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INSIDE COUNSEL AS TARGET?

SEC AND CRIMINAL ACTIONS

AGAINST INSIDE COUNSEL

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It is essential to recognize that in most instances, the following matters are only allegations and the facts have not been established. They are included solely to illustrate the types of claims and charges asserted against inside lawyers.

SEC ENFORCEMENT ACTIONS/ADMINISTRATIVE PROCEEDINGS VS. IN-HOUSE COUNSEL

Since the beginning of 2008, a number of in-house counsel have been targets of SEC civil enforcement actions, related administrative proceedings, or administrative cease and desist proceedings in connection with fraudulent schemes.[1] In addition, the SEC has pursued one general counsel for appearing and practicing before the SEC as an attorney without being duly licensed by a state bar, has brought enforcement actions against officers of a company who are attorneys, one of whom was responsible for overseeing the legal affairs of the company, and has brought administrative proceedings against a general counsel for failing to supervise a broker.

In some of the civil enforcement actions, in-house counsel have been charged with either directing, or knowingly participating in, a variety of fraudulent conduct, such as stock options backdating, unregistered securities offerings, and investment fraud schemes. In other actions, in-house counsel have been cited for facilitating self-dealing conduct on the part of other executives by preparing misleading public statements or filings or by failing to maintain appropriate internal accounting controls and procedures. In one administrative proceeding, the SEC alleged that the general counsel acted contrary to legal advice that she had sought and received from outside counsel.

The following is a summary of these actions and proceedings.

2008

1. *SEC v. Thompson Consulting, Inc., and David C. Condie, et al., Case: 2:08-cv-00171 (D. Utah, filed March 4, 2008)*

This is an action against an investment advisor firm, its officers, including its in-house counsel, and its investment advisers for conduct resulting in the collapse of two of its funds. The complaint alleges that the in-house counsel, who was not a licensed investment adviser, together with the other defendants, misrepresented to investors the trading strategy for these funds in order to induce the investors to invest in them, and misappropriated investor funds by transferring large sums of money after the funds' collapse. The complaint further alleges that in-house counsel, along with other defendants, directly participated in the solicitation of investors by telling them in seminars, through correspondence and other written materials, and in direct conversations that the firm would safely invest their funds using a low-risk investment strategy when, in fact, they used a highly risky trading strategy and made high-risk investments. The

[1] This survey does not include actions against in-house counsel for insider-trading schemes.

SEC charged the defendants with violating Sections 17(a)(1), (a)(2), and (a)(3) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5, and with aiding and abetting the firm's fraud in connection with the provision of investment advice.

Without admitting or denying the allegations, the defendants, including the in-house counsel, consented to the entry of judgment enjoining them from future violations of these provisions of the securities laws. *See SEC v. Thompson Consulting, Inc., Kyle J. Thompson, E. Sherman Warner, and David C. Condie,* Case: 2:08-cv-00171 (D. Utah), Litig. Rel. No. 21628 (Aug. 18, 2010). In a related administrative proceeding, the SEC barred the in-house counsel from association with any investment adviser. *See In the Matter of David C. Condie,* Inv

2. *SEC v. CMKM Diamonds, Inc., et al., Case No. 2:08-cv-00437 (D. Nev., filed April 7, 2008)*

This civil enforcement action was brought by the SEC against multiple parties, including the general counsel of a broker-dealer, arising out of a scheme to issue and sell unregistered stock of a company purportedly engaged in the diamond and mining business. In addition to serving as general counsel, the defendant served as executive vice-president and chief compliance officer and was also a registered representative.

According to the complaint, the scheme's mastermind traded the unregistered stock through accounts with the defendant's firm. The complaint alleged that, despite having concerns with his trading activities and with his association with the defendant company, an issuer considered to be questionable because reliable information about it was not publicly available, neither the general counsel nor the CEO or other registered representatives of the brokerage firm ever (1) questioned the trader as to his involvement with the issuer; (2) contacted the issuer to ask about the trader; (3) asked the trader for more information about the source of his stock in the issuer; (4) inquired into the unrestricted status of the shares; (5) obtained any information about the trader's unidentified clients; and (6) had contact with any person other than the trader in connection with his accounts. The complaint further alleged that, notwithstanding its receipt of inquiries from another regulator, the SEC's request for records related to the trader, and the SEC's suspension of trade in the issuer's stock and the initiation of deregistration proceedings, the brokerage firm continued to allow the trader to sell the issuer's stock.

Without admitting or denying the allegations, the general counsel consented to the entry of a judgment enjoining him from future violations of Section 5 of the Securities Act based on his participation in the sale of unregistered securities, barring him from participating in any offering of penny stock, and ordering him to pay approximately $4,746, plus prejudgment interest, in disgorgement of profits resulting from his conduct, and an additional $45,000 in civil penalties. *See SEC v. CMKM Diamonds, Inc., et al.,* Case No. 2:08-cv-00437, Final Judgment of Permanent Injunction and Other Relief against Defendant Anthony Santos (D. Nev., filed Feb. 9, 2010). In a related administrative proceeding, the general counsel was barred from associating with a broker-dealer. *See In the Matter of Anthony Santos,* Sec. & Exch. Act Rel. No. 61585; Admin. Proc. File No. 3-13791 (Feb. 25, 2010).

3. *SEC v. David Dull, et al., Civ. Action No. SACV08-539 (RNBx) (C.D. Cal., filed May 14, 2008)*

In this civil enforcement action, the SEC alleged that the defendants engaged in an improper stock option backdating scheme that resulted in the issuance of false financial statements that concealed billions of dollars in stock-based compensation packages. The complaint alleged that the scheme was orchestrated and carried out by senior officers of the company, including the general counsel, with the CEO being the final decisionmaker and the driving force behind the scheme. According to the SEC, the general counsel knew about, and participated in, the scheme by instructing subordinates to prepare false board and compensation committee documents which he reviewed and approved.

Following the acquittal of one of the officers in a criminal proceeding arising out of the alleged backdating scheme, and the court's dismissal, without prejudice, of the SEC's civil enforcement action, the SEC decided not to proceed further with the action. According to the SEC, its decision was based on the court's comments that the evidence adduced at the criminal proceeding, together with its ruling precluding certain testimony, would result in insufficient evidence to withstand summary judgment motions from the defendants. *See SEC v. Henry T. Nicholas III, Henry Samueli, William J. Ruehle, and David Dull,* Civ. Action No. SACV08-539 (RNBx) (C.D. Cal.), Litig. Rel. No. 21409 (Feb. 4, 2010).

4. *SEC v. Microtune, Inc., Nancy Richardson, et al., Case No. 3:08cv1105-B (N.D. Tex., filed June 30, 2008)*

This civil enforcement action alleges that the former general counsel, who also served as the chief financial officer, together with the former chairman and CEO of the company, perpetrated a fraudulent and deceptive stock option backdating scheme that awarded themselves and other employees with undisclosed compensation, and resulted in the company's filing of materially false and misleading financial statements with the SEC. According to the complaint, the CFO/GC substantially assisted the CEO in routinely backdating the dates on which the stock options were granted so that the records gave the false appearance that "at-the-money" options were granted when, in fact, "in-the-money" options were granted. The filings, therefore, greatly understated expenses and overstated net income. The complaint alleges that the CFO/GC drafted written consents that were backdated to give the false appearance that the prior date was the date on which the compensation committee approved the grants. The complaint further alleges that the CFO/GC was aware that the options would be substantially in-the-money on the prior date: according to the allegations, the CFO/GC questioned the CEO about the grant to one employee whose employment contract did not begin until after the purported date of the grant; the CFO/GC misrepresented to outside auditors that a particular grant was a mistake, not a valid grant, when she knew that the reason for its cancellation was to get a better price; and, the CFO/GC provided false information to outside auditors on a checklist document submitted to them in connection with their year-end audit. As part of her responsibilities, the CFO/GC reviewed and signed the

SEC filings, had substantial involvement in the drafting of public filings, and was involved in many complex stock option issues.

According to the SEC, the filing of the complaint "reaffirms our commitment to pursue those who perpetrate financial fraud and the corporate gatekeepers who allow it to happen on their watch." *See* SEC Press Release, No. 2008-128 (July 1, 2008). The complaint charges the CFO/GC and the CEO with violating and aiding and abetting the company's violations of Section 10(b) and Rule 10b-5; Sections 17(a)(1), (a)(2), and (a)(3); Section 13(b)(5) and Rules 13b2-1, 13b2-2, 13a-14; and Section 14(a) and Rules 14a-3 and 14a-9, and aiding and abetting the company's violation of Section 13(a) and Rules 12b-20, 13a-1, and 13a-13, as well as Section 13(b)(2)(A) and (B). The SEC seeks injunctive relief, disgorgement of ill-gotten profits, civil money penalties, officer and director bars, and reimbursement of profits from the stock sales.

5. *SEC v. Sycamore Networks, Inc., et al., Civil Action No. 08-CA-111666 (DPW) (D. Mass. Filed July 9, 2008)*

This civil enforcement action involving a stock options backdating scheme was brought against a company and three of its officers, two of whom were attorneys: one, the CFO/Vice-President of Finance and Administration, Secretary, and Treasurer of the company, who oversaw the accounting, legal, human resources and other functions of the company; and the other, who served as the Senior Director of Employment Affairs.

In its complaint against the CFO/VP having responsibility for accounting as well as legal functions of the company, the SEC alleged that, together with the Director of Financial Operations, the CFO/VP actively engaged in a recurring practice of granting undisclosed "in the money" options to company employees. As a CPA, the SEC alleges that the CFO/VP was well versed in stock options granting principles, but failed to adhere to these principles not only when authorizing backdated stock options that resulted in "in the money" grants, but also when drafting, preparing, and reviewing the company's public filings and financial statements. As a result of her conduct, the SEC alleged that the CFO/VP violated Section 17(a) of the Securities Act, Sections 10(b), 13(b)(5), 14(a), and 16(a) of the Exchange Act, and related regulations, and aided and abetted the company's violations of Sections 13(a), 13(b)(2)(A), (B) of the Exchange Act, and related regulations. Without admitting or denying the allegations, the CFO/VP consented to the entry of judgment enjoining her from engaging in, or aiding and abetting, future violations of the securities laws, barring her from serving as an officer or director of a public company, and ordering her to disgorge ill-gotten gains and pay a civil money penalty of $230,000. In a related administrative proceeding, the CFO/VP was suspended from appearing or practicing before the SEC as an attorney for a five-year period. *See In the Matter of Frances M. Jewels,* Sec. & Exch. Act Rel. No. 58232; Acct. & Aud. Enf. Rel. No. 2848; Admin. Proc. File No. 3-13102 (July 25, 2008).

With respect to the Senior Director of Employment Affairs, the complaint alleged that she substantially participated in carrying out the stock options backdating plan that had been devised by others, pursuant to which she altered or created, or caused to be altered or created,

personnel and payroll-related documents for the purpose of creating the impression that the employees to whom the stock options were granted had been employed at the company on the dates issued. The complaint also alleged that she knew, or was reckless in not knowing, that her actions would prevent the company's auditors from detecting the true start dates of the employees and the in-the-money nature of the option grants. The defendant consented to final judgment, permanently enjoining her from future violations of Section 13(b)(5) and Rules 13b2-1 and 13b2-2 and from aiding and abetting violations of Sections 13(b)(2)(A) and (2)(B) of the Exchange Act, and ordering her to pay a $40,000 civil money penalty. In a separate administrative proceeding pursuant to Rule 102(e), she was suspended from appearing and practicing before the Commission as an attorney for a two-year period. *See In the Matter of Robin A. Friedman*, Sec. & Exch. Act Rel. No. 58233; Admin. Proc. File No. 3-13103 (July 25, 2008).

