ANDREWS LITIGATION REPORTER

THOMSON WEST

Securities Litigation & Regulation

COMMENTARY

REPRINTED FROM VOLUME 13, ISSUE 6

Recent SEC Enforcement Actions Against In-House Lawyers: An Ominous Trend for the Legal Profession

By David B. Bayless and Tammy Albarrán

When Enron, WorldCom and the other major accounting frauds of recent history exploded, the cry arose: "Where were the lawyers?" This article focuses on the role of in-house lawyers as "gatekeepers" that came about as a direct result of these accounting scandals, discusses recent enforcement actions by the Securities and Exchange Commission against general counsel of public companies, explains the negative repercussions of this stepped-up enforcement practice, and provide options available to in-house lawyers.

Sarbanes-Oxley Act: The Push to Make Lawyers 'Cops on the Beat'

As a result of the perceived complicity of attorneys in the accounting frauds that surfaced between 2000 and 2002, Congress turned its attention to the duties of lawyers as corporate "gatekeepers" in the Sarbanes-Oxley Act of 2002. Pursuant to congressional mandate in Section 307 of the Sarbanes-Oxley Act, the SEC was required to adopt rules prescribing minimum standards of professional conduct for attorneys appearing and practicing before the agency.

The rules had to mandate "reporting up" obligations for attorneys with evidence of a material violation of securities laws or breach of fiduciary duty. To satisfy this obligation, in-house and outside attorneys must report evidence of a material violation by an issuer or its agent to the issuer's chief legal officer, CEO and board of directors. The purpose of these rules was to deter instances of attorney and company misconduct.

In adopting its final rules, the SEC was forced to defer consideration of the "noisy withdrawal" provisions of the original proposed rule, which would have mandated "reporting out" obligations. Specifically, with respect to in-house counsel, if a board failed to respond to a reported material violation, the proposed rule required the attorney to publicly disaffirm a tainted disclosure document by notifying the SEC.

This proposed provision stirred significant controversy in the bar, in part because it transformed the traditional role of in-house counsel as a trusted adviser who had the complete confidence of senior management to that of a whistle-blowing police officer, thus ensuring an immediate inquiry by the SEC.

While the SEC later proposed alternatives to the original "noisy withdrawal" provisions, these alternatives raised similar concerns. Any attorney mandate to "report out" threatens the attorney-client relationship and the confidentiality that lies at the heart of that relationship. Indeed, "reporting out" obligations discourage open and frank communications between company management and counsel, especially in situations where legal advice is most needed to prevent violations.

2007 Thomson/West.

Since the initial proposal of the "noisy withdrawal" provisions, the SEC has tabled this rulemaking strategy. But what has emerged in its stead is the SEC's efforts to obtain through the enforcement process what it could not obtain through rulemaking.

In-House Lawyers as 'Gatekeepers'

In public remarks made last March, SEC Chairman Christopher Cox, reiterating remarks made two years earlier by the SEC's general counsel, specifically stated that the Division of Enforcement would focus on "gatekeepers" — lawyers, outside auditors, independent directors and investment bankers — whose professional roles put them in a position to prevent, or at least blow the whistle upon, corporate wrongdoing.[1] In fact, the SEC already has begun to focus significant enforcement resources on the role of lawyers as "gatekeepers."

In the case of lawyers, however, there has always been tension at the SEC because it recognizes that lawyers, when engaged in what lawyers do, should not normally be the subject of enforcement actions. Lawyers are advocates for clients, including advocating before or even against the SEC. Enforcement actions against lawyers who engage in such advocacy could chill a lawyer's duty as a zealous advocate. Further, bad legal advice, or even malpractice, is not properly the subject of an SEC enforcement action. Rather, it is properly the subject of a private lawsuit or disciplinary action by state bars.

For these reasons, historically, the SEC brought few enforcement actions against lawyers. And when it did, the conduct that underlay the enforcement action was not peculiar to a lawyer, but rather would make any person liable for securities fraud (*e.g.*, insider trading).

