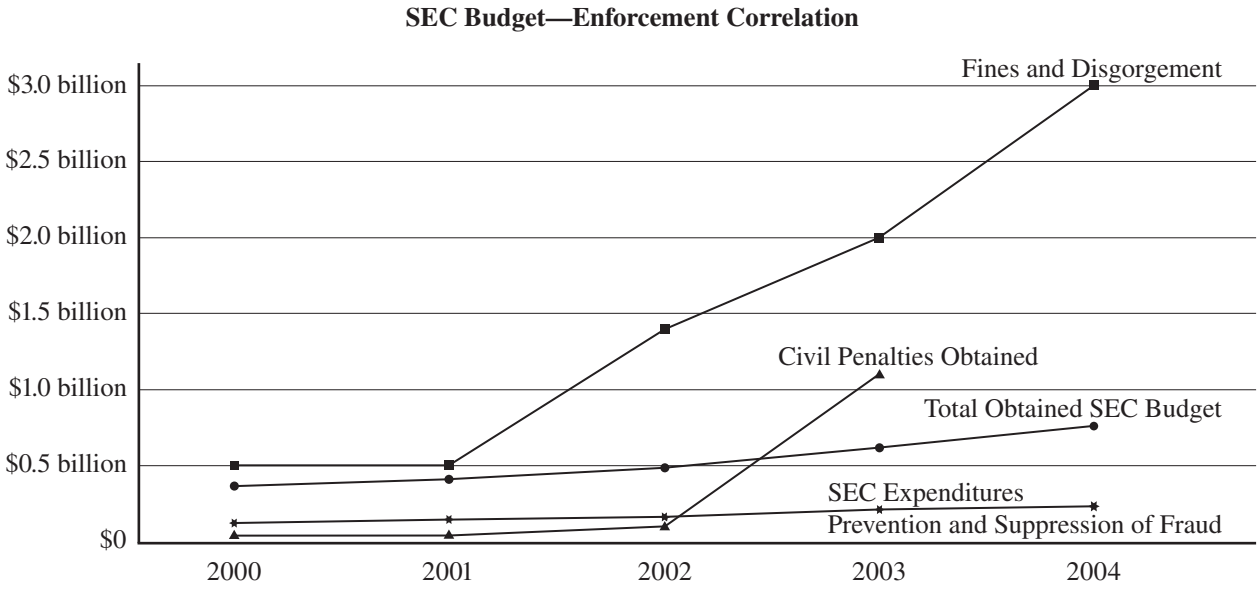
A "Get Tough" Policy

SEC Enforcement, And Penalties, Are Increasing



Source: Securities & Exchange Commission

It is particularly troubling that the SEC's model for holding directors accountable for fraud offers little guidance to directors as to what they must do to avoid such a charge. What will constitute a "red flag" or "yellow flag" will depend on the facts or circumstances of a given case.

A hypothetical scenario will show how unsuspecting directors can find themselves in the SEC's crosshairs. A business associate of the president of Acme Widgets is asked by the president if she would be willing to serve as an outside director on Acme's board. She accepts.

She learns shortly after joining the board that Acme's management has been dissatisfied with its outside auditors for over a year because of high billing and performance issues. The criticisms seem to have factual basis, and replacing the auditors has been discussed with the board.

The existing auditors complete the audit. In the course of doing so, the auditors insist revenue has been improperly recognized, and Acme must reduce its revenue by significant amounts. Acme's management objects, asserting that the auditors are applying criteria for revenue recognition too rigidly. Ultimately, though, the audit committee of the board of directors accepts the auditors' adjustments. The director signs the Form 10-K, which includes Acme's audited financial statements.

Half way through the following year, Acme's management advocates the removal of the auditors and cites the historical dissatisfaction with the accountants' billing and performance as the reasons. The board and the audit committee accept management's recommendation and new auditors, recommended by management, with apparently appropriate credentials, are hired.

They perform the next year's audit and, after completion, issue an unqualified opinion letter that the financial statements fairly present Acme's financial condition. Those financial statements reflect a significant increase in revenues over the prior year. The director who signed the Form 10-K is told that the new accountants have adopted some of management's positions on the recognition of

revenue that the prior accountants had rejected. The new auditors have issued a written report supporting the position.

To our outside director, who is not trained in accounting, the new accountants' position appears reasonable. She accepts the disagreement between the two sets of accountants simply as different interpretations of technical accounting rules. Relying on the opinion of the new auditors and on their "clean opinion" that the financial statements fairly present the company's financial condition, the director signs the next year's Form 10-K.

The SEC confirms that fraud occurred at the company, but there is no evidence the director knew anything about it. Is she home free? Not necessarily.

Some months after the Form 10-K is filed, a whistleblower reports to the SEC that during the course of the year, Acme's management directed the recognition of revenue on a substantial number of transactions that did not qualify, substantially inflating Acme's revenue. According to the whistleblower, false documents were created by Acme's officers to foster the impression that these transactions warranted revenue recognition and those same officers concealed many documents from the auditors. He also reports that members of management pressed the new accountants to accept management's views on revenue recognition.