6. *SEC v. HCC Insurance Holdings, Inc., and Christopher Martin, et al., Civ. Action No. 4:08-cv-02270 (S.D. Tex., filed July 21, 2008)*

This civil enforcement action involved a stock option backdating scheme conducted by officers of a commercial insurance provider, including the CEO and the general counsel. The SEC's complaint alleged that the general counsel facilitated the scheme by preparing documents indicating that the company's option grants had been made on earlier dates when the company's stock price had closed lower, but, in fact, the grants had not been made on those dates. These documents included written actions of the Compensation Committee, stock option agreements, and forms reporting the grants to the SEC. The SEC alleged that the general counsel acted at the direction of the CEO, had reason to know of the inaccurate grant dates on these documents, and was also a recipient of backdated options which he exercised. The SEC further alleged that, as the general counsel, the defendant reviewed and signed proxy statements, registration statements, and periodic reports filed with the SEC and disseminated to investors. As a consequence of his actions, the SEC alleged that the general counsel, directly and indirectly, violated Sections 17(a)(2) and (a)(3) of the Securities Act, 13(b)(5) and 16(a) of the Exchange Act, and Rules 13b2-1, 13b2-2, and 16a-3. In addition, the GC aided and abetted the company's violations of Sections 13(a) and 14(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, 13a-13, 14a-3, and 14a-9.

The general counsel consented to entry of an order permanently enjoining him from future violations of the Securities and Exchange Acts, as well as from aiding and abetting violations of these Acts, and ordering him to pay a $50,000 civil money penalty. In a related administrative proceeding pursuant to Rule 102(e), the general counsel was suspended from appearing and practicing before the SEC as an attorney for a two-year period. *See In the Matter of Christopher L. Martin,* Sec. & Exch. Act Rel. No. 58356; Admin. Proc. File No. 3-13130 (Aug. 13, 2008).

7. *SEC v. David Lubben, Case 0:08-cv-06454-PJS-FLN (D. Minn., filed Dec. 22, 2008)*

In this civil enforcement action against the general counsel/secretary of UnitedHealth Group, Inc., the SEC alleged that he participated in a stock options backdating scheme in which hindsight was used to pick advantageous dates for stock option grants. According to the SEC, the general counsel created, or directed the creation of, false or misleading company records indicating that the grants had occurred on the earlier dates. The SEC further alleged that the general counsel knew, or was reckless in not knowing, that quarterly and annual reports, proxy statements and registration statements filed with the SEC and disseminated to investors contained or incorporated by reference materially false and misleading information regarding the true grant dates and materially false and misleading financial statements that underreported compensation expenses. The SEC also alleged that the general counsel received and exercised backdated options, thereby personally benefitting from the backdating.

A final judgment was entered against the general counsel on January 23, 2009, permanently enjoining him from future violations of Section 17(a) of the Securities Act and Sections 10(b), 13(b)(5), 14(a) and 16(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, 13a-13 and 16a-3, and ordering the payment of a $575,000 civil penalty, and $1,403,310 in disgorgement plus $347,211 in prejudgment interest. In a separate administrative proceeding pursuant to Rule 102(e), the general counsel was suspended from appearing and practicing before the SEC for a period of three years. *See In the Matter of David J. Lubben,* Sec. Exch. Act Rel. No. 59423; Accounting & Audit Enf. Rel. No. 2939; Admin. Proc. File No. 3-13374 (Feb. 19, 2009).

2009

8. *In the Matter of Arthur P. Hipwell, Sec. & Exch. Act Rel. No. 59303; Admin. Proc. File No. 3-13353 (Jan. 31, 2009)*

This administrative proceeding was brought pursuant to Rule 102(e) of the Commission's Rules of Practice against the respondent, who held himself out as the senior vice-president and general counsel of Humana, Inc., a public company. According to the SEC, the Kentucky Bar Association had suspended the respondent from the practice of law in 1985 for non-payment of dues; however, between 1999 and 2007, the respondent represented that he was the general counsel at Humana and engaged in conduct that constituted appearing and practicing before the SEC as an attorney, even though he was not licensed as an attorney. Such conduct included signing SEC filings using the title "senior vice-president and general counsel," and advising the company on the documents required to be filed with the SEC. Because the respondent lacked the requisite qualifications for appearing and practicing before the SEC as an attorney, he was suspended from, and denied the privilege of, appearing and practicing before the SEC for a period of one year, with the right to apply for reinstatement after the one-year suspension.

9. *SEC v. Daniel W. Nodurft, Civil Action No. 8:09-CV-866-T26/TGW (M.D. Fla., filed May 8, 2009)*

This civil enforcement action was brought against the general counsel of Aerokinetic Energy Corporation, a developer and marketer of alternative power technologies and products, for his role in a fraud involving an unregistered securities offering. At the time of the complaint, the general counsel also served as the company's secretary and had previously served as a vice-president. He also maintained a private law practice.

According to the complaint, through material misrepresentations and omissions regarding its technology, products and financial prospects, the company raised approximately $535,000 from 24 investors, and was seeking to raise an additional $575,000, when the SEC filed an emergency action against the company in July of 2008. The alleged misrepresentations and omissions related to new energy technologies that the company claimed to have developed and with respect to which it held patents. The company also claimed to have standing purchase orders for the finished product from these technologies, and projected that it would have millions of dollars in sales revenue from these technologies within the first years of operation. According to the SEC, these claims were false. The SEC alleged that the general counsel was aware of these material misrepresentations and omissions, and was a key player in its fraudulent offering. The SEC alleges that as the only officer at the company, other than its president, the defendant was highly involved with investor relations: he was the contact person for investors and actively promoted the new technologies, even enticing at least two investors with false representations; he drafted, reviewed, and/or approved all investor solicitation materials; and, he handled all correspondence with potential and actual investors and all matters involving company agreements. According to the SEC, the general counsel was in constant communication with the president regarding all aspects of the company's business.

Because of his conduct, the SEC alleges that the general counsel violated Sections 5(a), 5(c), and 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5. On October 14, 2011, the federal district court for the Middle District of Florida entered by consent a judgment against the general counsel, permanently enjoining him from future violations of Section 5 and Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 and ordering him to pay a civil money penalty in the amount of $50,000. *See* SEC Litig. Rel. No. 22127A (Oct. 17, 2011). In a related, settled administrative proceeding, the SEC suspended the general counsel from appearing and practicing before the Commission as an attorney. *See In the Matter of Daniel W. Nodurft, Esq.*, SEC Rel. No. 34-65673; Admin. Proc. File No. 3-14612 (Nov. 2, 2011).

10. In the Matter of Melissa M. Hurley, Inves. Advisers Act of 1940 Rel. No. 2885; Inves. Co. Act of 1940 Rel. No. 28750; Admin. Proc. File No. 3-13493 (May 28, 2009)

This is a settled administrative cease and desist proceeding brought against the former general counsel/vice-president of a mutual fund administrator arising out of the execution of undisclosed side agreements between the fund administrator and fund advisers. As related by the SEC, the fund administrator provided administration services to mutual fund families. The nature and scope of the services were set forth in contracts entered into between the fund administrator and the funds. In separate side agreements with the fund advisers, the fund administrator and the advisers set forth how the administration fee would be split between the administrator and the adviser. Specifically, the side agreements set forth the fund administrator's

agreement to set aside a portion of its fee to be used at the advisers' discretion, in exchange for the advisers' agreement to recommend the administrator to the funds' board. The side agreements were not disclosed to the mutual funds' boards or shareholders.

The SEC alleges that the general counsel sought legal advice from outside counsel regarding marketing arrangements and fees shortly after assuming her position with the fund administrator. In a memorandum received by the respondent from outside counsel, counsel analyzed the three types of marketing arrangements, including one in which the administrator agreed to pay a fixed fee for marketing the funds, and advised the respondent as to the duty of the administrator to disclose the arrangement to the fund's directors in order to be compliant with the law. Notwithstanding this advice, the SEC alleges that the respondent failed to disclose the marketing arrangements as set forth in side agreements executed in 1999 and 2000, even though she received, reviewed, and commented on the drafts of these side agreements. The SEC further alleges that, even though the respondent drafted, reviewed, and commented upon disclosure statements in subsequent years, the disclosures were misleading since they failed to describe the exchange of part of the administration fee for a recommendation of the administrator to the fund boards, or to explain that the administrator's expenditures had been negotiated and agreed upon by the parties. In 2003, the SEC alleges, the general counsel received a performance bonus that was based in part on her division's increase in earnings from administration services.

Because of her conduct with respect to the side agreements, the SEC found that the general counsel willfully aided and abetted the administrator's violations of Sections 206(1) and (2) of the Adviser's Act prohibiting fraudulent conduct by an investment adviser, and ordered her to cease and desist from causing any future violations. In addition, the SEC ordered the general counsel to pay disgorgement of $15,000, plus prejudgment interest, and a civil money penalty of $15,000.

11. *SEC v. Kenneth Selterman, et al., Civil Action No. 09 CIV 6813 (S.D.N.Y., filed July 31, 2009)*

This civil enforcement action was brought against the former general counsel of Take-Two Interactive Software, Inc., a video game publisher and producer, for his role in a fraudulent stock option backdating scheme and his receipt of fraudulently backdated stock options. The complaint alleged that the general counsel knowingly or recklessly allowed the CEO/Chairman to backdate stock option grants in a scheme that involved granting backdated, undisclosed "in-the-money" stock options that coincided with dates of historically low annual and quarterly closing prices for the company's common stock. According to the complaint, the general counsel was responsible, in part, for ensuring that the options granting process complied with the company's stock option plans, including one which he helped to create and draft. In addition, the complaint alleged that the general counsel was responsible for insuring that actions taken by the Board or the Compensation Committee regarding stock options were properly documented in the company's books and records.

The complaint alleged that the general counsel knew, or was reckless in not knowing, that stock options were being backdated. In support of this allegation, the SEC cited two emails

received by the general counsel. In one email, received in late October of 2000, the CAO asked the date when options had been discussed for a new director and noted that the lowest price was in early August; in response, the general counsel stated "sometime in October." That option, the SEC alleged, was backdated. In the other email, received in late August of 2000, the CEO offered the general counsel 50,000 options at the closing price of July 30, 2000; according to the SEC, the general counsel forwarded the email to the CAO in late September and, in an email sent to the CEO and copied to the general counsel two days later, the CAO asked for clarification as to whether the CEO intended to price the options as of July 31 or August 1. In further support of this allegation, the SEC cites a particular grant to the CEO with respect to which, at the direction of the CEO in April of 2002, the general counsel drafted minutes of a purported February meeting of the Compensation Committee approving the grant. At other times, the SEC continued, the general counsel, without making any inquiry, simply recorded in the minutes what the CEO told him about the granting and approval of options.

The complaint further alleged that the general counsel knew the accounting consequences of granting stock options at below fair market value. In support of this allegation, the SEC cited an email from the general counsel to senior management explaining that options must be granted at an exercise price equal to 100% of the fair market value of the stock on the date of the grant, since any below market issuance would result in a charge to earnings on the date of the grant.

Because the general counsel reviewed and, in some cases, assisted in drafting, the company's annual reports, financial statements, and filings with the SEC, the SEC alleged that he knew, or was reckless in not knowing, that these documents were materially false and misleading and thereby aided and abetted the company's violations of the securities laws.

A final judgment was entered against the general counsel on August 6, 2009, pursuant to which he was enjoined from future violations of Sections 10(b), 13(b)(5), and 16(a) of the Exchange Act and Rules 10b-5, 13b2-1, 13b2-2, and 16a-3, and from aiding and abetting future violations of the recordkeeping and reporting provisions of the Exchange Act and its corresponding rules (Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 14(a); Rules 12b-20, 13a-1, 13a-11, 13a-13, and 14a-0). In addition, the court imposed an officer and director bar against the general counsel and ordered him to pay $363,185 in disgorgement of ill-gotten gains from his exercise of backdated stock options, $111,115 in prejudgment interest, and a $125,000 civil money penalty. In a related administrative proceeding pursuant to Rule 102(e), the general counsel agreed to the sanction of suspension from appearing or practicing before the SEC as an attorney. *See In the Matter of Kenneth Selterman, Esq.*, Sec. Exch. Act Rel. No. 60600; Acct. & Aud. Enf. Rel. No. 3042; Admin. Proc. File No. 3-13606 (Sept. 1, 2009).

