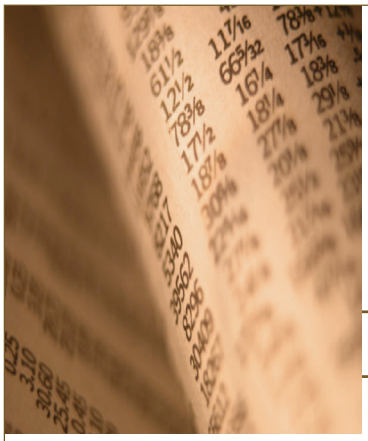

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Securities Law Developments NEWSLETTER

OCTOBER 22, 2003

# SEC Action Serves as a Warning to Outside Directors and Audit Committee Members

In an action with potentially far-reaching ramifications for outside directors and audit committee members, the Securities and Exchange Commission (the "SEC or Commission") charged Chancellor Corporation ("Chancellor"), a Massachusetts transportation equipment company, four former officers, and a former outside director with securities fraud.[1] Of particular note is the fact that the SEC charged an outside director, who was also chairman of the audit committee, with fraud solely on the basis of his failure to respond to significant red flags that should have alerted him to improprieties in which he played no direct role. This lawsuit highlights the increasing focus—in the courts as well as before the SEC—on the role of outside directors in overseeing management and protecting shareholders' interests.

Filed in the United States District Court for the District of Massachusetts, the charges stem from an alleged scheme in which Chancellor's former Chief Executive Officer ("CEO") directed the wholesale fabrication of corporate documents and coordinated the filing of false financial statements with the Commission. The Commission claimed that several former officers participated in the scheme by preparing and signing false or misleading financial documents.[2]

The Commission also charged a former outside director and chairman of Chancellor's audit committee, even though he was not alleged to have participated in preparation of the false financial statements. The outside director allegedly violated the anti-fraud provisions of the securities laws by "ignoring clear warning signs that financial improprieties were ongoing at the company and by failing to ensure that the company's public filings were accurate."[3] As Commission Enforcement Chief Stephen Cutler stated in a recent interview, "This case signifies the Commission's willingness to pursue cases against outside directors who were reckless in their oversight of management and asleep at the switch."[4]

**Factual Background**

*Falsification of Documents Supporting Premature Financial Consolidation*

According to the SEC's complaint, on August 1, 1998, Chancellor entered into a letter of intent to acquire MRB, Inc., a Georgia corporation involved in the retailing and wholesaling of used transportation equipment. Although Chancellor and MRB did not finalize the acquisition until January 1999, Chancellor's CEO, Brian Adley, directed Chancellor's officers to account for the MRB acquisition as of August 1, 1998. By prematurely consolidating the two company's financial results, Chancellor improperly increased its reported 1998 revenue by 177%.[5]

[1] SEC Litigation Release No. 18104 (April 24, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18104.htm

[2] *Id.*

[3] Complaint, Securities and Exchange Commission v. Chancellor Corporation, *et. al.* [hereinafter *Complaint*], *available at* http://www.sec.gov/litigation/complaints/comp18104.htm

[4] Otis Bilodeau, *SEC to go after directors who ignore fraud*, CHI. SUN TIMES, August 21, 2003, *available at* http://www.suntimes.com/output/business/cst-fin-sec21.html

[5] *Complaint*, at ¶ 2.

Chancellor's independent auditors at that time advised Adley that this premature consolidation violated Generally Accepted Accounting Principles ("GAAP"). In response to the auditors' concerns, Adley, Franklyn Churchill, Chancellor's Chief Financial Officer ("CFO") and David Volpe, the Chief Operating Officer ("COO"), allegedly backdated an existing Management Agreement between Chancellor and MRB and forged an amendment to the Agreement. The SEC charges that the officers hoped the fraudulent documents would allay any concerns the auditors had about the consolidation date and enable the auditors to sign off on the transaction.