An SEC investigation confirms the whistleblower's report, but finds no evidence that the director participated in or even knew of management's scheme to inflate revenue.

Is the director home free? Not necessarily. The director knew that the prior auditors had written off revenue and, in so doing, the auditors asserted that Acme had not adhered to revenue recognition standards. She knew that management was resistant and unhappy about the write-offs and had forcefully advocated the replacement of Acme's accountants. She knew that the new auditors accepted a revenue recognition policy previously advocated by management that the prior auditors had rejected. Coincidentally, with the new auditors in place, Acme's revenues had climbed to meet the market's expectations.

The SEC has seen "red flags" in circumstances not terribly different from those above. It has not regarded a "clean opinion" from the auditors as precluding fraud claims against a director who signed a Form 10-K that included false financial information.

We commonly think of fraud as intentional and purposeful deception, so how can the director's signature on an SEC report that she does not know to be false amount to fraud? The answer is that fraud in the securities context can be broader than the common understanding of the term.

While the SEC rules are intended to address intentional conduct, the "intent" element can be satisfied by a showing of recklessness. Courts have variously defined recklessness as carelessness approaching indifference or an extreme departure from ordinary care.

Whether the conduct of the director in the Acme scenario amounts to recklessness, she may not know until the end of trial. There is enough elasticity in the concepts of "red flag" and recklessness to leave directors uncertain and the SEC has set a low threshold for recklessness.

What will happen if the SEC staff investigating the Acme case decides fraud charges are warranted against the director? They will recommend to the Commissioners, in whom the authority to authorize suits is vested, that the director be charged with fraud. She or her counsel will receive a notice from the SEC staff, referred to as a Wells Notice, that a fraud claim is asserted against her. She has the option to submit a written or video presentation, referred to as a Wells Submission, to the Commission arguing against the commencement of a proceeding.

Many SEC practitioners do not make a Wells Submission because the prospective defendant does not have an opportunity to read the SEC staff's recommendation memorandum, and so submitting a Wells Submission is responding blindly.

If the SEC proceeds with the charges, it will either enter an order commencing an administrative proceeding against the director and other targets, or

authorize the staff to file a suit in federal court. In either case, the SEC may seek monetary penalties up to $100,000 per violation (or the gross amount of any benefit derived from the violation), bars against future violations of the law, bars on future participation as an officer or director of a public company, or other forms of relief.

The commencement of proceedings will generally be followed by an SEC press release announcing the proceedings, and the director, if named, will wake up one morning to a newspaper account that he or she has been "Sued by the SEC for Fraud."

The director and her co-defendants may litigate the SEC charges or seek settlement. Even litigants who believe that they have done nothing wrong often find settlement to be the better option because it will save them hundreds of thousands of dollars in legal fees and defense expenses, and may spare them the risk of large penalty assessments. Moreover, settlement puts the unhappy episode behind them.

In SEC settlements, defendant directors cannot deny the allegations, and must pay the settlement from their own funds.

Unlike general civil litigation, however, parties cannot proclaim innocence because the SEC's standard settlement includes an agreement by the defendant that he or she will not deny the validity of the SEC's allegations. Moreover, if fines are imposed, the settlement agreement will require that the settling party pay with his or her own funds, not with insurance proceeds or corporate indemnification funds. Ordinarily, the SEC will issue a press release announcing the settlement, but there is little that a defendant can say in response.

In sum, the cost of a director's inattention is obviously high and serving as a director is certainly a situation in which an ounce of prevention is worth a pound of cure.

How do directors keep their guard up? What action is required will depend on the circumstances, but basic principles for all directors to follow include:

☐ *Do not be a passive director.* A director who accepts the position thinking he or she can satisfy duties by simply showing up for meetings risks being caught in the fraud trap. If there are scoundrels in the executive suite, the passive director may be held accountable for "red flags" that went unnoticed.

☐ *"Know what you don't know."* When matters that come before the board extend beyond your knowledge and experience, get clear explanations from qualified professionals before you sign a document. A director may not be able to claim a lack of expertise as an excuse for being unaware of "red flags."

☐ *Look into conflicting information.* If the company's professional advisors give contradicting advice, the board may have to retain its own professionals to advise them.

☐ *Be mindful of hot button issues.* High levels of related-party transactions, or transactions with apparent conflicts of interest, for example, warrant further inquiry.

☐ *Pay strict attention to all company public pronouncements.* Directors cannot claim they were unaware of "red flags" contained in filings or announcements by asserting they were not familiar with their contents.

☐ *Read and fully understand any document before signing, particularly one that will be filed with the SEC.* When documents are complex, there will be a temptation to rely on management's assurances of accuracy, but the director who signs a document will be held accountable for its contents.

☐ *Be wary of management that is overly controlling of the board's processes or the flow of information to the board.* Management views are to be considered, but the board must exercise its own discretion in performing its oversight functions.

The SEC's approach to enforcement actions against directors has the effect of deputizing directors as agents of the SEC's Division of Enforcement. Perhaps this approach will also have the beneficial effect of curbing corporate dishonesty. However, directors who fail to follow clues, that in the glare of hindsight may appear to have been significant warnings of malfeasance, may well find themselves the pursued rather than the pursuer. ■