INSIDE COUNSEL AS TARGETS: FACT OR FICTION?

Over the past four years, a stream of news reports has described SEC enforcement actions and criminal prosecutions of inside corporate lawyers. Many in the corporate bar have asked whether the news coverage is exaggerating the frequency of these actions, and if the frequency is real, whether any common factors prompted these proceedings. If the answer to these critical questions is "yes," then inside lawyers can take steps to reduce their risks.

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Our analysis undertakes to answer at least the first question posed by this column: Are there in fact a large number of SEC actions and prosecutions aimed at inside corporate lawyers? For the first time, to my knowledge, all or virtually all SEC proceedings against inside counsel since 1998 and the criminal prosecutions of inside counsel since 1995 are collected and described in our report, "SEC and Criminal Proceedings Against Inside Corporate Counsel." Although readers can draw their own conclusions from the descriptions provided in the complete report, this analysis also attempts to distill common elements and themes from the cases. (We have excluded from our analysis all insider trading cases, because that conduct is not inherently linked to the role of an inside lawyer.)

This month's column summarizes some of the highlights of our analysis. For information on how to access ACC's website for the complete report and the accompanying webcast, see "The Inside Scoop," on p. 105.

ANALYZING SEC SANCTIONS: A BRIEF BACKGROUND

The SEC can initiate a variety of noncriminal sanctions against inside lawyers, including civil injunctive actions in federal district courts under § 21(d) of the Exchange Act, 15 USC § 78u(d)(1); administrative actions under § 15(c)(4) of the Exchange Act, 15 USC § 78o(c)(4); and cease-and-desist orders under § 21 of the Exchange Act, 15 USC § 78u-3(a). In addition, it can bring proceedings to prohibit a lawyer from appearing and practicing before the Commission pursuant to what has been known as its Rule 102(e) authority, 17 CFR § 201.102(e), which has been recently amended as required by § 307 of Sarbanes-Oxley. These are the types of SEC actions summarized below.

Because of the corporate failures in late 2001 and early 2002, the end of 2001 has become a convenient breaking point for analysis, and we will adopt it here. The SEC initiated enforcement actions against twelve inside counsel from 1998 to 2001. Most of these actions were directed at the general counsel or the most senior legal officer directly involved in the preparation, approval, and/or signing of allegedly false financial statements or representations contained in SEC fil-

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ings, securities offerings, and/or other publicly disseminated documents. Most SEC actions were resolved by settlement. In five of the actions, inside counsel were either barred or suspended from appearing or practicing before the Commission.

After the highly publicized corporate failures that began in the fall of 2001, the SEC increasingly focused its attention on the role of inside counsel. This increased attention has resulted in a corresponding increase in the number of enforcement actions directed at inside counsel: Since the beginning of 2002, approximately 19 inside counsel have been the targets of SEC enforcement actions. And, as indicated by the SEC's saber-rattling statements and its issuance of Wells notices,[1] others may find themselves defendants in the near future.

Collecting criminal cases against inside counsel was considerably more challenging because they were not all handled by one agency. In the six years between 1995 and 2001, the Justice Department brought approximately five criminal actions against in-house counsel for their role in fraudulent securities schemes engaged in by other officers or employees of their respective corporations. Many of these defendants were originally indicted for substantive securities law violations and pled guilty to conspiracy to commit securities fraud. Several defendants also pled guilty to obstruction of justice—an increasingly frequent addition to the indictment at the urging of the SEC. One might conclude that the nature of the charges reflects the government's view that the in-house lawyers' blameworthy conduct prevented disclosure of primary criminal conduct by others.

Since the beginning of 2002, when the Justice Department established the Corporate Crime Task Force, at least eight criminal actions have been brought against in-house counsel for various violations of the securities law, representing a significant increase over the number brought in the preceding six-year period. Most of these actions have received considerable publicity due to the magnitude of the losses sustained by the companies and their investors and the extent of the personal profits realized by the parties to the wrongful conduct. With one exception, all of the actions involve fraudulent securities and accounting schemes engaged in by both in-house counsel and other officers and/or employees. One of the actions remains pending; the rest have been resolved through one acquittal, two convictions, and four pleas of guilty.

NONCRIMINAL SEC SANCTIONS: SOME DERIVED PRINCIPLES

RULE 1: *The top lawyer is nearly always the target.* The most obvious common element in the SEC actions is that nearly all of them are brought against the chief legal officer of the company. The occasional exception usually involves the most senior lawyer in charge of a project or a disclosure document.