12. *SEC v. Golden Apple Oil and Gas Inc., et al., Civil Action No. 09-Civ-7580 (HB) (S.D.N.Y., filed Aug. 31, 2009)*

In this civil enforcement action, the SEC alleged the existence of a fraudulent "pump and dump" scheme involving the shares of a profitless company. On its website, the company listed the defendant attorney as its "SEC counsel." According to the complaint, the defendant "laid the initial groundwork for the scheme by orchestrating an illegal offering of 5,000,000 shares of

Company stock," which gave him control of 100% of the company's tradable stock. The defendant then distributed the stock illegally to persons who traded the stock publicly. The complaint further alleged that the defendant subsequently created the false impression that a legitimate market for the stock existed "by causing the market activity in the stock to commence with an artificial stock price quotation and matched trading order." The complaint also alleged that the defendant engaged in other illegal unregistered stock offerings. Because of this conduct, the SEC alleged that the defendant violated Sections 5(a), (c) and 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.

A final judgment was entered by consent against the defendant on November 3, 2010, pursuant to which the defendant was permanently enjoined from future violations of these provisions of the securities laws; was ordered to pay $52,488.32 in disgorgement of ill-gotten gains from sales of stock, $14,880.08 in prejudgment interest, and a civil money penalty of $25,000; and was barred for five years from participating in any penny stock offering or from engaging in activities with brokers or dealers in connection with the purchase or sale of penny stock. In a related administrative proceeding, the defendant was suspended from appearing and practicing before the SEC as an attorney for five years. *See In the Matter of John Briner,* Sec. Exch. Act Rel. No. 63371; Admin. Proc. File No. 3-14138 (Nov. 24, 2010).

13. *In the Matter of Theodore W. Urban, Securities Exchange Act of 1934 Rel. No. 60837; Investment Advisers Act Rel. No. 2938; Admin. Proc. File No. 3-13658 (Oct. 19, 2009)*

The SEC initiated administrative proceedings against the former general counsel and executive vice-president of an investment firm, alleging that he failed to provide reasonable supervision to one of the firm's registered representatives with a view to detecting and preventing the broker's violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. *See In the Matter of Theodore W. Urban,* Order Instituting Administrative Proceedings (OIP), Securities Exchange Act of 1934 Rel. No. 60837; Investment Advisers Act Rel. No. 2938; Admin. Proc. File No. 3-13658 (Oct. 19, 2009). After a hearing on the matter, the ALJ ruled in favor of the general counsel. *See In the Matter of Theodore W. Urban,* Initial Decision Release No. 402; Admin. Proc. File No. 3-13655 (Sept. 8, 2010). Subsequently, the Commission granted the Division of Enforcement's petition for review, as well as the general counsel's cross-petition for review, and denied the general counsel's motion for summary affirmance of the Initial Decision. Oral arguments were scheduled for December 6, 2011.

SEC Allegations

According to the SEC, the broker, together with two other brokers, participated in a scheme to manipulate the stock of a company, using funds from a $50 million offering fraud and Ponzi scheme that the broker orchestrated through a fund for which he served as the registered representative for the firm's accounts. OIP at ¶ 9. The SEC alleged that the general counsel approved the hiring of the broker by the head of Retail Sales and his assistant, even though each of them knew that the broker had ten customer complaints on his Form U-4. OIP at ¶¶ 10-11. Despite these complaints, the SEC alleged that the general counsel, the head of Retail Sales, and

his assistant permitted the broker to work under a special arrangement that allowed him greater freedom of action than other brokers at the firm. OIP at ¶ 12.

The SEC alleges that problems with the broker's conduct arose soon after he began working with the firm in early 2003: a compliance officer raised concerns about certain trades in accounts for which the broker was the registered representative, and these concerns were ultimat ely brought to the attention of the general counsel by the Compliance Director; subsequently, the compliance officer sent a memorandum to the firm's senior executives, including the general counsel, in which she detailed her concerns, warned that there might be manipulative trading with respect to a particular company's stock, and cautioned that the broker was not being properly supervised. OIP at ¶¶14-15. In response to the memo, the Compliance Director and the general counsel held a conference call with the head of Retail Sales and his assistant to discuss the issues addressed in the memo; the SEC alleges, however, that these officers failed to take any action and the general counsel failed to follow-up with them to determine whether they were taking steps to address the issues involving the broker. OIP at ¶ 16. A few weeks later, the compliance officer sent another memo to the general counsel, reiterating her concerns about the broker's supervision and recommending that the broker be placed under special supervision; however, the SEC alleges, the general counsel ignored this recommendation, despite the firm's written supervisory procedures that called for special supervision when the conduct of a registered representative raised concerns about business practices or adherence to rules. OIP at ¶ 17.

As further alleged by the SEC, the general counsel met with the broker and imposed temporary restrictions on certain trades, but failed to address his lack of supervision. When the restrictions were lifted, the broker and his cohorts continued their questionable conduct. After being informed that trades with respect to certain accounts controlled by the broker were being manipulated, the SEC allegs that thegeneral counsel met with the Compliance Director and officer to discuss a plan of action as to these accounts and the broker's lack of supervision, but failed to address the red flags concerning these accounts. OIP at ¶¶20-21. When subsequently alerted by the Operations Director of other questionable trades involving the broker's customer accounts, the SEC alleges that the general counsel also failed to reasonably address these red flags. ¶ 22. Even though the general counsel discussed supervision issues with the head of Retail Sales, as well as unusual trading activity in the broker's customer accounts, the SEC alleges that the general counsel failed to take any follow-up action. OIP at ¶¶23-24.

Upon being alerted that the margin debit on a particular fund account had grown to over$16 million and that several securities in the account were illiquid and highly concentrated, the SEC alleges that the general counsel placed further restrictions on the broker's trading activities, and, at the same time, sent a memo to the Credit Committee concerning the lack of clarity as to supervisory responsibility for the broker. OIP at ¶ 25. Despite these restrictions, the SEC alleges that the broker continued to engage in manipulative trading with other customer accounts. OIP at ¶ 27. The broker was subsequently transferred to another office; however, his questionable conduct was not disclosed to his new branch manager. OIP at ¶ 28.

In the spring and summer of 2004, turnover in the Compliance Department led the general counsel to hire a new Compliance Director and some new Compliance officers.

According to the SEC, the general counsel did not brief these new employees as to any of the issues involving the broker. OIP at ¶ 29. In a subsequent review of the broker's accounts during the course of an audit of his branch office, the new Compliance officers became concerned that the broker was engaging in unsuitable and manipulative trading practices and were told by the branch manager that he was unable to supervise the broker and recommended his termination. The Compliance officers detailed their findings in a memo to the general counsel; however, the SEC alleges, the general counsel failed to reasonably respond to the memo's red flags at that time. OIP at ¶ 30. A few months later, after being informed that the broker had engaged in questionable trades of which his customers were unaware, the general counsel sent a memo to the head of Retail Sales and his assis tant detailing the broker's activities and recommending his termination. OIP at ¶¶32-34. Following a meeting with the head of Retail Sales and his assistant, the general counsel retracted his termination recommendation and agreed to place the broker on special supervision with the head of Retail Sales as his supervisor. OIP at ¶¶35, 37.

While under special supervision, the broker continued to engage in questionable trading activity. The SEC alleges that the firm's anti-money laundering officer sent several emails to the general counsel in early 2005 about whether a particular trade was suspicious so as to require the filing of a suspicious activity report; after not responding to these emails, the general counsel, when confronted by the officer, finally stated that no such report would be filed. OIP at ¶ 39. The SEC further alleges that the general counsel failed to respond reasonably to red flags suggesting manipulative trading submitted in subsequent emails and audit reports, but finally agreed with respect to another trade in June of 2005 that the transaction raised manipulation concerns. OIP at ¶¶40-42. According to the SEC, the general counsel stated that he would provide directions to the trading desk; however, the broker remained an employee of the firm until November of that year. OIP at ¶ 43.

Initial Decision

In the administrative hearing held in March of 2010, the SEC argued that the general counsel had supervisory responsibility over the broker but failed reasonably to supervise him with a view to preventing his violations of the antifraud provisions of the federal securities laws. *See In the Matter of Theodore W. Urban,* Initial Decision Release No. 402; Admin. Proc. File No. 3-13655 (Sept. 8, 2010). Relying on prior Commission rulings, the SEC urged that, even though the general counsel was not a direct supervisor of the broker, he was still a supervisor because he had the requisite degree of responsibility, ability, and authority to affect the broker's conduct when informed of the misconduct by senior management seeking advice on how to respond to the problem. Initial Decision Release No. 402, at 46. The SEC contended that the general counsel failed to provide reasonable supervision by failing to respond reasonably to a number of red flags indicating the illegality of the broker's conduct. As summarized by the ALJ, it was the SEC's position that once the general counsel became involved in addressing the red flags – such as when he was apprised of the Compliance department's initial concerns, was told of the results of a review of the broker's trades during the course of an audit of his branch office, or placed the broker on special supervision status – he was obligated to respond vigorously but failed to do so; instead, he acted recklessly in ignoring the red flags. *Id.* at 47. The SEC further argued that the general counsel was required to report his concerns about the broker to the firm's

board or executive committee and, if either failed to take action, to resign and report the misconduct to regulatory authorities. *Id.*

In his defense, the general counsel argued that the broker was not subject to his supervision and that he acted reasonably under the circumstances, such as by encouraging the Compliance department to inquire into the fund, recommending that the Credit Committee restrict credit to the fund, urging increased vigilance of the broker by Retail Sales, instructing the Compliance department to conduct additional diligence on the broker, advocating strongly for the broker's termination and, upon the refusal of senior business managers to terminate the broker, for strict terms of special supervision. *Id.* The general counsel further argued that a claim of failure to supervise was unfounded where his reasonable actions were frustrated by consistent lying on the part of the broker, the failure of the firm's executives from fulfilling their responsibilities, and the refusal of the head of Retail Sales and his assistant to accept the general counsel's advice to terminate the broker. *Id.* at 48.

After reviewing the evidence, the ALJ first concluded that the general counsel was a supervisor of the broker, "[e]ven though [he] did not have any of the traditional powers associated with persons supervising brokers[.]" The ALJ explained: "As General Counsel, [his] opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in FBW's business units, but not by Retail Sales. [He] did not direct FBW's response to dealing with [the broker], however, he was a member of the Credit Committee, and dealt with [the broker] on behalf of the committee." *Id.* at 52.

On the issue of the reasonableness of his supervision, the ALJ concluded that the general counsel did not fail to provide reasonable supervision under the circumstances. Distinguishing the facts from those in the leading authority on which the SEC relied,[2] wherein the Commission found that the CLO acted unreasonably because he did not direct an inquiry into the criminal conduct, did not recommend appropriate procedures to prevent and detect future misconduct, did not place additional restrictions on the trader, and did not inform the Compliance Department of the misconduct, the ALJ found that the broker's conduct was not known to be criminal when he worked at the firm, the general counsel had received assurances that the broker was being supervised, the Credit Committee had placed trading restrictions on the broker, and the general counsel shared all of his information with Compliance. *Id.* at 52-53. The ALJ further found that, even if the general counsel's reliance on representations made by the head of Retail Sales was considered unreasonable, there were no reasonable, alternative actions available to him. As explained by the ALJ, the general counsel could not go to the firm's CEO since "[t]he evidence is overwhelming that [the CEO] deferred to [the head of Retail Sales] on matters involving retail Sales[,] knew that there were supervisory concerns about [the broker], and . . . did absolutely nothing to support Compliance or [the general counsel's] efforts to assure that [the broker] was supervised, despite being the CEO with ultimate responsibility for supervision." *Id.* at 55. Similarly, the ALJ continued, the general counsel could not go the board or the executive committee "because the unanimous evidence is that he would not have succeeded[,]" due to the CEO's deferral to the head of Retail Sales and the fact that, excluding the head of Retail Sales, four of the twelve remaining board members worked for the head of Retail Sales. *Id.*

[2] John H. Gutfreund, 51 S.E.C. 93 (1992).