Prior to receiving the fraudulent documents, the auditors sent letters to Chancellor's audit committee and board of directors advising that the premature consolidation was improper.[6] After receiving the altered documents, the auditors' position remained unchanged and they continued to insist that Chancellor account for the MRB acquisition as of January 1999. The Complaint alleges that when the auditors refused to sign off on the premature consolidation, Adley and Volpe fired them.[7]

After firing the auditors, Chancellor engaged the accounting firm of Metcalf Davis to conduct an independent audit of its 1998 financial statements. At Adley's direction, Volpe and Churchill provided Metcalf Davis with falsified documents indicating that Chancellor had acquired control of MRB as of August 1, 1998. The Commission charges that, although Metcalf Davis had reason to question the authenticity of these documents, the auditors nevertheless signed off on the consolidation as of August 1, 1998.

*Chancellor's Filing of Materially Misleading Financial Statements*

In April of 1999, Adley, Churchill, and Rudolph Peselman, an outside director and member of the audit committee, signed Chancellor's Form 10-KSB for 1998. In signing the Form, Adley, Churchill, and Peselman certified that "there was no fraud involving management" and that Chancellor's financial statements conformed with GAAP. The Commission, however, claims that the financial statements accompanying the Form 10-KSB contained misstatements and misrepresentations and violated GAAP by prematurely consolidating the financial results of MRB and Chancellor for 1998. According to the Commission, Chancellor's Form 10-KSB also falsely represented that Chancellor owed millions to a consulting company owned by Adley for consulting services provided in connection with the MRB merger.[8]

Upon reviewing Chancellor's 1998 filings, the Commission's Corporate Finance Staff advised Chancellor that the August 1998 consolidation date appeared improper and directed the company to restate its 1998 financials to reflect a 1999 consolidation date. The Staff further informed Chancellor that, when restating its financials, it would have to expense rather than capitalize the consulting fees paid to Adley's company.[9] In corresponding with the Staff regarding the restatement, however, Chancellor allegedly provided false information. Moreover, the forms restating Chancellor's 1998 financial results, forms signed by Adley, Churchill, and Peselman, allegedly contained additional material misrepresentations, false statements, and omissions.

**The Commission's Charges**

*Charges Against the Officers*

In the face of these alleged improprieties, the Commission charged Adley, Churchill, and Volpe with violating Rule 10b-5, aiding and abetting Chancellor in reporting false and misleading information, maintaining false and misleading books and records, and failing to maintain internal controls. Additionally, the Commission charged the officers with circumventing internal controls, falsifying accounting records, and misrepresenting information to auditors.

*Charges Against the Outside Directors*

The Commission moved aggressively against Peselman, the outside director and audit committee chairman. While Peselman may not have actively participated in any fraud, he allegedly ignored a number of glaring red flags that, if examined, would have led him to discover the misconduct at Chancellor. The Complaint charges that Peselman failed to question why Metcalf Davis signed off on the 1998 consolidation date when Peselman knew Chancellor's previous auditors had refused to do so. Peselman also allegedly signed financial statements containing conflicting information without attempting to reconcile the conflict or ascertain the truth. According to the SEC, Peselman signed financial statements reflecting millions of dollars owed to Adley's entities without checking whether there was adequate support for the amounts or whether the related party transactions were adequately disclosed.

The Commission asserted that Peselman violated the securities laws by:

1. Signing Chancellor's 1998 Form 10-KSB without taking any steps to ensure that it did not contain materially misleading statements;
2. Signing two restatements of Chancellor's finances even though the restatements contained misstatements and contradictions to earlier filings that Peselman had signed;

[6] The Commission contends that Adley, Churchill, and outside director Rudolph Peselman received the auditors' letter at a board meeting. *Id.* at ¶ 25.

[7] *Id.* at ¶ 28.

[8] The Commission maintains that even if the fees had been genuine, Chancellor failed to conform to GAAP by capitalizing the fees rather then expensing them. *Id.* at ¶ 39.

[9] *Id.* at ¶¶ 51-58.