But the SEC's recent focus on lawyers as gatekeepers has now come to a head and overridden the historical reticence of the agency to bring enforcement actions against lawyers. In the first five months of this year, the SEC has settled one enforcement action against a former general counsel and filed seven other enforcement actions against former in-house counsel of public companies (and, in one of these actions, it also sued the company's top in-house securities lawyer) — an unprecedented event. Historically, the agency has not pursued enforcement actions against lawyers (much less against general counsel) as aggressively as it has in the last six months. So this is truly a monumental change in direction by the SEC's Division of Enforcement.

2007 SEC Enforcement Actions Against In-House Counsel

First, on Jan. 10, the SEC settled securities fraud charges against the former general counsel of Comverse Technology Inc., William F. Sorin.[2] The agency charged that Sorin had engaged in a fraudulent scheme for a number of years to grant undisclosed, in-the-money options to himself and others by backdating stock-option grants to coincide with historically low closing prices of Comverse common stock. Sorin created records that indicated that Comverse's compensation committee had approved stock-option grants on certain dates when in reality no such actions had taken place. Sorin also created records that facilitated a similar backdating scheme at a majority-owned subsidiary of Comverse.

Sorin consented to the entry of a final judgment permanently enjoining him from violating both antifraud and non-fraud provisions of the federal securities laws. Under the terms of the settlement, Sorin paid more than $1.6 million in disgorgement, of whichmore than $1 million represented his in-the-money benefit from exercises of backdated stock options. He also paid $800,000 in prejudgment interest and a $600,000 civil penalty. In a separate matter, Sorin pleaded guilty to criminal charges, including conspiracy to commit securities fraud.

Second, about a month later, the SEC filed a federal court action Feb. 15 against the former general counsel of Monster Worldwide Inc., Myron F. Olesnyckyj.[3] The SEC's complaint alleged that for nearly six years Olesnyckyj backdated stock-option grants to coincide with a date on which the stock price was low, resulting in grants of in-the-money options to numerous individuals, including himself.

Olesnyckyj prepared documentation for Monster's compensation committee that reflected dates on which Monster's common stock had a low closing price and that were chosen by certain Monster officers and employees receiving such awards. Olesnyckyj then caused Monster to misrepresent these facts in SEC filings. He also misled Monster's outside auditors by providing them with documentation misrepresenting the grant date of the stock options.

In his settlement with the SEC, Olesnyckyj is permanently enjoined from violating the antifraud and non-fraud provisions of federal securities laws and from serving as an officer or director of a public company.[4]

2007 Thomson/West.

Third, less than two weeks later, on Feb. 28, the SEC sued Kent H. Roberts, the former general counsel and corporate secretary of McAfee Inc.[5] Roberts is accused of wrongfully repricing McAfee's stock-option grants awarded to him and to others to secretly increase their value.

The SEC's complaint alleges that in 2000, without authorization, Roberts changed the grant date of an earlier stock-option grant to himself to take advantage of McAfee's declining stock price. This increased the potential value of his stock-option grant by nearly $200,000. Roberts then allegedly concealed this repricing by filing false stock-ownership reports with the SEC.

Two years later, in 2002, Roberts, as secretary of the compensation committee of the board of directors, created minutes of the committee's meeting that caused the company to issue stock-option grants to the CEO a day later than the committee had actually directed. This resulted in the CEO obtaining a potential benefit of $700,000 due to an intervening decline in McAfee's stock price. Roberts then signed a proxy statement that misleadingly described this grant and failed to disclose the CEO's additional compensation.

According to the SEC, McAfee conducted an internal investigation and Roberts then confessed to his option repricing. But the SEC's press release announcing the lawsuit contained no discussion of any settlement with Roberts.[6] The case is pending before the U.S. District Court for the District of Columbia.