RULE 2: *Inside lawyers who relied on outside counsel advice are seldom SEC targets*. The factor most notable by its absence is that very few SEC enforcement actions involve a defendant or respondent who relied upon the advice of an outside law firm. One could divine from this fact that inside lawyers who rely upon outside counsel rarely make mistakes. But we think it's more likely that the SEC judges enforcement actions are unlikely to succeed when inside counsel followed the advice of an outside law firm. The inside lawyers' "advice of *outside* counsel" defense must have a significant impact on the exercise of enforcement discretion.

RULE 3: *Putting money in your pocket is not necessary to prompt SEC enforcement.* An unexpected observation is the relatively small role that financial rewards apparently play in the SEC's exercise of discretion. One might have expected that the SEC would take enforcement action only where inside counsel received unreasonably high compensation or bonuses, or benefited through increased stock value. That does not prove to be accurate. Many inside lawyers appear to have been the target of enforcement action when it appears their only motive was, in the SEC's view, a misguided attempt to help their corporate employer.

RULE 4: *Disclosures, particularly omissions in disclosures, are usually the problem.* Many of the cases against inside counsel involve allegedly false and misleading disclosures—more often than not, omissions. While some instances of outright fraud have been

THE INSIDE SCOOP

You can hear John Villa deliver his analysis and discuss it with Robert S. Lavet, senior vice president and general counsel, Sallie Mae, Inc., in the ACC webcast, "In-house Counsel as Targets: Fact or Fiction?" A recording of this webcast, which took place on September 21, 2005, is available via ACC Online℠ at *www.acca.com/networks/webcast*.

To read the full report, "SEC and Criminal Proceedings Against Inside Corporate Counsel," with details of the SEC proceedings and criminal prosecutions of in-house lawyers discussed in this summary, go to *www.acca.com/protected/article/ethics/seccrimproceed.pdf*.

alleged, such as totally fictitious offshore operations or sham contracts, in other instances the SEC has pursued inside lawyers on decisions that involve matters of professional judgment.

RULE 5: *A generalist lawyer serving as general counsel must seek out sound advice or pay the price*. Although there are very few cases in which the SEC has brought an action where the inside lawyer appears to have relied on outside counsel, the SEC has chosen to bring actions where the inside lawyer claimed not to be an expert on a technical issue and either relied unjustifiably on an inside technical expert or saw a red flag and failed to seek outside legal advice. Put another way, the SEC appears to be willing to impose on an inside lawyer the obligation to seek expert legal and technical advice or face enforcement action. The "I am just a generalist lawyer" defense is *not* well received, especially if the general counsel is on notice of a potentially serious problem. The message seems to be that if one chooses to become the general counsel of a public company, one is obliged either to learn the rules or to seek guidance from those who do know the rules. This echoes the SEC's new attorney conduct regulations,[2] in which the SEC suggests that the question of whether counsel should have been aware of evidence of a "material violation," so as to trigger the reporting obligations under the regulations, may depend on whether other lawyers were available *with whom counsel could have consulted on the matter*.[3]

RULE 6: *If you hold several corporate offices, your company failed, or you sat on a serious problem you could have taken to the Board, your risk increases.* There are a few factors that appear to increase the likelihood of enforcement action, but the data is too limited to draw firm conclusions. For example, holding a position as inside counsel *and* director seems to increase the enforcement risk. In addition, large losses also increase the risk—probably because the SEC is more likely to investigate those matters than other situations where there are no losses. One can speculate that in the situations where the company has failed or nearly failed and the inside counsel does not have the resources for vigorous representation and defense, the likelihood of consented-to enforcement action also increases. Finally, the SEC seems to attach significance to whether an inside lawyer raised troublesome issues with the Board; those who chose not to do so are judged more harshly.

SEC CRIMINAL PROSECUTIONS: SOME DERIVED PRINCIPLES

The criminal prosecutions are described in more detail in the study. With only about a dozen prosecutions to draw on, it is difficult to discern distinct patterns in the criminal prosecution of inside counsel in securities fraud and related cases. Some themes, however, emerge.

RULE 1: *Chief legal officers are criminal targets, too.* The focus of criminal prosecutions seems to be almost entirely on the chief legal officers. No subordinate in-house counsel have been charged with federal criminal violations.

RULE 2: *Big losses increase risk of prosecution.* No surprises here. Large losses sharply increase the likelihood of criminal prosecution, with several of the prosecutions resulting from the largest restatements and corporate failures in America.

RULE 3: *Having outside counsel can make a big difference.* Again, there is an almost total absence of outside counsel involvement in the conduct that led to criminal indictments. This is predictable, as an inside lawyer could effectively deflect criminal criticism by showing reliance on a law firm—whose incentive to engage in or approve criminal conduct by a client is doubtful.