Citing Section 15(b)(4)(E)(i) of the Exchange Act, providing that (1) no person will be deemed to have failed reasonably to supervise any other person if there are supervisory procedures being applied which could reasonably be expected to detect and prevent the violations, and (2) the person discharging his or her duties and obligations under the supervisory procedures had no reasonable cause to believe they were not being complied with, the ALJ concluded that the general counsel did not fail to supervise the broker, but instead, "performed his responsibilities in a cautious, objective, thorough, and reasonable manner." *Id.* at 56.

2010

14. *SEC v. American Equity Investment Life Holding Co., and Wendy C. Waugaman, et al., Civil Case No. 4:10-CV-87 (S.D. Iowa, filed March 3, 2010)*

In the civil enforcement action, the SEC alleged that the former chief financial officer, who also served as the general counsel, participated in submitting a misleading disclosure of a related-party transaction in its 2006 proxy statement. According to the SEC, the company, American Equity, acquired for $1, another company that was wholly owned by the founder, chairman, and CEO of American Equity. The acquisition conferred significant benefits on the CEO which were not properly disclosed in the 2006 proxy statement. Because the liabilities of the acquired company exceeded its assets by approximately $19 million, and it was unable to meet its upcoming financial obligations or to survive as an entity in the long-term, and because the CEO had personally guaranteed a significant portion of the acquired company's liabilities and had received a $2.5 million distribution from the company prior to its acquisition, the acquisition conferred a substantial benefit upon the CEO since it resulted in American Equity absorbing all of the liabilities of the acquired company. Although the proxy statement disclosed the acquisition, it omitted material facts about the nature and amount of the CEO's interest in the acquisition.

The complaint alleged that CFO/GC, together with the CEO, had a role in issuing the proxy statement and "directly or indirectly, knowingly, recklessly, or negligently" solicited the proxy statement containing statements which were false and misleading as to material facts; failed to comply with rules governing solicitation of proxies; and violated Section 14(a) of the Exchange Act, and Rules 14a-3 and 14a-9.

Without admitting or denying the allegations, the CFO/GC settled the charges, agreeing to a permanent injunction against future violations, and the payment of a $130,000 penalty.

15. *SEC v. Joe B. Dorman et al., Civil Action No. 3:10-cv-440 (N.D. Tex., filed March 3, 2010)*

This is a civil enforcement action arising out of the CEO's misappropriation of funds which resulted in the company's filing of false and misleading reports to the SEC. The complaint alleged that, on several occasions, the CEO requested reimbursement for fictitious expenditures and purchases on behalf of the company; rather than requiring supporting documentation for these purchases, the complaint alleged that the chief financial officer, who also served as general counsel, and the controller authorized the reimbursements and recorded these expenses as "Prepaid Other and Inventory." The complaint further alleged that the CEO knew that both the CFO/GC and the controller would rely on the CEO's representations as to the purpose of the expenditures and purchases when recording them in the company's books. As CFO, the defendant was responsible for ensuring that the company's books and records were reasonably detailed, accurate, and a fair reflection of the company's transactions and assets. Accordingly, the SEC charged that the CFO/GC knowingly, or with severe recklessness, provided substantial assistance to the company with respect to its failure to keep accurate books and records, and to maintain a system of internal accounting controls.

Without admitting or denying the allegations, the CFO/GC consented to the settlement of the action, agreeing to be enjoined from aiding and abetting future violations of the books and internal controls provisions of Sections 13(b)(2)(A) and (B), and to pay a civil penalty of $15,000. *See SEC v. Rodney E. Wallace, Joe B. Dorman and John A. Blank*, Civil Action No. 3:10-cv-440 (N.D. Tex., filed March 3, 2010), Litig. Rel. No. 21434 (March 4, 2010).

2011

16. *In the Matter of Rick Lawton*, SEC Rel. No. 34-65270; Admin Proc. File No. 3-14531 (Sept. 6, 2011)

In this settled administrative proceeding, the respondent consented to the imposition of sanctions for his role in connection with a fraudulent investment scheme involving the sale of interests in mining claims. The proceeding arose out of an enforcement action filed in 2007, *see* Complaint, *SEC v. Earthly Mineral Solutions, Inc., Natural Minerals Processing Company, Roy D. Higgs, Frank L. Schwartz, and Rick Lawton,* Case No. 2:07-cv-01057 (D. Nev. Filed Aug. 9, 2007), in which the SEC alleged that the respondent, who served as secretary and in-house counsel to two related entities, operated a Ponzi scheme together with other officers of the entities. According to the SEC, the respondent offered investors a guaranteed annual return of 7% to 9% on their investment, telling them that the returns would be paid out of the operating revenue of a purported fertilizer business that used minerals mined by one of the entities from the claims to produce a highly profitable fertilizer. *See* Complaint at ¶ 4. In fact, however, neither company ever extracted mineral or produced fertilizer; instead, the returns cam solely from the sale of interests in the mining claims. *Id.* at ¶ 5.

On March 16, 2011, the respondent consented to the entry of a judgment in the enforcement action,permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Sections 10(b) and 15(a) of the Exchange Act, and Rule 10b-5. In view of this judgment and the respondent's offer of settlement in the administrative proceeding, the SEC imposed the following sanctions: (1) the respondent was barred from associating with any broker, dealer, investment adviser, municipal securities dealer or advisor,

transfer agent, or nationally recognized statistical rating organization; and (2) the respondent was barred from participating in any offering of penny stock.

17. *In the Matter of Lisa Berry, SEC Rel. No. 34-65582; Admin. Proc. File No. 3-14589 (Oct. 18, 2011)*

In this settled administrative proceeding, the respondent consented to the imposition of sanctions in connection with her role in engaging in stock option backdating schemes while serving as general counsel in two, separate companies. The proceeding arose out of a civil injunctive action originally filed by the SEC in 2007. *See SEC v. Berry,* Case No. C-07-4431-RMW (N.D. Cal., filed Aug. 28, 2007). In October of 2011, the respondent consented to the entry of judgment in the civil action, pursuant to which she was permanently enjoined from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Section 13(b)(5) of the Exchange Act, and Rule 13b2-1, and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 14 of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, 13a-13, and 14a-9. In addition, the respondent was ordered to pay disgorgement with interest in the amount of $77,120, as well as a civil money penalty in the amount of $350,000.

In view of the entry of judgment in the enforcement proceeding, the SEC sanctioned the respondent in the administrative sanction by suspending her from appearing and practicing before the Commission as an attorney for a period of five years, after which she could petition for reinstatement.

18. *In the Matter of LeadDog Capital Markets, LLC, F/K/A LeadDog Capital Partners, Inc., Chris Messalas, and Joseph LaRocco, Esq.,* Sec Rel. Nos. 33-9277, 34-65750, IA-3314, IC-29861; Admin. Proc. File No. 3-14623 (Nov. 15, 2011)

This is an order instituting public administrative and cease and desist proceedings against the owners and controllers of an adviser to a purported hedge fund in connection with their alleged material misrepresentations and omissions in information provided to investors. One of the respondents served as a managing member, general counsel, and 40% owner of the adviser, and was responsible for all legal functions on behalf of the fund, as well as most marketing and administrative functions, including the compiling of the fund's private placement memoranda and marketing materials. In addition, the respondent maintained a law practice that included advising hedge funds on compliance with federal securities laws and regulations and involved practicing before the SEC in the representation of clients under investigation by the SEC. The respondent was not, however, registered with the Commission in any capacity. *See* Admin. Proc. File No. 3-14623, at ¶¶7, 9.

According to the SEC, the fund was invested in illiquid penny-stocks or other micro-cap companies, each of which had received "going concern" opinions from auditors, and all but one of which had a consistent history of net losses. In addition, most of these companies were owned or controlled by the respondents or their affiliates. *See* Admin. Proc. File No. 3-14623, at ¶ 1. Notwithstanding this background, the SEC alleges that the respondents deliberately or recklessly

conveyed a materially different picture to existing or prospective investors in order to induce them to stay with or invest in the fund. Admin. Proc. File No. 3-14623, at ¶ 2. Specifically, the SEC alleges that the respondents deliberately or recklessly made material misrepresentations and omissions of fact regarding their experience and reputation in the securities industry, the liquidity of the fund and the nature of its investment holdings, and the existence of substantial conflicts of interest and related party transactions. Admin. Proc. File No. 3-14623, at ¶¶2-4, 13-28.

Because of their conduct, the SEC alleges that the respondents have willfully violated Section 17(a) of the Securities Act, Section 10(a) of the Exchange Act. and Rule 10b-5, and have willfully aided, abetted and caused the adviser's violations of these provisions of the securities laws. Additionally, the SEC alleges that the respondent general counsel willfully aided, abetted, and caused the adviser and the other respondent to violate Section 206(4) of the Advisers Act and Rule 206(4)-8.

19. *SEC v. Heart Tronics, Inc., et al.,* Case No. SACV-11-1962-JVS (ANx) (C.D. Cal. filed Dec. 20, 2011)

This is a civil enforcement action brought against seven defendants for a series of allegedly fraudulent schemes designed for the purpose of artificially inflating the securities of a company that purportedly sold a heart monitoring device. The complaint alleges that although the key architect of the scheme held himself out as outside counsel to the company and claimed not to be an officer or director of the company, he was a *de facto* officer who controlled many of the company's business decisions and public disclosures. *See* Complaint, *SEC v. Heart Tronics, Inc., et al.*, Case No. SACV-11-1962-JVS (ANx) (C.D. Cal. filed Dec. 20, 2011), at ¶ 2. The SEC alleges that the defendant attorney's wife, a relief defendant, was the largest shareholder of the company, owning approximately 85% of the common stock. *See id.* at ¶ 3.

According to the SEC, the fraudulent schemes were varied and included the following: the use of straw or fictional purchasers and the false reporting of fictitious sales of the company's flagship product in press releases and public filings prepared by the defendant attorney or by others in reliance upon documents supplied by the defendant attorney that contained materially false and misleading information, *see id.* at ¶¶33-73; the use of a promoter to tout the company's stock to investors without disclosing the fact that the promoter was being compensated by the company, *see id.* at ¶¶74-78; secret sales of company stock through the use of purportedly blind trusts and other nominee entities, *see id.* at¶¶80-94; and, the sale of improperly registered S-8 stock. *See id.* at ¶¶95-103.

Because of the conduct alleged in the complaint, the SEC alleges that the defendant attorney violated numerous provisions of the securities laws: Sections 10(b), 13(d), and 16(a) of the Exchange Act and Rule 10b-5; and, Sections 5(a), 5(c), and 17(a) of the Securities Act and Rules 13d-1 and 16a-3.The SEC further alleges that the defendant attorney is subject to controlling person liability under Section 20(a) of the Exchange Act for his violations of Section 10(b) and Rule 10b-5, and is also liable for aiding and abetting the company's violation of Sections 10(b) and Rule 10b-5, as well as Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1. In addition to seeking preliminary and permanent injunctions against future

violations of the securities laws, the SEC seeks disgorgement of all ill-gotten gains and the payment of civil money penalties.

RECENT CRIMINAL ACTIONS AGAINST IN-HOUSE COUNSEL

Since the beginning of 2008, the government has brought a number of criminal actions against an entity's chief legal officer or general counsel, and one criminal action against the associate general counsel of a company.[3] In six of the actions, the government has charged in-house counsel for their roles in schemes involving investment fraud, health-care fraud, bank fraud, securities fraud, and fraudulent tax shelters. In the other actions, the government has charged in-house counsel with violations of the Foreign Corrupt Practices Act, immigration law violations in connection with the company's hiring practices, obstruction of justice and false statements in connection with a government investigation, and embezzlement. In most of the actions, in-house counsel has pled guilty, while in one of the actions, in-house counsel went to trial and was acquitted of the charges. Four of the actions remain pending.