Fourth, the SEC sued two former in-house counsel at Enron March 28 for their alleged roles in the 1999 sale of the company's interest in a troubled Brazilian power project to a partnership controlled by Andrew Fastow, Enron's CFO at the time.[7] According to the SEC, the transaction was intended to inflate Enron's reported revenues shortly before its collapse in November 2001.

The agency alleges that Jordan H. Mintz, Enron's general counsel, made material misstatements about this related-party transaction, which was consummated under an oral side agreement that ensured the partnership did not lose money in the deal. In 2001 Enron bought back its interest in the power project, resulting in a profit to the partnership despite a decrease in the value of the original investment. The SEC alleges that Mintz knew, or was reckless in not knowing, that the buy-back was in fulfillment of the secret oral side agreement — that is, it was a sham transaction.

The SEC further alleges that Rex R. Rogers, Enron's top securities lawyer, made material misstatements in Enron's proxy statement and other SEC filings regarding this transaction (as well as other matters). The case is pending before the U.S. District Court for the Southern District of Texas.

Fifth, on April 2, the SEC sued the former general counsel of Tenet Healthcare Corp. (along with former senior management) for securities fraud based on Tenet's "unsustainable strategy" to reach earnings targets by exploiting a loophole in Medicare's reimbursement system.[8] Significantly, the allegations against Tenet's former general counsel, Christi R. Sulzbach, are based on the failure to disclose Tenet's strategy, its impact on revenues and earnings, and its unsustainability in the company's SEC filings, and, in particular, in the MD&A portion of Tenet's public filings.

The SEC seeks a permanent injunction against future violations of the federal securities laws, an order barring Sulzbach from serving as an officer or director of a public company, disgorgement of ill-gotten gains (with prejudgment interest), and civil penalties. The case is pending in the U.S. District Court for the Central District of California.

Sixth, the SEC sued Kevin J. Heron, the former general counsel and corporate secretary of Amkor Technology Inc., for insider trading April 18.[9] The SEC alleged that from October 2003 through June 2004 Heron engaged in a pattern of insider trading prior to Amkor's public announcements relating to financial results and business transactions. He allegedly executed more than 50 illegal trades in Amkor stock and options based on material nonpublic information he acquired in his role as general counsel. Almost all these trades were executed during the company's blackout periods.

The SEC is seeking injunctive relief, disgorgement, civil penalties, as well as a bar on Heron serving as an officer or director. This case is pending in the U.S. District Court for the Eastern District of Pennsylvania. Heron was also indicted for criminal securities fraud violations with respect to this same conduct.

Seventh, on April 24, the SEC sued Apple Inc.'s former general counsel, Nancy R. Heinen, for her alleged participation in the fraudulent backdating of stock options granted to the computer company's senior executives.[10] According to the SEC, Apple backdated a February 2001 grant of 4.8 million options to the executive team, which included Heinen, and a December 2001 grant of 7.5 million options to Apple CEO Steve Jobs.

Heinen allegedly directed her staff to prepare documents indicating that the board had approved the grant to Apple's executive team Jan. 17, 2001, when they had not, and she created board minutes stating the board had approved Jobs' grant at a special meeting Oct. 19, 2001, when such a meeting never occurred. It goes without saying that Apple's share price was substantially lower on those dates.

The SEC alleges that Heinen's conduct caused Apple to under-report its expenses by nearly $40 million. The agency is seeking injunctive relief, disgorgement and civil penalties, in addition to an order barring Heinen from servings as an officer or director of a public company. The case is pending in the U.S. District Court for the Northern District of California.

Finally, on May 31, the SEC sued Mercury Interactive's former general counsel, Susan Skaer, for securities fraud.[11] The agency alleges that Skaer participated in a scheme from 1997 to 2005 to award herself and other senior officers and employees undisclosed compensation by backdating stock-option grants, failing to record hundreds of millions of dollars in compensation expenses, and creating documents to further this scheme.