RULE 4: *Perjury and obstruction often become the crimes charged.* A recurring theme in the prosecution of lawyers is allegations of cover-ups—obstruction of justice and perjury.

Obstruction came from directing employees to lie or mislead investigators.

RULE 5: *Mere knowledge of conduct later deemed criminal is typically not enough.* Perhaps the most important observation is the following: Mere knowledge of the conduct and decisions that are later deemed to be financial fraud does *not* appear sufficient to charge in-house counsel with criminal conduct. One can reach this conclusion by examining many corporate failures and massive restatements that have occurred over the past four years and comparing that number to the small number of criminal indictments of inside counsel. Direct and active involvement of in-house counsel in the questionable conduct, with knowledge that the conduct is fraudulent, is necessary to bring federal charges.

RULE 6: *Counsel are seldom charged where the alleged fraud is complex and its propriety debatable.* A criminal prosecution of an inside lawyer has *never* resulted where the alleged fraud is complex and its propriety is debatable. The indicted cases have all alleged (at least some were not proven) out-and-out frauds involving sham companies, hidden financial interests, and phony documents, where the lawyer not only knew and understood that the conduct was fraudulent but was an essential participant in it.

RULE 7: *The prosecutors' true goal: Undermine the executive's advice-of-counsel defense.* Indeed, even in those cases where the in-house counsel is charged with broad misconduct, there are pleas to much lesser offenses with much lighter sentences. The most likely explanation for this is that in-house counsel are most often targeted in order to secure their cooperation against the real target—the CEO or very senior management. The presence of the in-house lawyer is a factor that many executives who are targets of investigations rely upon to argue that their conduct was presumptively not illegal. After all, the in-house lawyer knew everything but failed to object! One effective way to strip a potential defendant of this quasi-advice-of-counsel-defense is to pursue the lawyer and give him the option of cooperating against the targeted executive—or becoming a defendant himself.

From this point on . . .
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ACC's website has a new feature, The Compliance and Ethics Exchange, at *www.acca.com/practice/compliance/*. This page brings together the elements of an ethics and compliance program in one easily searched source. The Exchange currently offers three subject areas: Privacy, Workplace, and Law Department Internal Controls. If you investigate the third subject heading, Law Department Internal Controls, you'll find links to materials that include the following:

- "In-house Counsel Standards Under Sarbanes-Oxley," an ACC InfoPAK℠ (2004). This material can help attorneys navigate the new attorney standards mandated by the Sarbanes-Oxley Act of 2002 and the specific rules issued by the Securities and Exchange Commission (SEC Rules) on January 23, 2003. *www.acca.com/infopaks/sarbanes.html.*
- Richard F. Ober Jr. and J. Michael Parish, "Maybe You Need a Lawyer: Does the Sarbanes-Oxley Act Make the SEC Your Client?" *ACCA Docket* 21, no. 4 (April 2003): 70–85. *www.acca.com/protected/pubs/docket/am03/client1.php.*
- Sarbox 307 Up-The-Ladder Reporting and Attorney Professional Conduct Programs (2003), an ACC Leading Practice Profile. This practice profile explores what eight companies and five law firms are doing to address attorney professional conduct and Sarbox 307 up-the-ladder reporting requirements. *www.acca.com/protected/article/corpresp/lead_sarbox.pdf.*
- John K. Villa, "Supervisory Attorney Liability under § 307 of Sarbanes-Oxley: Another Sand Trap for the Unwary," *ACCA Docket* 21, no. 5 (May 2003): 112–116. *www.acca.com/protected/pubs/docket/mj03/ethics1.php.*

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NOTES

1. *See, e.g.*, "Stock Markets: SEC Investigating AMEX Execs With Respect To Options Trading Probe," 36 Sec. Reg. L. Rep. (BNA) 2056 (Nov. 22, 2004) (noting that the SEC had sent Wells notices to three executives of the American Stock Exchange, including its general counsel, warning that civil enforcement proceedings could be brought against them).
2. Pursuant to 17 CFR § 205.3(b), an attorney's duty to report evidence of a material violation is triggered when the attorney "becomes aware" of such evidence, which is defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." *Id.* at § 205.2(e).
3. *See* 68 Fed. Reg. 6296, 6302 (Feb. 6, 2003) (discussing the definition of "evidence of a material violation," and noting that one of the circumstances that may inform counsel as to whether he or she is obligated to report certain information up the ladder is "the availability of other lawyers with whom the lawyer may consult").