The following is a summary of these actions.

2008

1. U.S. v. Simring, No. 3:08cr00321- REP (E.D. Va., filed July 9, 2008)

The chief legal officer of a company that operated several qualified intermediary entities for 1031 tax exchanges was charged by information with conspiracy to commit mail fraud and money laundering in connection with his participation in a fraudulent scheme orchestrated by the company's owner and its COO. Pursuant to the scheme, the owner misappropriated client funds held by his 1031 entities for his personal use, for the payment of bonuses and salaries to his co-conspirators, for the payment of the operating expenses of his companies, and for the purchase of investment property (Information at ¶¶14, 15). The misappropriation resulted in the depletion of client exchange accounts to the extent that they were in danger of being unable to fund their clients' 1031 exchanges. In order to conceal the misappropriation, the owner would use client exchange funds from a newly acquired qualified intermediary entity to cover the amounts he had previously misappropriated from another entity (Information at ¶ 16).

According to the information, the defendant was first retained by the owner while in private practice. At that time, the owner consulted the defendant for the latter's advice concerning the owner's potential criminal liability for transferring client exchange funds. After reviewing the agreements between the owner and his exchange fund clients, conducting

[3] The summary does not include prosecutions for conduct, such as insider trading, where in-house counsel's role and function are not integrally related to the wrongdoing.

independent legal research, and speaking with both in-house and outside counsel who had raised concerns about the transfers, the information alleges that the defendant concluded that the owner's prior course of conduct with respect to the transfers risked criminal liability (Information at ¶ 22). After advising the owner of his conclusions, the information alleges that the defendant also informed the owner that his advice could not rectify past conduct but that the owner could minimize the risk of a law enforcement inquiry by ensuring that none of his clients lost money (Information at ¶ 23). In response, the information continues, the owner told the defendant that the exchange agreements would be changed and that he would repay a majority of the funds taken from his clients' accounts (Information at ¶ 23). Soon after this consultation, the owner hired the defendant as chief legal officer of his company (Information at ¶ 24).

Approximately two months after being hired as chief legal officer, the information alleges that the defendant became aware that the exchange agreements had not been changed, that the owner was continuing to make illicit transfers of funds from his clients' accounts, and that the owner's company that operated the qualified intermediary entities was on the verge of insolvency. In response to the defendant's concerns, the information alleges that the owner stated that the transfers were only for the short term and that he was in the process of repaying the company to ensure its liquidity (Information at ¶ 25). One month later, when the company's condition deteriorated to the point that it was unable to fund certain client exchanges in a timely manner, the information alleges that the defendant, together with other conspirators, lied to the clients in order to conceal the misappropriations, telling them that their funds were secure and that the delay was a short-term liquidity issue (Information at ¶ 26). According to the information, the defendant, the owner, and other conspirators continued to conceal the misappropriations by making "lulling" payments to earlier unwitting clients from deposits belonging to later unwitting clients (Information at ¶ 27). When the defendant was made interim CEO upon the resignation of the former CEO due to concerns about the illegal transfers, the information alleges that, acting at the direction of the owner, the defendant transferred approximately $8 million in client exchange funds to accounts controlled by the owner and other conspirators. Three days after being appointed interim CEO, the defendant resigned (Information at ¶ 28). Soon thereafter, the company declared bankruptcy (Information at ¶ 29).

In response to the information, the defendant entered a plea agreement in which he waived indictment and pled guilty to one count of conspiracy to commit mail fraud and money laundering in violation of 18 U.S.C. § 371. *See U.S. v. Simring*, No. 3:08cr00321- REP (E.D. Va. July 24, 2008) (Plea Agreement). At sentencing, the defendant received a term of imprisonment of three years, followed by a term of supervised release of three years, and was ordered to pay restitution in the amount of $4, 252,751.19. *U.S. v. Simring,* No. 3:08cr00321-REP (E.D. Va. Nov. 17, 2009) (Judgment).

2009

2. U.S. v. Kramer, No. 2:2009-cr-00322-CDJ-1 (E.D. Pa., filed May 8, 2009)

In this criminal action, the general counsel of a company that operated car wash businesses in a three-state region was charged by information with violating the immigration

laws by engaging in a pattern and practice of employing illegal aliens in violation of 8 U.S.C. § 1324(a)(2) and (f). According to the information, the defendant, who also served as chief operating officer of the company, was responsible for oversight of all self-service and full-service car washes in the region, and with establishing and overseeing the procedures and practices for hiring, maintaining, and terminating employees (Information at ¶ 4). The regional manager, responsible for the day-to-day operations of the car washes, reported to the defendant, as did a second, unnamed person to whom other regional managers reported (Information at ¶ 5).

As alleged in the information, certain of the company's car washes employed illegal workers and provided them with the names of former employees to use. Each of these workers were paid by check, issued in the name of the former employee, and the checks were cashed at a local bank under an informal arrangement whereby the bank did not require identification from the workers if they were wearing car-wash t-shirts or sweatshirts (Information at ¶ 11). The information alleged that the defendant, having constructive knowledge that a significant number of car wash employees were illegal workers, put in place procedures that hindered discovery of the company's employment of illegal workers, and failed to adequately investigate complaints that many car wash employees were illegal workers (Information at ¶ 13).

The defendant pled guilty to a Class B misdemeanor, was sentenced to one year probation and six months of home confinement, and ordered to pay a fine of $75,000.

3. *U.S. v. Mushriqui, No. 1:09-cr-00335-RSL-1 (D. D.C., filed Dec. 11, 2009)*

The general counsel/United States manager of a Pennsylvania company that manufacturers and exports bullet proof vests and other equipment for law enforcement and military purposes was indicted for conspiracy to violate, and violations of, the Foreign Corrupt Practices Act (FCPA) as well as violations of the money laundering statute, and aiding and abetting these violations. Indicted with the general counsel was her brother, the owner and director of the company. On April 16, 2010, a superseding indictment was filed against these defendants, and several other individuals engaged through various companies with the manufacture and export of law enforcement and military equipment, for conspiracy to violate and violations of the FCPA, and for related violations of the money laundering statute.

The indictment alleges that the defendants met with purported representatives of a foreign government's Ministry of Defense for the purpose of obtaining contracts for the sale of bullet proof vests to that country, and knowingly entered into contracts for the sale of this equipment that included, over and above the sales price, a 20% commission, one-half of which was intended as a bribe to the foreign government's Minister of Defense, and the other half of which was intended as a fee to the purported representative and a company sales agent for their corrupt services. The indictment further alleges that the defendants agreed to inflate the price of the bullet proof vests by 20% in order to conceal the 20% commission. According to the indictment, the defendants entered into these contracts in order to obtain and retain lucrative business opportunities. After executing these contracts, the indictment alleges that the defendants received a wire transfer of money purportedly from an account controlled by the foreign government for the purpose of purchasing the bullet proof vests, wired the 20% commission to

the purported representative's bank account for the payment of the bribe to the foreign government and the service fee to the representative and the sales agent, and emailed the representative that a shipment of bullet proof vests had been sent by the company. Upon being informed that the Minister of Defense was satisfied with the shipment, the indictment alleges that the defendants met with another purported representative of the foreign government and executed a second purchase agreement.

The defendant has pled not guilty to the charges.

2010

4. U.S. v. Parrott, No. Cr-10-81-KI (D. Ore., filed March 9, 2010)

The general counsel of GeoStar Corporation, an oil and gas exploration business, was charged by information with a conspiracy to defraud the government by engaging in a fraudulent tax shelter scheme. In addition to serving as general counsel, the defendant also served as executive vice-president, director, and a partial owner of GeoStar.

According to the information, the tax shelter investment scheme involved a thoroughbred horse leasing program operated by a wholly-owned subsidiary of GeoStar. Pursuant to this program, an investor would lease the reproductive capacity of a specific thoroughbred mare and, if the mare produced a foal during the term of the lease, the investor would then own the foal (Information at ¶ 13). Promoters of the investment told investors that it was a legitimate way to reduce or eliminate income taxes, since deductions could be taken on any losses caused by the thoroughbred horse breeding program (Information at ¶¶ 13-14). The investments were generally financed through loans obtained from a purportedly independent lending company, but which, in fact, was funded and controlled by GeoStar's wholly-owned subsidiary (Information at ¶ 15). The information alleged that it was the practice of the lending company to transfer funds between bank accounts in the names of the wholly-owned subsidiary and the lending company in order to create the appearance that the loans were funded (Information at ¶ 15).

As alleged in the information, the wholly-owned subsidiary failed to purchase a sufficient number of thoroughbred mares to fulfill its contractual obligations to investors and, therefore, substituted less valuable quarter-horses to enable investors to take deductions on their taxes (Information at ¶ 18). In order to mollify the investors, the information alleged that GeoStar allowed investors to trade their interests in the quarter-horses for units of ownership in another affiliated entity that purportedly held interests in both horses and coal bed methane wells (Information at ¶ 19).

The information further alleged that the wholly-owned subsidiary's inability to fulfill its obligations to investors with respect to the leasing of thoroughbred mares was largely due to GeoStar's diversion of funds from its subsidiary (Information at ¶ 18). According to the government, between 2001 and 2007, GeoStar moved approximately $330 million of the leasing program's sale proceeds from the subsidiary's bank accounts to bank accounts held by GeoStar, and used the money for several purposes, including for the personal enrichment of its principals,

such as the defendant (Information at ¶ 20). Because of the leasing program, the government alleged that investors filed tax returns claiming false tax deductions of over $500 million, thereby resulting in a tax loss to the U.S. of over $200 million (Information at ¶ 21).

For his role in the fraudulent scheme involving false representations, the concealment of material facts, and the diversion of investment proceeds for purposes unrelated to the thoroughbred breeding program, the government alleged that the general counsel helped to draft documents creating the entity that purportedly held interests in coal bed methane gas wells, attended meetings that addressed issues such as the insufficient number of thoroughbred horses and GeoStar's estimated net cash flow from the investment program sales, contacted outside counsel regarding the fee for their preparation of an opinion letter on the legality of the tax benefits of the leasing program, and caused an invoice to be submitted to GeoStar for management consulting fees allegedly incurred with respect to the affiliate with the purported gas well interests, with payment to be made by wire transfer into an account that he controlled. The government further alleged that the defendant, acting on behalf of another related entity engaged in the gas exploration business, requested a bank to remove restrictions on the sale of the entity's stock. Finally, the government alleged that, acting in his capacity as vice-president, the defendant signed agreements through which GeoStar transferred certain producing and non-producing properties to the related gas exploration entity (Information at p. 7-9).

On April 1, 2010, the general counsel pled guilty to the one-count information. *See* U.S. Department of Justice, Office of the United States Attorney—District of Oregon, Press Release (April 1, 2010).

5. *U.S. v. Mackert, No. 3:10-cr-00257-REP (E.D. Va., filed Sept. 9, 2010)*

In this criminal prosecution, the general counsel for A & O Resource Management, Ltd. (A&O), a company that acquired and marketed life settlement investments, was charged by information with conspiracy to commit mail fraud and bulk cash smuggling in connection with an investment fraud scheme. The information alleged that the defendant, together with his co-conspirators, who were co-owners of A&O, misled investors into believing that their investment in life settlement policies would remain safe and secure because A&O would set aside a sufficient portion of investor funds to pay for all future premiums and would not commingle those funds with A&O's general, operating funds (Information at ¶ 21). Because of the defendants' fraudulent marketing efforts, which included material misrepresentations and omissions in marketing materials as to the size and staff of A&O, its investment success, and the fact that investor funds were deposited into escrow accounts (Information at ¶ 23), the information alleged that A&O obtained over $100 million in investor funds from more than 800 investors (Information at ¶ 53).