The SEC alleges that Mercury and its senior executives, including Skaer, backdated option grants despite a 1998 shareholder-approved change in Mercury's stock-option plan that required options to be priced at the fair market value of the company's stock on the grant date. As alleged in the SEC's complaint, Skaer helped select historical dates for the backdated grants and prepared documentation memorializing backdated option grants. Skaer allegedly benefited personally by receiving backdated stock options that were in-the-money. Skaer is also alleged to have assisted in structuring loans for option exercises by overseas employees to avoid recording expenses.

The SEC is seeking injunctive relief, disgorgement and civil penalties, in addition to an order barring Skaer from serving as an officer or director of a public company. The case is pending in the U.S. District Court for the Northern District of California.

The Meaning and Impact of These Enforcement Actions

What are the lessons from these eight cases against nine attorneys? The sixth action mentioned above — alleged insider trading by Amkor's Heron — is a classic suit against an attorney. After all, being an attorney does not render a person exempt from the prohibition against insider trading. So that action is not a surprise and does not amount to a change in policy.

But the five stock-option cases are different. Assuming the SEC's allegations are true (which may or may not be proven), the type of conduct that those in-house lawyers engaged in is the type of conduct that lawyers typically undertake: preparing board or compensation committee minutes, preparing and editing disclosures in SEC filings and proxy statements, and documenting stock-option grant dates. It is unusual for these types of actions to be the subject of an SEC enforcement action for securities fraud.

Yet, to be fair, no lawyer should be surprised to be the subject of an SEC investigation if he or she prepares an SEC filing that contains a statement that the lawyer knows is false. Likewise, knowingly preparing false corporate documents that are attached to, or incorporated in, SEC filings also would be, not surprisingly, the subject of a fraud investigation. But the "knowing" element is critical. In-house lawyers — at least with respect to the practice of backdating or repricing option grants, or their documentation — likely relied on outside counsel for advice or were documenting what they honestly thought had been approved. So unless they actually *knew* that they were preparing false documents, these cases by the SEC seem to be a stretch and beyond what the agency has traditionally done in this area.

And the Tenet and Enron cases are really aggressive positions by the SEC. First, the claims against the lawyers in those cases, especially Tenet's Sulzbach, are based upon the absence of language in the MD&A, *i.e.*, non-disclosures. But deciding whether to disclose something and how to disclose information are quintessential attorney tasks — judgments that lawyers make daily. As practicing attorneys know, determining what does or does not go into the MD&A requires judgment and analysis. Often there are no right or wrong answers. To have such judgments second-guessed after the fact in an enforcement action for securities fraud is truly terrifying.

Second, the Enron case presents a harsh reality for in-house counsel, specifically with respect to the SEC's expectations of them. The allegation that Mintz was "reckless in not knowing" that a related-party transaction was in fulfillment of a "secret oral side agreement" makes clear in stark terms the SEC's new expectations of in-house counsel. In-house counsel are not only expected to blow the whistle upon learning of corporate wrongdoing, but now they also are expected to play the role of private investigator and somehow discover "secret" oral side deals or else be sued for securities fraud.

2007 Thomson/West.

This standard erodes the inherent trust between in-house lawyers and their clients (*i.e.*, the company and its management). After all, in advising the company, in-house counsel must be able to rely on and trust the representations of management. They should not be expected to question the veracity of every representation or view every representation of management with a high degree of skepticism. That simply is not the role of in-house attorneys.

What Can In-House Counsel Do?

So, what can in-house counsel do? There appear to be at least four options.

First, when confronted with borderline conduct or issues on the margin, in-house lawyers should seek and obtain advice from outside counsel. Like any person seeking legal advice, they must make sure that they inform outside counsel of *all* relevant and material information related to the legal advice sought.

This helps because an outside law firm may spot issues that the in-house lawyer never sees. All lawyers understand the benefit of running a course of action by another lawyer to get his or her view. This same principle applies to in-house counsel talking to outside counsel.