3. Failing to inquire into the reasons underlying the approval of the 1998 consolidation of MRB even though that approval was completely contrary to the position of Chancellor's original auditors; and
4. Acquiescing in the CEO's complete control of accounting decisions, including those relating to payments to the CEO's own consulting company.[10]

The SEC charged that Peselman "completely neglected to fulfill his duties as a director and audit committee member."[11] He allegedly failed to oversee Chancellor's financial reporting and exercised no care to ensure that the company had appropriate accounting procedures and internal controls in place or that its financial records were accurate.[12] As a result of these alleged failures, the Commission charged Peselman with violating Rule 10b-5, aiding and abetting Chancellor's reporting of false and misleading information, and maintaining false and misleading books and records.[13]

In addition to charging Peselman for the alleged fraud at Chancellor, the Commission also entered into a settlement with Michael Marchese, another former outside director. The Commission found that Marchese acted recklessly in signing Chancellor's Form 10-KSB for 1998 and did not fulfill his responsibility as a director to ensure that Chancellor maintained accurate books and records and adequate internal controls. Without confirming or denying the Commission's findings, Marchese consented to an order requiring him to cease and desist from committing or causing any violations or future violations of the anti-fraud, periodic reporting, record keeping, and internal control provisions of the federal securities laws.[14]

**Background and Implications for the Future**

In recent financial frauds, significant attention has been given to the perceived failure of outside directors, and particularly audit committee members, to exercise adequate vigilance. What began in the late 1990s as relatively non-controversial attention to the role of directors and audit committee has developed into focused and critical examination of the adequacy of particular boards' discharge of their duties in highly publicized financial frauds. It should not be surprising that the Commission is now putting the force of its remedial power behind this public demand for board accountability, and it is to be expected that the Commission will continue to do so in the future.

In the late 1990s, the New York Stock Exchange and the National Association of Securities Dealers constituted the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee"). Commissioned to study all aspects of audit committee composition and function, the Blue Ribbon Committee issued a report containing ten recommendations for improving audit committee independence, operations, and effectiveness.[15] The recommendations were primarily structural, addressing such matters as independence, qualifications, and procedures. Responding to these recommendations, the Commission adopted new rules designed to enhance the reliability of financial statements and to improve disclosure regarding audit committees.[16] Similarly, the New York Stock Exchange, the Nasdaq Stock Market, and the American Stock Exchange promptly followed suit by amending their listing requirements to reflect the Blue Ribbon Committee's recommendations.[17]

In the wake of the corporate scandals of the last two years, a much harsher light has been placed on the conduct of directors in general, and audit committees in particular.[18] The Boards of Directors of Enron and WorldCom, as prime examples, have been harshly criticized for their action and their inaction in the events leading to the collapse of those companies.[19] Congress' most concrete response, the Sarbanes-Oxley Act of 2002, includes provisions requiring

[10] *Id. at* ¶¶ 48, 60.

[11] *Id.* at ¶ 60.

[12] *Id.*

[13] As sanctions for Peselman's alleged violations, the Commission seeks civil money penalties and a permanent prohibition on Peselman acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act. *Id.*

[14] SEC Litigation Release No. 18104, *supra* note 1.

[15] Report and Recommendations of the Blue Ribbon Committee on Improving Effectiveness of Corporate Audit Committees (1999), *available at* http://www.nyse.com/about/p1020656067652.html?displayPage=%2Fpress%2F1020656068711.html

[16] Securities and Exchange Commission Release No. 34-42266 (Dec. 22, 1999) (Final Rule: Audit Committee Disclosure), *available at* http://www.sec.gov/rules/final/34-4226.htm

[17] The new listing requirements adopted by the exchanges involved (1) who is an independent director for purposes of audit committee membership, (2) the audit committee charter, and (3) what are the structure and duties of the audit committee. *See Responses of the Major Stock Markets to the Blue Ribbon Committee and COSO Reports*, BNA Corporate Practice Series, 49-3rd § 3 (2003).