According to the information, because of scrutiny by state securities and insurance regulators who were concerned that A&O was engaged in offering unregistered securities, the owners of A&O agreed to establish hedge funds to sell securities backed by life settlements (Information at ¶ 26). After securing outside legal advice on setting up the hedge funds, the owners began offering Capital Appreciation Bonds, promising investors a minimum rate of

return backed by a pool of underlying life insurance policies (Information at ¶ 27). Contrary to the advice from the law firm, however, the owners continued to use the same sales agents to market the bonds, even though most were not licensed to sell securities (Information at ¶ 29). With increasing scrutiny from state and securities regulators, the owners sought legal advice from another firm, which advised the owners that A&O could not sell its securities through the unlicensed sales agents (Information at ¶ 33).

In order to avoid continued scrutiny, the information alleged that two of the owners secretly agreed to make a purported sale of A&O and enlisted the assistance of the defendant, who previously had done legal work for A&O (Information at ¶¶ 34-35). As alleged in the information, the defendant actively facilitated a sham sales transaction pursuant to which A&O would be "sold" to an offshore entity that, unbeknownst to the third owner, was owned and controlled by the other two owners (Information at ¶¶ 36-38). The information alleges that the defendant's conduct included: (1) secretly purchasing the purported buyer, an offshore shell corporation; (2) creating a fictitious person to serve as the buyer's representative; (3) getting someone to sign the sales transaction in the name of the fictitious representative; (4) allowing the two owners to make secret deposits into the defendant's trust accounts, which the defendant used to pay the third owner's share of the sales price; and (4) hiring an actor to pretend to perform due diligence on behalf of the purported buyer (Information at ¶ 38). Subsequently, the information further alleges, the defendant created another, offshore-based shell company, secretly owned and controlled by the two owners, that purchased the other shell company that had bought A&O (Information at ¶¶ 39-40).

Following the purported sale of A&O, the information alleged that the company continued to sell unregistered securities, the defendant continued to provide guidance and advice (Information at ¶¶ 42-43), and state regulators continued to scrutinize A&O's offerings (Information at ¶ 47). Soon after a meeting with regulators, A&O transferred approximately $4.6 million into third-party escrow accounts, ostensibly for the purpose of paying the premiums on the underlying life settlement policies to ensure that they did not lapse (Information at ¶ 48). The information alleged that the defendant, through a company that he owned and controlled, then entered into a management agreement with one of the shell corporations; pursuant to the agreement, which was signed by the fictitious representative on behalf of the shell corporation, the defendant agreed to monitor the premium payments for A&O and to work with an accounting firm to deliver an annual letter to investors (Information at ¶ 49). Based on false representations provided by the defendant, the accounting firm sent out letters to investors regarding the genesis and sufficiency of the escrow accounts in order to reassure them of the safety and security of their A&O investments (Information at ¶¶ 50-51). Not long thereafter, the defendant placed several of the entities comprising A&O into bankruptcy because of A&O's inability to pay the premiums on the underlying policies (Information at ¶ 52).

On November 23, 2010, the defendant pled guilty to the two-count information, *see* U.S. Department of Justice, Press Release (November 23, 2010) ("Lawyer for A&O Entities Pleads Guilty for His Role in $100 Million Fraud Scheme Involving Life Settlements"), and was subsequently sentenced to 15 years in prison. *See* U.S. Department of Justice, Press Release (July 22, 2011) ("Five Employees of A&O Entities Sentenced to Prison for $100 Million Fraud Scheme").

6. *U.S. v. Stevens, No. 8:10-cr-00694-RWT (D. Md., filed Nov. 8, 2010; re-filed April 13, 2011)*

The vice-president and associate general counsel of a pharmaceutical company was indicted and charged with obstruction of justice (18 U.S.C. § 1512), falsification of documents (18 U.S.C. § 1519), and making false statements (18 U.S.C. § 1001), in connection with an FDA inquiry regarding the company's promotion of unapproved uses for a particular drug. After the first indictment was dismissed, without prejudice, because of misleading instructions given to the grand jury regarding the advice-of-counsel defense, the government re-indicted the general counsel in April of 2011.

According to the indictment, the FDA requested the defendant to provide it with all materials presented at company-sponsored promotional programs by health care professionals during a two-year period, even if the materials were not created by, or under the custody or control of, the company (Indictment at ¶ 12). In response, the indictment alleged that the defendant confirmed that she would attempt to obtain these materials and would inform the FDA of the company's inability to secure any materials (Indictment at ¶¶ 13-15). As related in the indictment, the defendant identified over 2,000 speakers during this time period, sent letters to 550 of the speakers, and received materials from approximately 40 speakers. While reviewing these materials, the indictment alleged that the defendant learned that some of the speakers had appeared at hundreds of promotional events and had repeatedly promoted the use of the company's drug for unapproved purposes (Indictment at ¶¶ 16-19, 21-25). The indictment further alleged that, notwithstanding this information, the defendant sent several letters to the FDA containing false statements as to the company's possession of materials about, and its active involvement in, promoting off-label uses for the drug (Indictment at ¶¶ 26-34). In support of its allegations, the government cited a memorandum received by the defendant from outside counsel that sets forth the pros and cons of submitting materials from some of the promotional speakers and notes that some of the materials appear to discuss off-label uses for the drug (Indictment at ¶¶ 35-36). Upon subsequently learning that a company sales representative had reported the company's promotion of unapproved uses for the drug to the FDA, and had submitted materials from a speaker at one of the promotional events, the indictment alleged that the defendant produced the same materials to the FDA and, in a letter intended to mislead the FDA, stated that, while there had been isolated deficiencies, the objective evidence showed that the company had not developed, maintained, or encouraged off-label uses of the drug (Indictment at ¶¶ 40-41).

At trial, the defendant moved for a judgment of acquittal before presentation of the matter to the jury. The court granted the motion, finding that the evidence, consisting of privileged documents obtained by the prosecution under the crime-fraud exception, did not show a defendant engaged to assist a client in perpetrating a crime or fraud, but "[i]nstead . . . show[ed] a studied, thoughtful analysis of an extremely broad request from the Food and Drug Administration and an enormous effort to assemble information and respond on behalf of the client." *U.S. v. Stevens*, Criminal Action RWT-10-694, Transcript of Hearing, at 5 (D. Md. May 10, 2011). According to the court, the defendant's responses were "sent to the FDA in the course

of her bona fide legal representation of a client and in good faith reliance of both external and internal lawyers[.]" *Id.*

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7. *U.S. v. Bereday., No. 11-cr-00115 (M.D. Fla., filed March 2, 2011)*

This is a criminal action alleging that executives of WellCare Health Plans, Inc., including its general counsel, engaged in a Medicaid fraud scheme in connection with the company's operation, through its subsidiaries, of several health maintenance organizations (HMOs) that targeted recipients of government-sponsored health care programs. In addition to serving as general counsel, the indictment alleges that the defendant also served as senior vice-president, secretary, and chief compliance officer of the parent; as secretary, vice-president and a director of two of the subsidiaries; and as a director and vice-president of a third subsidiary (Indictment at ¶ 21).

According to the indictment, the defendants conspired to submit, and submitted, false and fraudulent expenditure reports to the state agency that administered the Medicaid program in order to reduce the amount of the refund contractually owed by the defendants' HMOs to the state agency (Indictment at ¶ 26). As explained in the indictment, the agency provided the HMOs with a worksheet on which the HMOs were required to calculate and report expenditure information relating to the provision of covered services, as well as the amount of the refund, if any, owed by the HMOs to the agency (Indictment at ¶ 14). Pursuant to the Medicaid contract and as set forth in the worksheet, the HMOs were required to refund the agency the difference between the amount of the premium paid by the agency to the HMOs and the amount actually expended by the HMOs for covered services, if the amount was less than 80% of the premium (Indictment at ¶ 17). Instead of accurately reporting the expenditures for covered services, the indictment alleges that the defendants utilized several methods to prepare worksheets containing false information, such as: (1) including expenditures that were not expenditures for covered services; (2) using a wholly-owned entity to conceal the true costs of providing covered services and to fraudulently increase the expenditures reported on the worksheets; (3) falsely and fraudulently reporting expenditures made by the HMOs in areas not covered by the contract as made in covered areas; (4) including false, fraudulent, and misleading information in the worksheets; and (5) fraudulently certifying to the truthfulness and accuracy of the information contained in the worksheets (Indictment at ¶ 26). The indictment further alleges that, in order to avoid scrutiny by the agency, the defendants reported a refund but not in accordance with the instructions and guidance set forth in the worksheets and required to be followed, and, when questioned by the agency, intentionally failed or refused to respond truthfully when explaining the wide variance between the refund reported to the agency and the refund independently calculated by the agency (Indictment at ¶ 26).

In furtherance of the conspiracy, the indictment alleges that the general counsel directed an in-house attorney to cease work related to the drafting of contracts between the parent and its subsidiary HMOs, and to enlist an outside law firm to complete the contracts (Indictment at ¶ 27(a)). The indictment then alleges that, subsequently, the general counsel, while acting in that capacity, executed agreements between the parent and the subsidiary HMOs in which the latter agreed to arrange and manage the delivery of covered services in exchange for a certain per-

patient, per-month capitation fee (Indictment at ¶ 27(q), (r)). Prior to the execution of these agreements, the indictment alleges that emails were exchanged among several defendants discussing the calculation of the refund amount, in one of which the general counsel advised that the CEO of the parent (who was also the CEO and/or President of the subsidiaries) wanted to rely on the general counsel on the "80/20" issue (Indictment at ¶ 27(j)). In a later conversation with another defendant, the indictment alleges that the general counsel responded "right" after being told how the refunds submitted to the agency were calculated for a particular one-year period (Indictment at ¶ 27(u)).

Because of the defendant's conduct as alleged in the indictment, the government has charged the general counsel with conspiracy to commit, and the commission of the crimes of health care fraud in violation of 18 U.S.C. § 1347, and of making false statements relating to health care matters in violation of 18 U.S.C. § 1035.

8. *U.S. v. Hairston, No. 2:11-cr-00311-LS (E.D. Pa., filed June 2, 2011)*

The former general counsel of Children's Hospital of Philadelphia was charged by information with mail fraud, money laundering, and filing a false tax return in connection with his embezzlement of $1.7 million from the hospital while serving as general counsel. According to the information, the defendant created fraudulent invoices that falsely claimed that expert medical witnesses had provided services with respect to medical malpractice claims brought against the hospital or that companies had provided consulting services and prepared economic impact studies for the hospital, and concealed the fraud through various shell companies that he created. The defendant has pled guilty to the charges.

9. *U.S. v. Maloney, No. 1:11-cr-00121-SCJ-LTW-3 (N.D. Ga., filed June 22, 2011)*

A former inside attorney for a bank, together with two former bank officers, were indicted for their roles in a bank fraud scheme. As an inside attorney, the defendant was responsible for handling legal matters involving the bank, reviewing loan files and documentation relating to loans made by the bank, and preparing corporate documentation for borrowers, including the formation of new corporate entities for borrowers.

According to the indictment, the defendant helped to disguise, hide, and conceal a co-defendant's personal financial interests in commercial real estate loans and other loans made by the bank that funded payments to the co-defendant or to his benefit, and helped to disguise the true nature and purpose of the transactions. In return, the indictment alleges that the defendant received multiple payments in the form of "legal fees" from the co-defendant which were in addition to his salary. Specifically, the indictment alleges that the defendant engaged in the following conduct: prepared and signed false and fraudulent credit memoranda recommending and approving loans that falsely and fraudulently portrayed the underlying transaction and the purpose of the loans; prepared deeds and other documents that disguised and concealed the co-defendant's personal financial interest in the transactions through short-term "flips" to straw parties; maintained an attorney escrow account to receive funds and make payments for his co-

defendant, thereby disguising the co-defendant's personal financial interest in the transactions; and, made false and fraudulent statements to federal and state bank examiners.