And in-house lawyers are in a difficult position because, while their client is the company, as a practical matter, senior management normally retains them and may put subtle — or not so subtle — pressure to do things not obviously illegal, but that may be questionable. Often these pressures are unconscious and can become ingrained. In-house lawyers want to be seen as "team players" and want to avoid the perception of always saying "no" to a proposed course of conduct. Senior management wants in-house lawyers to enable — not disable — a course of conduct. Outside counsel do not face these same pressures. In the worst-case scenario, reliance on such legal advice is a defense to fraud.

Second, in-house lawyers can be more proactive and participate in internal discussions where the opportunity to engage in potential wrongdoing may exist. For example, in-house lawyers can actively participate in discussions with accounting personnel at the company or on the disclosure committees of the company. It is also good practice to meet periodically with those individuals responsible for the company's financial reporting functions, such as any internal audit group, accountants and outside auditors. Having the in-house lawyer actively involved can help prevent situations where disclosures are unintentionally not made or made inaccurately.

Third, in-house counsel can flex their collective muscles and assert pressure on the SEC to change its course of action. Trade associations such as the Association of Corporate Counsel can and should speak out against the SEC's enforcement practices.[12] This has worked in the past, specifically in the area of corporate penalties.

Since the passage of Sarbanes-Oxley in 2002, civil penalties imposed against public companies grew dramatically both in amount and frequency. Critics questioned the SEC's lack of standards for determining such penalties, deeming the agency's practices arbitrary and inconsistent. Others criticized the SEC's approach as accomplishing nothing more than penalizing the very same shareholders who were victimized by the alleged fraud.

After much pressure and to address those criticisms, the SEC released a statement setting out guidelines for imposing civil penalties on corporations that violate the federal securities laws.[13] There is much that can be accomplished by rattling the cage.

Finally, when push comes to shove, in-house counsel can always, and in some instances should, fight back. As a recent federal court decision shows, the SEC does lose cases on the merits. In *SEC v. Todd*[14] the court granted almost all the post-trial motions made by two former Gateway Inc. executives charged with securities fraud and aiding and abetting filing violations. Significantly, the court noted throughout the opinion that either the evidence was not what the SEC claimed or there simply was no evidence to support the agency's allegations.

So, when the stakes are high, as in the case of in-house lawyers sued for securities fraud whose careers and livelihoods are on the line, the battle may be worth the economical and emotional costs of forcing the SEC to prove its case. Litigating against the SEC remains a viable option for in-house lawyers facing an enforcement action.[15]

The Resulting Changing Role of In-House Counsel

This recent trend of enforcement actions against general counsel, whether deliberate or unintended, accomplishes what the SEC failed to achieve with the "noisy withdrawal" provisions initially proposed in Section 307 of Sarbanes-Oxley: deputizing lawyers and encouraging them to report violations to the SEC. In-house lawyers are now being closely scrutinized by the agency for failure to be the "cop on the beat."

But, as noted in the beginning, this fundamentally changes the role of in-house counsel. Historically, in-house attorneys have viewed themselves, and have been viewed by company management, as "trusted advisers." In-house counsel, to do their job effectively, must have full and frank discussions with senior management. And management must feel free to communicate honestly and

fully with in-house counsel, confident that the lawyer, as a trusted adviser, will advise what is best.

But once management adjusts to the new reality of in-house counsel being, in essence, an extension of the government — the cop on the beat — the dynamics within corporate America will likely change. This is not at all an unlikely or farfetched scenario. Our admittedly informal polling of in-house counsel has confirmed this changing dynamic. More often we are hearing from in-house counsel that certain issues are not brought to their attention early on, and the fear is that this is occurring as a result of a shift in how in-house lawyers are perceived internally. They are no longer viewed as the company's confidantes.

