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C-LEVEL INSIGHTS FOR BUSINESS LEADERS

UNSUSPECTING EMPLOYEES CAN BE SNARED

THE PERILS OF SECURITIES FRAUD CLAIMS

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YOU MIGHT THINK that the public company executives caught in the cross hairs of federal prosecutions the past few years knew exactly what they were doing, and were directly involved in preparing false financial information. Think again. The government is more than willing to go after executives and managers who aren't directly involved in financial wrongdoing and who thought they were acting legally.

Many "scoundrels" did not understand they stood in harm's way as they participated in the events that brought them into the spotlight. The complex environment in which public company financial activities occur does not always give fair warning. Company leaders seeking to instill a culture of ethics would be wise to warn their top managers of this danger and ensure that systems are in place to sniff out and report potential wrongdoing.

A BROAD NET

Investors look to SEC filings, including annual 10K reports and the quarterly 10Q reports, to assess the performance of public companies. The company's executives and managers often see the reported numbers as a reflection of their performance. If they hold shares or options they hope to report good news that may enhance their own wealth. The financial reports often are what link an executive or other employee to trouble.

False filings can trigger serious criminal and civil charges. You expect that those involved in preparing financial statements and those with a direct line of responsibility for them could face severe consequences, but the government doesn't draw the line there. Other employees have found themselves facing prison sentences and SEC sanctions, even though the fraudulent financial statements were filed by others and they played no role in determining what information would be reflected in the company's financial statements. Senior executives have received that chilling "come hither" call from the SEC or Justice Department simply by virtue of being involved in transactions that impacted information reported in those statements.

Prospective targets of enforcement actions will usually learn of the government's interest when the SEC requests testimony and documents from them, or issues a subpoena for that information.

If the SEC concludes that violations of law have occurred, it will initiate civil or administrative enforcement proceedings. The end result can be significant fines, banishment from future officer and director positions with public companies, disgorgement of any financial benefit that a court concludes was derived from improper actions and a permanent scarlet letter, visible to everyone with an Internet link.

Alternatively, DOJ prosecutors could commence a grand jury investigation. When this happens, the SEC often will suspend its investigation until any resulting prosecutions are completed. Meanwhile the government is sorting through the evidence it gathers and is categorizing individuals as witnesses, subjects and targets. Those labels often change as the investigation progresses.

It is a process fraught with risks that requires many judgment calls an executive shouldn't make alone. At some point in the process the prosecutor will decide whether to charge an individual criminally. Even if an executive isn't charged criminally, the SEC may subsequently file a civil enforcement action.

There are a number of legal doctrines that can extend liability beyond the preparers and signers of the financial statements and impute wrongful intent from inaction. In the criminal arena, conspiracy and aiding and abetting greatly broaden liability.

To be liable as a co-conspirator, the government need only show that an executive or other employee entered into an agreement to do something wrong, and that an overt act was taken by someone in furtherance of the conspiracy. Whether an employee has entered into a conspiracy can be inferred from the overall circumstances. It does not require direct evidence that he or she expressly agreed to participate.

Aiding and abetting requires the government to prove an individual knew of the underlying criminal act and intended to help the principal. These elements can be met by inferences drawn from indirect evidence. Thus, an executive who did not perform the underlying criminal act, was not present when it was performed, and did not know the details of its execution, may still be found guilty of aiding and abetting.

The most common federal securities law violations require proof of knowing and willful wrongdoing. Avoiding people or meetings, refraining from asking obvious questions, or dodging questions, can all constitute evidence that someone ignored fraud.

RED FLAGS

Here's a hypothetical that shows how unsuspecting senior executives or other employees can be snared. It's based on similar claims that have been asserted by the SEC and DOJ:

Top executives of a public company become concerned that their company will not attain projected revenue and profits, and that lesser results will affect the stock price. The company's principal business is medical software, but it also invests surplus funds in other companies, particularly those that might buy the company's products.

The company has several employees who identify potential investments. Hoping to generate more sales, company leaders push to make more investments that will have the collateral impact of selling its product. Top executives violate accounting rules by including sales to other companies in which the company has made investments in financial statements. Some of those companies have shaky financial profiles.

The company's managers and other employees have little understanding of when sales to the companies in which investments have been made can be included in their company's sales, and do not know what revenues are actually included.

The SEC learns of the activity and asserts that the managers and other employees should have understood that the investments in shaky companies made no sense and must have been done to create false revenue. The SEC staff seeks to hold the managers and employees accountable, even though they did not play any role in including revenue in the SEC filings.

Circumstances similar to these have made executives and other employees the subject of SEC investigations and recommendations for enforcement, and have resulted in criminal prosecutions even of some not involved in recording revenue. An executive who participates in activities that may be part of a scheme to inflate a company's revenues or profits is at risk of being treated as a co-conspirator or aider and abettor.

AVOIDING PEOPLE OR MEETINGS, REFRAINING FROM ASKING OBVIOUS QUESTIONS, OR DODGING QUESTIONS, CAN ALL CONSTITUTE EVIDENCE THAT SOMEONE IGNORED FRAUD.

Never ignore red flags, such as transactions that do not make business sense, or appear to have the creation of manufactured revenues and profits as their primary purpose. One classic gambit to support increased revenue recognition is generating paperwork that makes it appear that goods were shipped before the end of a quarter, when in fact they were shipped after the quarter ended. Another gambit is to ship non-conforming goods (or even empty boxes) to make it appear sales were completed before quarter end.

Prosecutors aren't interested in a shipping clerk with a high school education who has never owned a share of stock. But executives and other employees are at risk if they are college-educated, have taken accounting courses, read the Wall Street Journal, receive bonuses based upon the company's financial performance, and own company stock or hold company stock options. Whatever the truth, the government investigators may infer the worst.

Managers and other employees can take advantage of their company's internal whistleblower program. Since the passage of Sarbanes-Oxley in 2002, a public company must have a system for prompt internal reporting of violations of its code of ethics. Corrective action may be taken in advance of any public disclosure. The internal investigation may reveal that an executive misunderstood the significance of his or her observations.

An executive who isn't satisfied with the outcome of that process should review those concerns with company counsel. If that doesn't help, consult a private attorney. Drastic actions such as resigning from the company or contacting a government agency — or continuing employment under troubling circumstances – shouldn't be undertaken without legal advice.

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