The indictment charges the defendant with conspiracy to commit bank fraud, in violation of 18 USC 1349; bank fraud, in violation of 18 USC 1344; false entries, in violation of 18 USC 1005; and conspiracy to commit money laundering, in violation of 18 USC 1956(h).

10. U.S. v. Stein, No. 9:11-cr-80205-KAM-1 (S.D. Fla., filed Dec. 13, 2011)

A former attorney for a health care device company was indicted for his role in a market manipulation fraud scheme. The SEC has filed a parallel civil enforcement action, which is discussed more fully *supra*. Because of his role in the allegedly fraudulent scheme, the indictment charges the defendant with numerous offenses, including securities fraud, wire fraud, attempt and conspiracy to commit mail fraud, money laundering, and obstruction of justice, and seeks forfeiture of the proceeds of the offenses. *See* U.S. Department of Justice, Justice News (Dec. 20, 2011) ("Attorney Charged in Multi-Million Dollar Stock Fraud").

UPDATE

2011-2016

SEC and Criminal Actions Against Inside Counsel – Continued

SEC Civil Proceedings

In the Matter of Peter J. Bottini, Phillip J. Hoeh, and Kevin E. Strine, Securities Exchange Rel. No. 66814; Admin. Proc. File No. 3-14847 (April 12, 2012)

This is a cease and desist proceeding brought pursuant to Section 21C of the Securities Exchange Act of 1934 against officers of a self-clearing, retail, on-line broker specializing in options and futures. One of the officers was the Vice-President of Compliance who was also a licensed attorney as well as the holder of Series 4, 7, 24, and 63 licenses. The proceedings arose out of the broker's violation of the delivery and close-out requirements of Regulation SHO of the Exchange Act, which require participants of a registered clearing agency to deliver equity securities to a registered clearing agency when delivery is due, generally three days after the trade date. According to the Order Instituting Cease and Desist Proceedings (Order), the broker failed to satisfy its close-out obligations under Regulation SHO by repeatedly engaging in sham "reset" transactions that gave the appearance that the broker had purchased shares to close-out an open failure-to-deliver position while not, in fact, doing so. The Order alleges that the officers knew or should have known that the trading was problematic, citing recent regulatory guidance on the issue, recent SEC enforcement activity directed at the same or similar trading practices, concerns raised by traders regarding these practices, efforts by the compliance department to institute new procedures to address the practices, and communications with regulators.

Without admitting or denying the findings set forth in the Order, the officers submitted an Offer of Settlement which the Commission accepted. The Commission found that the officers were a cause of the broker's violations of Regulation SHO because they knew or should have known that their actions would contribute to those violations, and ordered the officers to cease and desist from committing or causing any violations and any future violations of Regulation SHO.

SEC v. MayfieldGentry Realty Advisors, LLC, Civil Action No. 13-CV-12520 (E.D. Mich. filed June 10, 2013)

This is an action brought by the SEC against an investment advisor and its CEO for the misappropriation of approximately $3.1 million from the pension fund of one of the firm's primary clients, and against the firm's senior executives, including its general counsel who was also chief compliance officer, for hiding the theft from the client. According to the complaint, the CEO secretly stole the funds on behalf of the firm in order to purchase two shopping malls in California. Upon learning of the theft, the complaint alleges that the senior executives conspired with the CEO to keep the theft a secret and devised a plan to pay back the fund without the client ever learning of the theft. However, four years after the theft, the client was informed of the theft which resulted in the termination of the firm as manager of the client's funds and the firm's subsequent collapse as a business. *See* Complaint, *SEC v. MayfieldGentry Realty Advisors, LLC,* at ¶¶1-4, 6-7.

The complaint alleges that the first officer to learn of the theft was the CFO: although he knew that the funds used to purchase the shopping malls came from the client because, as CFO, he forwarded those funds to the CEO, he did not know that the client had not consented to the transfer of its funds until he questioned the CEO why the closing documents did not identify their client as the owner. For approximately three years after the closing and the CFO's learning of the theft, the complaint alleges that the CFO and the CEO would meet periodically to discuss how to replace the funds without the theft being discovered. At a meeting held three years after the theft without the presence of the CEO, it is alleged that the CFO, COO, CIO and general counsel discussed the fact that $3.1 million was taken from the client's account without the client's permission and also discussed ways in which to pay back those funds; however, they never discussed revealing the theft to the client. The complaint alleges that the general counsel and the CIO appeared at the client's board meetings at which they only touted the firm's performance as asset manager for the client and never disclosed the theft. At one such meeting, the complaint alleges that the general counsel discussed how well each of the properties held by the client was doing, but never included the shopping malls in her discussion. *See* Complaint, at ¶¶60-85, 88.

For her role in covering up the theft of the client's funds, the general counsel was charged with aiding and abetting violations of Sections 206(1) and 206(2) of the Adviser's Act, 15 U.S.C. §§80b-6(1) and 80b-6(2). The SEC sought permanent injunctive relief, disgorgement, and the imposition of a civil money penalty. On June 23, 2016, the district court entered a final judgment by consent against the general counsel and permanently enjoined her from future violations of the Sections 206(1) and 206(2) of the Adviser's Act. In a related administrative proceeding, the Commission accepted the general counsel's offer of settlement and suspended her from appearing and practicing before it as an attorney for three years. *See In the Matter of Alicia M. Diaz, Esq.,* Securities Exchange Act Rel. No. 78274; Investment Adviser's Act Rel. No. 4448; Admin. Proc. File No. 3-17333 (July 11, 2016).

[*See also* Litigation Rel. No. 22646 (March 15, 2013), announcing settlement of action with the former general counsel of Mercury Interactive LLC who was originally sued in 2007, along with other executives, for a stock options backdating scheme. *See SEC v. Mercury Interactive, LLC (f/k/a Mercury Interactive Corp.), Anmon Landan, Sharlene Abrms, Douglas Smith, and Susan Skaer,* Civil Action No. 07-2822 (WHA) (N.D. Cal. May 31, 2007). Without admitting or denying the SEC's allegations, the general counsel agreed to an order permanently enjoining her from violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act as well as the financial reporting, record-keeping, internal controls, false statements to auditors and proxy provisions of the securities law, and ordering the payment of $628,037 in disgorgement and $225,000 as a civil penalty. The general counsel also agreed to an order suspending her from appearing and practicing before the Commission as an attorney.]

SEC v. Samuel Braslau, Rand J. Chortkoff and Stuart E. Rawitt, Civil Action No. CV 14-01290-ODW (C.D. Cal. filed Feb. 20, 2014)

This is an action against three individuals for an alleged fraudulent investment scheme involving a purported multi-million-dollar movie project. One of the defendants, the alleged architect of the scheme, was a licensed attorney who served as legal counsel and registered agent for two companies that offered and sold securities for the purpose of financing the movie project. According to the complaint, the attorney exercised *de facto* control over these entities. The complaint alleges that the defendants, through unregistered salespeople, persuaded more than 60 investors to invest in the project which they claimed would involve appearances by well-known actors, would be directed and produced by a well-known director and producer, and would generate enormous revenues. In addition to private placement memoranda (PPMs) drafted by the attorney, the complaint alleges that prospective investors were sent brochures created by the attorney and a co-defendant that featured biographical sketches of the producer and director, a "proposed A-list cast," budget and revenue figures for other movies made by the producer and director, and budget and revenue figures for other blockbuster films deemed comparable to the movie project. According to the SEC, the brochure's budget and revenue comparisons were tenuous at best; and none of the potential cast members had ever been contacted about the movie project. After merging with another entity controlled by the attorney and changing the title of the movie, the defendants continued to solicit investors with similar PPMs and brochures. *See* Complaint, *SEC v. Samuel Braslau, Rand J. Chortkoff and Stuart E. Rawitt,* at ¶¶3-43.

As alleged in the complaint, the PPMs affirmatively misrepresented or failed to disclose material facts concerning the offerings, such as the rates of commissions paid to salespeople, the extent of the legal fees paid to the defendant attorney, the nature and existence of other fee arrangements, and the impact of all of these financial obligations on their ability to pursue the movie project. *See* Complaint, at ¶ 44. As the drafter of the PPMs and the undisclosed side agreements governing disbursement of the offering proceeds, the complaint alleges that the defendant knew or was reckless in not knowing that the offering proceeds were not being used as represented to the investors and would not be sufficient to make the movie. *See* Complaint, at ¶ 50. Ultimately, the SEC alleges, only $2,241 remained of the $1.8 million raised from the offering. *See* Complaint, at ¶ 81.

The SEC charged the defendant attorney with violating the antifraud provisions of Section 17(a) of the Securities Act, 15 U.S.C. § 77q, and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, and, for relief, sought an order permanently enjoining him from violating the antifraud provisions of the securities law, and requiring the disgorgement of ill-gotten gains and the payment of a civil money penalty. Following a trial on the charges, the district court found that the defendant violated the specified antifraud provisions of the securities laws and permanently enjoined the defendant from further violations of these provisions. Citing the district court's decision, the fact that the district court did not find that the attorney's conduct was not willful, the attorney's criminal conviction arising out of the same conduct, and his suspension from the practice of law in California, the SEC, in a related administrative proceeding, suspended the attorney from appearing or practicing before the Commission

pursuant to Rule 102(e). *See In the Matter of Samuel Braslau,* Securities Exchange Act Rel. No. 78410; Admin. Proc. File No. 3-17359 (July 25, 2016).

In the Matter of Alpha Titans, LLC, Timothy P. McCormack, and Kelly D. Kaeser, Esq., Securities Exchange Act Rel. No. 74828; Investment Advisers Act Rel. No. 4073; Investment Company Act Rel. No. 31586; Admin. Proc. File No. 3-16520 (April 29, 2015)

In this cease and desist proceeding, the SEC charged a hedge fund advisory firm and two of its executives, including its principal and its general counsel, with improperly using the assets of two affiliated funds in order to pay for the firms' operating expenses. According to the Order Instituting Public Administrative and Cease and Desist Proceedings, the SEC alleged that the expenditures were not clearly authorized under the funds' operating documents and were not accurately reflected in the funds' financial statements as related-party transactions. The Order alleges that the operating and limited partnership agreements for the funds, which were created and distributed by the executives to investors in private placement memoranda (PPMs), provided that the firm would bear its operating costs and expenses, but did not include any language that the funds would bear the cost of the firm's operational or administrative expenses. In addition to the PPMs, the Order alleged that the firm and the two executives distributed materially misleading financial statements for the funds that inadequately and incorrectly explained both the total amount of the firms' expenses that were paid for by the funds' assets and the related-party transactions. Finally, the Order alleged that the principal and general counsel were responsible for preparing, reviewing and updating the firm's compliance manual, and that the manual was deficient in failing to include policies and procedures to prevent the nondisclosure of conflicts of interest or to prevent conduct that was not in the best interests of the firm's clients in connection with related party transactions. *See* Order Instituting Proceedings, at ¶¶1, 7-9, 12-16, 22-35.

For his conduct as alleged in the Order, the SEC charged the general counsel with willfully aiding and abetting and causing the firm's and the principal's violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8, and with willfully aiding and abetting the firm's violations of Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7. Without admitting or denying the allegations, the general counsel, together with the firm and its principal, submitted an offer of settlement which the Commission accepted. In addition to ordering the general counsel to cease and desist from further violations of the above provisions of the Advisers Act and accompanying Rules, the Commission temporarily suspended him from any association with a broker, dealer, investment adviser, or related entities, temporarily prohibited him from serving as an officer, director, or member of an investment adviser or related entity, and temporarily suspended him from appearing or practicing before the Commission as an attorney. Based upon the general counsel's sworn Statement of Financial Condition, the Commission did not impose a civil penalty.

