Parallel Prosecutions and Their Collateral Consequences

Parallel criminal and SEC prosecution presents new risks for companies—and complicated questions for their general counsel.

BY STEPHEN A. JONAS AND JONATHAN A. SHAPIRO

NEWSCOM.COM

[IN BRIEF]

An unprecedented spike in SEC-related criminal cases demonstrates that parallel prosecutions may be here to stay. GCs facing such an investigation or prosecution should:

- Recognize the warning signs of a potentially serious inquiry
- Think disclosure
- Assume that multiple agencies are collaborating in the investigation
- Understand that parallel does not mean simultaneous
- Remember that all conversations with the government are memorialized—and that the Fifth Amendment has a downside
- Ensure that cooperation with the government is real, not cosmetic
- Avoid being labeled obstructionist

Presumably no one from HealthSouth was in the Ann Arbor lecture hall in November 2002, when the Securities and Exchange Commission's enforcement chief delivered the message to University of Michigan law professors and students that "it's a whole new ball game." Instead of "cajoling" criminal prosecutors into bringing securities cases, director Stephen Cutler explained that his Enforcement Division was "fending off calls." Only the setting was academic: the SEC and U.S. attorneys now routinely prosecute public company malfeasance with "parallel" criminal and civil enforcement proceedings.

The SEC's message arrived in Birmingham, Alabama, on March 18, 2003. The FBI executed a search warrant at HealthSouth's headquarters and seized documents from its executives' offices as part of an investigation that later culminated in the first criminal prosecution for a violation of the Sarbanes-Oxley certification requirements. The other shoe dropped the following day, when the SEC filed a civil enforcement action against the company and then-CEO Richard Scrushy, and a federal court entered a temporary restraining order escrowing "extraordinary payments" by the company and freezing Scrushy's personal assets. To date, 15 former HealthSouth executives have pled guilty to various securities fraud charges, and in November an 85-count indictment was unsealed charging Scrushy with securities fraud, mail and wire fraud, money laundering, conspiracy, and other federal offenses.

The HealthSouth case is a prime example—but by no means the only one—of the government's willingness to bring parallel prosecutions: WorldCom, Enron, Qwest, Adelphia, Rite Aid, and Imclone/Martha Stewart are just a few of the others. General counsel should expect the SEC and U.S. attorneys to continue to prosecute the same conduct, under the same or similar statutes, without any effort to divvy up investigations for sole prosecution by one agency or the other.

The trend is not limited to headline cases:

- "SEC-related criminal cases" were filed against 259 defendants during fiscal year 2002. The last time the commission

From left: Joel Gordon, acting chairman of the board of directors at HealthSouth; Sage Givens, an audit committee member; Phillip Watkins, former compensation committee member; Larry Striplin, former chairman of the compensation committee; and Robert May, acting CEO of HealthSouth, are all sworn in prior to testifying before the House Subcommittee on Oversight and Investigation on November 5, 2003, in Washington, D.C.

reported the statistic was 1999, when, according to the annual report, there were just 64 indictments or informations in "related criminal proceedings." Although the SEC has not yet released official numbers for fiscal year 2003, by all indications the prosecutors again will break records.

• Since its inception in 2002, prosecutors working with the President's Corporate Fraud Task Force have investigated potential corporate fraud involving more than 500 individuals and companies and filed at least 169 corporate fraud crime cases. (See "Getting the Bad Guys," p. 37.)

• Last fall, SEC Chairman William Donaldson told a room of corporate directors and their counsel that he is putting "new cops on the beat." Smaller issuers and those accused of less egregious conduct may bear the brunt of the SEC's 800-plus additional lawyers, accountants, and other personnel.

General counsel should expect the SEC and U.S. attorneys to continue to prosecute the same conduct, under the same or similar statutes, without any effort to divvy up investigations for sole prosecution by one agency or the other.

• Since the summer, the SEC has aggressively prosecuted (sometimes in tandem with criminal prosecutors) "other participants" in securities fraud, who before now were probably out of danger. Enforcement actions have been brought against lower-level employees, those who may not have benefited (at least directly) from the alleged misconduct, or didn't benefit much, as in the recent case against an attorney who avoided a $922.14 loss by insider trading. (The SEC brought the latter case as part of a broader investigation with help from the FBI, the National Association of Securities Dealers, the San Diego District Attorney, the British Columbia and Ontario Securities Commissions, and the Royal Canadian Mounted Police.)