[18] As the Commission's Chief Accountant noted in a 2002 speech, because accounting and auditing matters are on the front page of newspapers and in the evening news like never before, regulators expect audit committees to play a central role in "insuring the integrity of published financial statements on which investors rely and which are central to the efficiency of capital markets." Securities and Exchange Commission Chief Accountant, Robert K. Herdman, Making Audit Committees More Effective, Address Before the Tulane Corporate Law Institute (Mar. 7, 2002), *available at* http://www.sec.gov/news/speech/spch543.htm.

[19] This has included a report by the Senate Permanent Subcommittee on Investigations entitled "The Role of the Board of Directors in Enron's Collapse," S. Rep. 107-70, 107th Cong., 2d Sess. (July 8, 2002), and reports by a court-appointed monitor, a bankruptcy court-appointed examiner, and a special committee of independent directors in WorldCom. *See Restoring Trust*, Aug. 2003, *available at* http://www.findlaw.com/hdocs/docs/worldcom/corpgov82603rpt.pdf; Second Interim Report of Dick Thornburgh, June 9, 2003, *available at* http://www.findlaw.com/hdocs/docs/worldcom/bkexmnr60903rpt2d.pdf; Report of Investigation by the Special Investigative Committee, Mar. 31, 2003, *available at* http://www.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf. Wilmer, Cutler & Pickering acted as counsel to the Special Investigative Committee in connection with its report.

corporate audit committees to take a number of steps intended to improve governance and oversee the work of outside auditors.[20]

As required by the Sarbanes-Oxley Act, the Commission adopted new audit committee rules that set forth independence standards a director must satisfy in order to serve on an audit committee.[21] The new rules also addressed complaint procedures, accounting firm retention, audit committee funding and a committee's ability to engage independent counsel.[22] The Commission acknowledged many securities experts' concern that "audit committees may be exposed to additional liability, and that consequently it may be difficult for companies to find qualified people to serve on audit committees."[23] The Commission stated at the time that "it is not our intention to subject audit committee members to increased liability."[24] Despite those earlier assurances, the *Chancellor* action makes clear that individuals must be conscious of the potential liability they face in serving on an audit committee.

Indeed, just as the Enforcement Division has made failure-to-supervise claims a regular aspect of its proceedings against regulated entities in recent years, it may be expected to take a careful look at the role of directors, as well as senior management, in corporate financial frauds in the future. SEC Enforcement Chief Stephen Cutler warned of as much in characterizing this action as a "first salvo" in what may be a continuing campaign scrutinizing the conduct of outside directors.[25] According to Cutler, the case against Peselman will serve as a model for future enforcement actions against outside directors who ignore clear warning signs of ongoing financial improprieties.

What does this mean for directors and audit committee members seeking to satisfy the standards of this new era? When serving on the board or on an audit committee, a conscientious director will, among other things

- Insist on adequate time to review documents before filing;
- Put forth the necessary effort to understand the transactions he or she is being asked to approve;
- Diligently pursue any indication of disagreement with auditors, learn why the disagreement arose, and understand how the disagreement was resolved;
- Carefully examine interested party transactions; and
- Ensure that an independent examiner with no stake in the outcome investigates whistle-blower type allegations made to the board.

In the current environment, board actions are placed in the harshest light and viewed with the benefit of hindsight after corporate wrongdoing is discovered. The SEC has made clear its determination to improve the quality of board oversight by making examples of directors it believes were not vigorous in responding to red flags.

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[20] The Sarbanes-Oxley Act directed the Commission to promulgate audit committee independence requirements and issue rules regulating a public company's retention of accounting firms, its handling of accounting complaints, the amount of funding it must provide to its audit committee, and the audit committee's authority to engage advisors. 15 U.S.C.S. § 78j-1(m)(2003)

[21] Securities and Exchange Commission Releases Nos. 33-8220; 34-47654; IC-26001 (Final Rule: Standards Relating to Listed Company Audit Committees), *available at* http://www.sec.gov/rules/final/33-8220.htm#respon

[22] *Id*.

[23] Securities and Exchange Commission Release No. 34-42266*, supra* note 16.

[24] *Id.*

[25] Bilodeau, *supra* note 4.