So, the bottom line is that in-house lawyers are squarely within the target zone of the SEC's Division of Enforcement. The agency has stated this publicly in the past, but now is bringing an unprecedented number of enforcement actions. The SEC's stated emphasis on lawyers as gatekeepers is no longer just talk. Based on what we've seen so far in 2007, the agency is proving that it meant what it said.

Notes

[1] *See* Christopher Cox, Chairman, Securities and Exchange Commission, Address to the 2007 Corporate Counsel Institute (Mar. 8, 2007), *available at* http://sec.gov/news/speech/2007/spch030807cc.htm. *See also* Giovanni P. Prezioso, General Counsel, Securities and Exchange Commission, Remarks Before the Spring Meeting of the Association of General Counsel (Apr. 28, 2005), *available at* http://sec.gov/news/speech/spch042805gpp.htm.

[2] *See SEC v. Alexander et al.*, No. CV-063844 (E.D.N.Y.); SEC Litigation Release No. 19964 (Jan. 10, 2007).

[3] *See SEC v. Olesnyckyj*, No. 07 CV 1176 (HB) (S.D.N.Y. 2007).

[4] *See* SEC Litigation Release No. 20056 (Mar. 27, 2007).

[5] *See SEC v. Roberts*, No. 07-CV-00407 (D.D.C. 2007).

[6] *See* SEC Litigation Release No. 20020 (Feb. 28, 2007).

[7] *See SEC v. Mintz et al.*, No. 07-1027 (S.D. Tex. 2007).

[8] See SEC v. Tenet Healthcare Corp. et al., No. CV 07-2144 (C.D. Cal. 2007).

[9] *See SEC v. Heron*, No. 07-cv-01542 (E.D. Pa. 2007).

[10] *See SEC v. Heinen et al.*, No. 07-2214 (N.D. Cal. 2007).

[11] See SEC v. Mercury Interactive LLC et al., No. 07-2822 (N.D. Cal. 2007).

[12] Trade associations can also impact proposed rulemaking. The Association of Corporate Counsel has played an important role in advocating on behalf of in-house counsel on issues that could impact their professional roles. In 2002 the ACC (formerly known as the American Corporate Counsel Association) submitted to the SEC persuasive comment letters that detailed how impractical and detrimental proposed "reporting out" requirements would be to the confidential nature of the lawyer-client relationship. Ultimately, the SEC reconsidered these requirements. *See* Comments of American Corporate Counsel Association on S7-45-02 (Dec. 18, 2002), *available at* http://sec.gov/rules/proposed/s74502/bnagler1.htm; *see also* Comments of American Corporate Counsel Association on S7-45-02 (Apr. 7, 2003), *available at* http://sec.gov/rules/proposed/s74502/acca040703.htm.

[13] Christopher Cox, Chairman, Securities and Exchange Commission, Statement of Chairman Christopher Cox Concerning Objective Standards for Corporate Penalties (Jan. 4, 2006), at 1, *available at* http://www.sec.gov/news/speech/spch010406cc.htm; Statement of the Securities and Exchange Commission Concerning Financial Penalties, SEC Press Release No. 2006-4 (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

[14] *See SEC v. Todd*, No. 3:03-cv-02230-BEN-WMC (S.D. Cal. May 30, 2007) (order granting in large part defendants' motion for judgment as a matter of law).

[15] *See* Jamie A. Levitt, David B. Bayless and Geoff Graber, *Is Litigating Against the SEC an Option for Individuals?*, A.B.A. Sec. Litig. J., 17 (Winter 2007).

David B. Bayless is a partner and **Tammy Albarrán** is a special counsel at **Covington & Burling** in San Francisco, where they specialize in SEC enforcement work, internal investigations and private securities class-action litigation. Mr. Bayless was the head of the SEC's San Francisco office from 1994 to 1999. Mr. Bayless and Mrs. Albarrán have extensive experience representing public companies; their officers, directors and employees; broker-dealers; and investment advisers in SEC investigations and enforcement actions.

2007 Thomson/West.