• The SEC has prosecuted private and public companies that engage in round-trip or side-letter deals that wind up as someone else's overstated revenue, which is what happened to a former executive of Logicon (aiding and abetting securities violations by Legato Systems Inc.) and executives of a private company that assisted Homestore in implementing a round-trip transaction. Given this trend, counsel also may wish to monitor relationships with vendors and other business partners.

Making Difficult Decisions With Limited Information

Companies under parallel criminal and civil investigations are extraordinarily vulnerable because decisions that bolster the defense of one proceeding may compromise or even imperil their position in another. Unfortunately, general counsel

Timeline: From All Sides

In just two years, Homestore, the online real estate company, has faced some two dozen shareholder suits, five rounds of prosecution, and more.

December 6, 2001 Resignation: Homestore CFO resigns ("personal reasons").

December 21, 2001 Restatement: Homestore announces plan to restate financials (extent and time period unknown) and inquiry into accounting practices. Trading halted.

December 27, 2001 Shareholder Suit: First of at least 19 class actions filed (federal court).

January 2, 2002 Restatement: Homestore announces preliminary finding that advertising expense in FY 2001 overstated by $54 million–$95 million.

January 4, 2002 Shareholder Suit: First of four derivative actions filed (California and Delaware state courts).

January 7, 2002 Resignation: Homestore announces new CEO, CFO, and COO. Former CEO resigns to pursue new technology venture.

January 16, 2002 Resignation: Seven more employees terminated or resign.

February 22, 2002 NASDAQ: Trading resumes, but market initiates delisting process for failure to timely file SEC filings.

March 12, 2002 Restatement: Homestore announces that it overstated FY 2000 revenue by $41.4 million.

April 3, 2002 Restatement: Homestore announces that it overstated FY 2001 revenue by $123 million.

April 10, 2002 NASDAQ: Homestore announces that it will remain listed.

September 25, 2002 Parallel Prosecution (Round 1): SEC and U.S. attorney simultaneously prosecute former CFO, former COO, and former VP; each settles with SEC and pleads guilty to criminal charges. SEC does "not bring any enforcement action against Homestore because of its swift, extensive, and extraordinary cooperation."

September–October 2002 Insurance: D&O insurer sues to rescind policies.

January 9, 2003 Parallel Prosecution (Round 2): SEC and U.S. attorney simultaneously prosecute former manager, who settles with SEC and pleads guilty to criminal charges.

April 23, 2003 Parallel Prosecution (Round 3): SEC and U.S. attorney simultaneously prosecute three officers and directors of advertising agency that did business with Homestore.

May–July 2003 Insurance: D&O insurers granted summary judgment; policies judged rescinded. Homestore appeals.

August 13, 2003 Shareholder Suit: Homestore settles class action for $13 million in cash, issuance of 20 million new shares common stock, and adoption of new corporate governance provisions.

September 18, 2003 Parallel Prosecution (Round 4): SEC and U.S. attorney simultaneously prosecute three former Homestore managers; each settles with SEC and pleads guilty to criminal charges. SEC also files enforcement proceedings against former Homestore VP and manager, and against former CEO and CFO of private company that did business with Homestore; each settles with SEC.

September 26, 2003 Parallel Prosecution (Round 5): SEC and U.S. attorney simultaneously prosecute former CFO of advertising agency that did business with Homestore.

Unfortunately, general counsel must react to SEC and other inquiries before they understand the potential magnitude of the investigation under way or the issues under scrutiny.

must react to SEC and other inquiries before they understand the potential magnitude of the investigation under way, perhaps even without knowing their clients' current and potential status (nonparty witness? target?) or the issues under scrutiny (last quarter's revenue recognition? last year's cost accounting?). It often also is unclear if the SEC is working alone, and if so, whether criminal prosecutors or other agencies are likely to become involved.

The SEC's recent "real-time" enforcement initiative and criminal prosecutors' renewed enthusiasm have also accelerated the pace of investigations and the responses required. The government sets the calendar, providing little, if any, warning before it files charges and issues press releases, which beyond creating a legal problem, attract unwanted publicity and disrupt investor relations. As a result, public companies must quickly assess their exposure and options before unanticipated events in effect make decisions for them.