SEC v. Chris Faulkner, et al., Civil Action No. 3:16-cv-01735-D (N.D. Tex. filed June 24, 2016)

In this civil action, the SEC has charged four companies and eight individuals, including the general counsel/COO of one of the companies, with a fraudulent scheme involving oil and gas investments. According to the litigation release, the mastermind of the scheme offered and sold unregistered "turnkey" oil and gas working interests, first through a privately-held company that he controlled, and subsequently through a reporting company with shares traded on OTC Link and through two affiliated entities, all of which were also controlled by the scheme's mastermind. *See* Litigation Rel. 23582 (June 24, 2016). Instead of using investors' funds as set forth in the offering materials, the SEC alleges that the defendants misappropriated at least $30 million of the funds for personal expenses. In addition, the SEC alleges that the defendants lied to auditors and made material misrepresentations in the reporting company's public filings. *See id.*

According to the complaint, the general counsel joined the mastermind's private company prior to its acquisition of a publicly-traded company through an asset transfer agreement, and then became general counsel of the new public entity which was portrayed in public filings and on its website as an exploration and production company that would acquire and develop oil and gas prospects in three states. None of the management, however, had any experience in this area, a fact that the complaint alleges was material and was omitted from these disclosures. *See* Complaint, *SEC v. Chris Faulkner, et al.*, at ¶¶72-76.

At about the same time as the asset transfer agreement, the complaint alleges that the mastermind changed the name of one of his private shell companies, installed as its management former management of his privately-held company, and transferred to its staff most of the sales staff and employees from his privately-held company. According to the complaint, this affiliated entity continued the fraudulent scheme that started with the mastermind's privately-held company: offering unregistered oil and gas investments based on embellished cost estimates disguised as legitimate Authority for Expenditures (AFEs) from actual oil and gas drillers and producers, and on production projections from a purportedly independent petroleum geologist who, in fact, was associated with the mastermind's companies and who had an undisclosed record of providing grossly overestimated production figures. The offerings also failed to disclose that the properties offered and sold to investors were subject to ongoing obligations which could result in the loss of investor funds. *See* Complaint, at ¶¶6, 78, 86-92.

Together with the scheme's mastermind, the complaint alleges that the general counsel designed and organized the former shell company to operate covertly as the public entity's sales arm and primary funding source. *See* Complaint, at ¶¶77-78. As alleged in the complaint, the general counsel drafted documents that ostensibly obligated the affiliated entity to pay the public company millions of dollars and to purchase certain prospects at exorbitant premiums, and then instructed the affiliated entity's managing member to sign the documents. According to the SEC, the arrangements set forth in these documents were shams designed to conceal the actual relationship between the affiliated entity and the public company. *See* Complaint, at ¶¶80-82.

The complaint alleges that the mastermind repeatedly requested the affiliated entity to transfer to the public company funds resulting from the offerings, and that the general counsel advised that these transfers did not pose any problem because the two entities were consolidated.

Notwithstanding the existence of an expense reimbursement policy, the complaint alleges that the transferred funds were used to pay the mastermind's personal credit expenses and that the general counsel, indiscriminately and in blatant disregard of the company's internal controls, approved these reimbursements. In order to help conceal the reimbursements, the complaint further alleges that the mastermind and the general counsel obtained personal credit cards that were subordinated to the account of another company officer. According to the SEC, both the general counsel and the mastermind used these credit cards for personal entertainment, with the costs ultimately paid for by investors' funds. *See* Complaint, at ¶¶83-98.

As part of the fraudulent scheme, the complaint alleges that the general counsel signed public filings containing material false and misleading statements concerning (a) the public company's relationship with, and dependence upon, its undisclosed affiliate, (b) the mastermind's control over the affiliate's operations and the personal financial benefits received from it, (c) the fact that the public company's business model was identical to that of the former privately-held company with the affiliate serving as the sales arm,(d) its results of operations, and (e) the sufficiency of its internal controls and the existence of mechanisms to ensure the mastermind's accountability to the board. The complaint further alleges that similar false and misleading statements were made to the company's auditors, and that, because of fraudulent expense reimbursement requests and the disregard for devising and maintaining internal controls, the general counsel caused the company to fail to keep and maintain accurate books and records. *See* Complaint, at ¶¶14, 100-118.

Because of his conduct, the SEC has charged the general counsel with violations of the antifraud provisions of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, the reporting provisions of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-1, 13a-11, and 13a-13, the books and records and internal controls provisions of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, 15 U.S.C. §§78m(b)(2)(A), 78m(b)(2)(B), and with circumventing and failing to implement internal controls under Section 13(b)(5) of the Exchange Act and Rule 13b2-1, making misrepresentations in required reports in violation of Rule 13b2-2, and violating the proxy provisions of Section 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), and Rule 14a-9. The SEC seeks permanent injunctive relief, disgorgement of ill-gotten gains, with prejudgment interest, a civil money penalty, and an officer and director bar.

SEC v. RPM Int'l Inc., et al., Case No. 16-cv-01803 (D.D.C. filed Sept. 9, 2016)

This is a civil fraud action brought by the SEC against a chemical company and its general counsel for the failure to disclose a material loss contingency, or to record an accrual for, a government investigation when such disclosure or recording was required under the securities laws and governing accounting principles. *See* Litigation Rel. No. 23639 (Sept. 9, 2016).

According to the complaint, the investigation arose in response to a complaint filed under the False Claims Act in which the relator alleged that the company's wholly-owned subsidiary overcharged the government on certain government contracts. The general counsel oversaw the

investigation, which ultimately resulted in the company settling with the government for $61 million. *See* Complaint, *SEC v. RPM Int'l Inc., et al.*, at ¶¶2-3. The SEC alleges that the general counsel, who also served as the company's chief compliance officer, failed to disclose material facts about the investigation to the company's CEO, CFO, audit committee, and independent auditors, including the following: (1) that the company sent the government several analyses estimating that its subsidiary's overcharges amounted to at least $11.9 million; (2) that the company agreed to submit a settlement offer to the government by a specified date to resolve the investigation; and (3) that prior to submission of the settlement offer, the overcharge estimates increased to at least $28 million. *See* Complaint, at ¶ 3. The complaint also alleges that the general counsel made material false statements to the company's auditors as to the status of the investigation and the amount of the potential loss to the company. *See* Complaint, at ¶¶31-35.

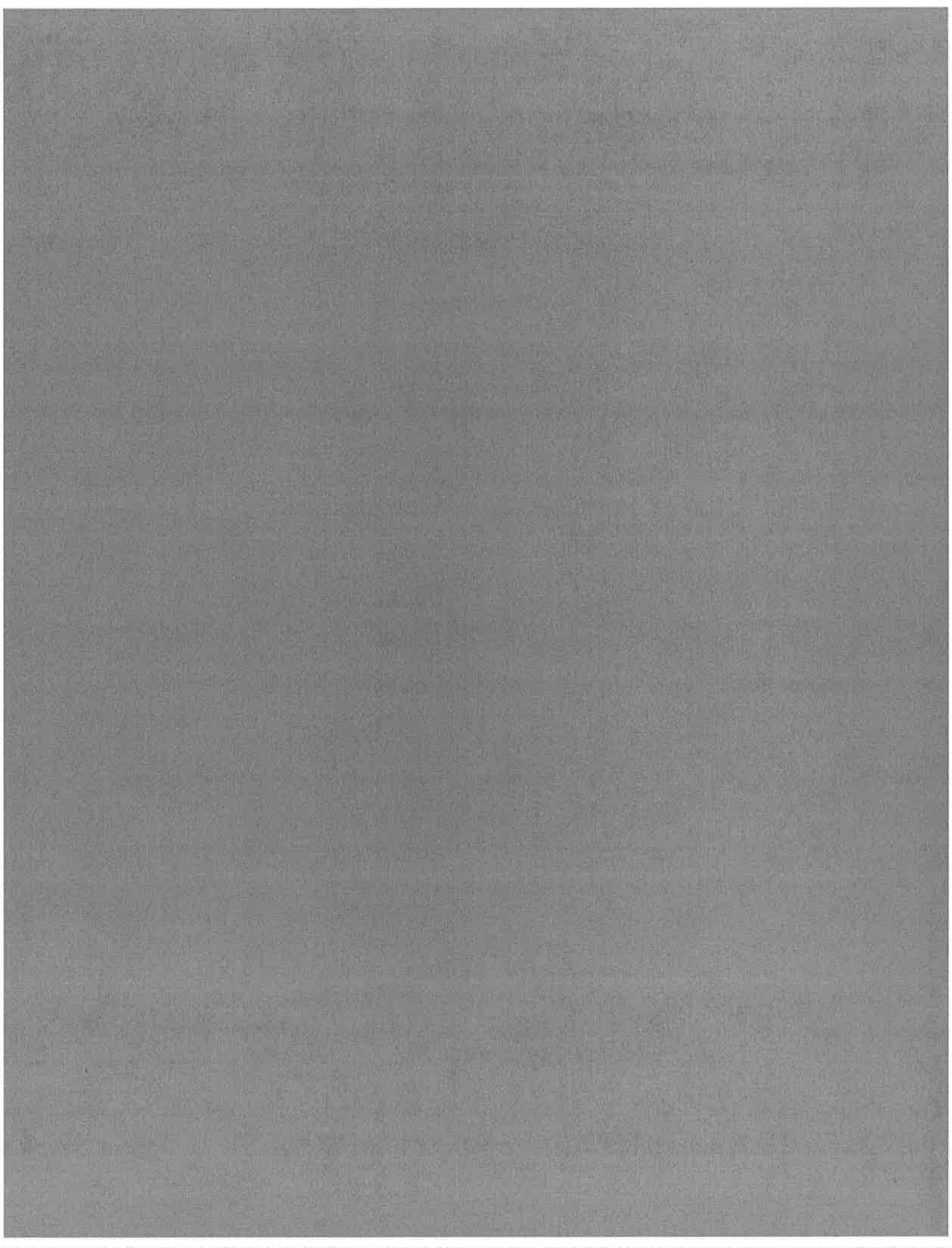
Because of the general counsel's conduct, the complaint alleges that the company filed false and misleading reports to the SEC. Specifically, the complaint alleges that the filings were false and misleading because they failed to disclose a material loss contingency as required by ASC 450-20, a trend or uncertainty reasonably expected to have a material, unfavorable impact as required by Item 303, or material information needed to make the statements not misleading as required by Rule 12b2-20. *See* Complaint, at ¶ 38. Additionally, the complaint alleges that the reports contained false and misleading statements concerning the effectiveness of the company's disclosure controls and procedures. *See* Complaint, at ¶ 40. As a consequence, the complaint alleges that investors were not provided with accurate information regarding the company's financial condition. *See* Complaint, at ¶ 7. In a subsequent restatement of its financial results for the quarters involving the government investigation, the company disclosed the investigation; in amended filings, it also disclosed errors in the timing of its disclosures and accruals for the investigation and weaknesses in its internal controls over financial reporting. *See id.*

The SEC has charged the general counsel with violating Sections 17(a)(2) and (a)(3) of the Exchange Act, 15 U.S.C. §§77q(a)(2) and 77q(a)(3), and Rules 13b2-1 and 13b2-2, and seeks a judgment providing permanent injunctive relief, the payment of disgorgement with prejudgment interest, and the imposition of a civil money penalty.

Criminal Prosecutions

U.S. v. Braslau, No. 2:14-cr-00044-RGK (C.D. Cal. Nov. 14, 2014)

This is a criminal action arising out of the fraudulent movie investment scheme discussed above. On November 14, 2014, the defendant was convicted of eleven counts of mail fraud, five counts of wire fraud, and one count of making false statements to the SEC. On April 27, 2015, the defendant was sentence to 87 months in prison.



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.

By John K. Villa
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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-

John K. Villa, "Inside Counsel as Targets: Fact or Fiction?" *ACC Docket* 23, no. 10 (November/December 2005): 104–107.

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 . . .
Explore information related to this topic

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.*

If you like the resources listed here, visit ACC's Compliance and Ethics Exchange to see the latest additions. If you have questions or need assistance in accessing this information, please contact Nichole Opkins, web editor, at opkins@acca.com with your comments and suggestions.

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").