Although every case is different, general counsel facing an SEC investigation and possible parallel criminal prosecution should consider the following guidelines:

- **Recognize the warning signs.** Parallel prosecutions may first appear as a seemingly "routine" inquiry from the SEC, a customer calling with a "usual course" question that may have been prompted by an investigator, or even a boilerplate information request from an SRO. Although many inquiries are as benign as they sound, sometimes even a little scrutiny of the conduct at issue will unmask a problem that warrants closer review or should be reported to senior management or the board. General counsel should fine-tune and then regularize their companies' process for responding to government inquiries in order to best understand why the questions are being asked, the significance of the

information sought, and what, if any, steps should be taken.

• **It's all about process.** Upon learning of a government investigation, general counsel should remember the central message of Sarbanes-Oxley: corporate governance is all about the process of identifying, discussing, and fixing problems. The first steps are to avoid any further violations (such as by silencing the CFO who is about to tell a room of institutional investors that the quarter is on track), followed by a meaningful and, if necessary, self-critical conversation with appropriate management or the board. How companies react to bad news can make a difference; in August, the SEC said that apparel maker Cutter & Buck's cooperation and prompt "remedial acts" were part of the reason that company was able to negotiate a cease-and-desist order for books and records violations despite the former CFO's participation in a $5.7 million fraud.

• **Think disclosure.** Comprehensive disclosure may include the disclosure of a pending government investigation or the facts unearthed during the investigation. Increasingly, issuers are disclosing informal inquiries by the SEC and other regulators, and sometimes the issuer's service with civil and grand jury subpoenas, even where it appears that someone else is under investigation. Disclosure issues also may arise in the context of certifications under Section 302 of the Sarbanes-Oxley Act or may flow from an issuer's status as a government contractor. Delayed disclosure—or spin control that minimizes the significance of an investigation or its subject matter—will attract scrutiny and sometimes prove more problematic than the underlying conduct. In 2002, Dynegy was fined $3 million in part because, after the SEC inquired of an accounting irregularity, the CFO allegedly soft-pedaled the issue when communicating with investors.

• **Assume agency collaboration.** Those who provide documents and testimony to the SEC should assume that everything will go to criminal prosecutors even if there is no indication that anyone outside of the SEC is interested. Sometimes, the SEC consults criminal authorities even before it makes information requests. Federal prosecutors in California filed criminal securities fraud and other charges against the former CEO of eConnect Inc. based on statements he made six days earlier during an SEC deposition. Unbeknownst to the CEO, the FBI had started "working closely" with the SEC before it took the critical deposition and, in fact, an FBI special agent expressly relied on the information collected by the SEC in an affidavit filed as grounds for the criminal complaint.

• **Parallel does not mean simultaneous.** Notwithstanding the recent pattern, parallel prosecutions often do not start with the simultaneous filing of criminal and civil charges. Sometimes the SEC begins, and even concludes, investigations and civil enforcement actions before there are any signs of involvement by criminal authorities. Federal law specifically allows criminal prosecutors to rely on the SEC (and the fruits of its subpoena power), regardless of whether there is a criminal grand jury investigation. The time lag may be significant; in one recent case, the U.S. attorney obtained an indictment for securities fraud more than six months after the SEC filed a civil lawsuit against the same defendant for the same overstated revenue (and well over a year after the SEC began its investigation).

• **The Fifth Amendment.** The SEC

The Still Bigger Picture

General counsel should remind their public company clients that making peace with federal authorities often does not quell problems associated with parallel proceedings.

• ***Class actions.*** Class-action complaints can be drafted from admissions made by former officers who plead guilty, or from (unproven) allegations taken from SEC complaints and press releases. Pending government investigations not only make it easier for plaintiffs to sue, but they may also subject those under investigation to discovery that they may prefer not to provide until the SEC and/or criminal charges are resolved.

• ***Waiver.*** Companies likely waive the attorney-client privilege and work-product protection by reporting to the SEC the details of internal investigations, even if such reporting is done pursuant to a nonwaiver agreement. Issuers should structure their cooperation to minimize the risk of future claims of waiver, such as by only providing the government with nonprivileged information.

• ***Insurance.*** Cooperation may jeopardize insurance coverage, which is what happened to Homestore Inc. (formerly Homestore.com). Although Homestore avoided prosecution by helping the government obtain pleas by three former officers and an SEC settlement (see "Timeline: From All Sides," p. 44), praise from the U.S. attorney and the SEC did not stop the company's D&O carrier from suing to rescind the policies. Products are now being offered that may protect innocent directors and officers from loss of coverage due to another's wrongdoing.

• ***State authorities.*** This past fall, the attorney general of Oklahoma initiated a criminal investigation concerning WorldCom, more than a year after the SEC and U.S. attorney started prosecuting the same conduct. The specter of state action brings still more complexity, expense, and uncertainty to companies looking for a global resolution. The SEC has a track record of assisting state regulators, who have been given access to the SEC's files on more than 250 occasions within the past two years.

Although many inquiries that accompany parallel prosecution are as benign as they sound, sometimes even a little scrutiny of the conduct at issue will unmask a problem that warrants closer review or should be reported to senior management or the board.

and criminal prosecutors often make "informal" requests for witness interviews or serve formal subpoenas compelling deposition or grand jury testimony. Sometimes witnesses receive unannounced calls or visits from investigators from the SEC, FBI, Postal Inspection Service, or other agencies. Regardless of how the government poses its questions, the decision whether to respond is critically important and often complicated. Those who speak should remember that the government will memorialize their statements in interview memoranda (or depending on the setting, a formal transcript), which may be used as evidence against the speakers or others. On the other hand, those who invoke the Fifth Amendment during an SEC deposition may invite a prosecution and should realize that the mere fact they invoked the Fifth creates an inference of wrongdoing that the SEC will highlight in (public) papers filed with the courts.

- **The cooperation decision.** It often makes sense to cooperate with the government, although the decision of when, how, and with whom to cooperate has become increasingly complicated. If the decision is made to cooperate, the cooperation should demonstrate a willingness to go the extra mile. To maximize the benefit of cooperation, general counsel should consider opening similar lines of communication with other agencies. Finally, companies can cooperate with government investigations without agreeing to waive the attorney-client privilege or work-product protections, even though the government increasingly requests that they do so.
- **Avoid being labeled obstructionist.** The government aggressively prosecutes those who appear to interfere with investigations or other regulatory machinery. In the securities fraud context, obstruction-of-justice-type charges can be more difficult to defend than those based on the complicated transactions or accounting issues that may have triggered the government's investigation in the first place. The risks are even greater in parallel proceedings, when the same witness may be interviewed or deposed repeatedly by different agencies, each of which will compare notes and look for inconsistencies. For the same reason, companies and individuals under investigation should ensure appropriate and consistent document preservation and comprehensive and careful document production. The SEC recently criticized a company for withholding a key document and for a subpar document collection effort in response to SEC requests and subpoenas—contributing to a $10 million penalty.
- **Cooperation can be a one-way street.** General counsel for companies that cooperate should not expect that their seemingly open dialogue with the SEC (or any agency) entitles them to advance notice of what will come next in the investigation, much less in any parallel criminal investigation. For example, having spent months cooperating with an SEC investigation that included the former CEO's deposition, HealthSouth and some of its officers may have been surprised later to learn that the SEC was (or was about to begin) preparing a civil enforcement action and that as part of a parallel grand jury investigation, the FBI had wiretapped the former CEO (by attaching a wire to a former CFO who entered a guilty plea) and later executed a search warrant at company headquarters.
- **Whistle-blowers.** Many securities fraud cases begin with or are aided by the cooperation of current or former insiders. Sometimes companies can avoid investigations by addressing allegations of impropriety made by employees promptly and efficiently, and even where government scrutiny is inevitable, a proper response can soften the blow. Conversely, existing problems become worse if reported by a potential whistle-blower who is not taken seriously, or if management conducts an internal investigation that prosecutors perceive as superficial, as occurred in Enron. Given the government's reliance on insiders, companies should review official policies and practices so legitimate efforts to protect business confidences are not misunderstood as an attempt to silence legitimate concerns or cover up illegality. There are, of course, now criminal and civil sanctions for those that penalize employees for assisting with fraud investigations. •

Stephen A. Jonas is co-chair of Hale and Dorr's government investigations and litigation group. Jonathan A. Shapiro is a senior partner in Hale and Dorr's corporate and securities litigation group. Hale and Dorr's Andrea J. Robinson, Richard V. Wiebusch, and Daniel Gold also contributed to this article. E-mail any of these authors at clearticle@haledorr.com.