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# Parallel Criminal and SEC Prosecution Present New Risks for Public Companies and their Officers and Directors

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For years the Securities and Exchange Commission was nearly alone in the federal government's enforcement of the securities laws. Criminal securities fraud charges rarely were brought outside of the Southern District of New York, and SEC officials (including its current enforcement director) complained about needing to "cajole" criminal prosecutors to bring cases.

In the post-Enron climate, however, the SEC and United States Attorneys routinely prosecute alleged public company malfeasance by bringing both criminal and civil enforcement proceedings against the same defendants based on the same conduct. Within the last year, nearly every major securities fraud prosecution—including those involving Worldcom, Enron, Qwest, HealthSouth, Adelphia, Rite Aid and ImClone/Martha Stewart—has involved "parallel" civil and criminal proceedings. The trend is not limited to headline cases:

- "SEC-related criminal cases" were filed against 259 defendants during FY 2002. The last time the Commission reported the statistic was 1999 (when, according to the annual report, there were 64 indictments or informations in "related criminal proceedings").
- During its first 90 days, the President's Corporate Fraud Task Force obtained about 50 criminal convictions or plea agreements. The task force was organized last summer under the direction of the Deputy Attorney General to coordinate the work of the SEC, FBI, U.S. Attorneys' offices and other agencies with jurisdiction to enforce the securities laws.
- Smaller issuers and those accused of less egregious conduct may bear the brunt of the SEC's planned hiring of 800-plus additional lawyers, accountants and other personnel (pursuant to legislation the President signed three weeks ago). This will substantially increase enforcement activity.

Although the intensity of the inter-agency cooperation is new, the charges that are being brought are not. The SEC and U.S. Attorneys for the most part are prosecuting the same conduct, under the same statutes, as they did prior to Sarbanes-Oxley, and apparently are doing so without an effort to divvy up investigations for sole prosecution by one regulator or the other. The McKesson prosecution typifies the joint approach; on June 4, 2003, the U.S. Attorney for the Northern District of California and the SEC, respectively, filed a superceding indictment and a civil lawsuit against the former CEO

for allegedly filing a false registration statement in violation of Section 17(a) of the Securities Act and for violating the anti-fraud and books and records provisions of Sections 10(b) and 13(b)(5) of the Securities Exchange Act. The substantive elements of securities fraud claims are essentially the same in both civil and criminal cases, and both types of cases may be tried using the same or similar strategy, evidence and witnesses, even though criminal prosecutors must prove their cases beyond a reasonable doubt. As in other parallel proceedings, in *McKesson*, the U.S. Attorney brought additional charges under mail fraud, wire fraud, and conspiracy statutes, which traditionally have been the offenses charged in many securities and other fraud cases, while the SEC sought more investor-oriented remedies, such as director and officer bars and disgorgement.

**Making Difficult Decisions with Limited Information**

Those facing parallel criminal and civil proceedings have always been in a vulnerable position because decisions that bolster the defense of one proceeding may compromise or even imperil a litigant's position in another. Unfortunately, companies and individuals often must react to SEC and other inquiries before they understand the magnitude or potential magnitude of the investigation underway, perhaps even without knowing their current and potential status (non-party witness? target?) or the issues under scrutiny (last quarter's revenue recognition? last year's cost accounting?). It often 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 accelerated the pace of securities fraud investigations. 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. This poses a difficult challenge in complicated fraud cases where unraveling the facts takes weeks, and even longer when senior management have been implicated. The window for meaningful cooperation also has narrowed; the SEC is looking for a level of "swift, extensive and extraordinary cooperation" that, even if possible, may be unwise to provide until the salient issues come into sharper focus.

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

- ***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 by management of the conduct at issue will reveal a worrisome situation that warrants closer review or should be reported to senior management or the board. Public companies should fine tune and then regularize their 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 next.
- ***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, as well as the issuer's service with civil and grand jury subpoenas, even where it appears that someone else is under investigation. These issues also may arise in the context of certifications under Section 302 of the Sarbanes-Oxley Act, which requires disclosure of corrective actions and of discovery that certain personnel committed fraud. 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. Last year, Dynegy was fined $3 million because, after the SEC inquired of an accounting irregularity, the CFO allegedly soft-pedaled the issue when asked about it during an interview.

- ***Assume Agency Collaboration.*** Those who provide documents and testimony to the SEC should assume that everything will be sent 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 its own or the criminal authorities' requests are made. For example, 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 defendant, the FBI had started "working closely" with the SEC before it took the critical deposition and, in fact, the special agent expressly relied on the information collected by the SEC when it filed the criminal charges.
- ***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 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, the 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 its statements in interview memoranda (or, depending on the setting, a formal transcript), which may be used as evidence against the speaker 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 itself 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. As noted above, in today's climate, issuers and individuals often are under pressure to decide quickly how to respond to SEC inquiries or whether to voluntarily disclose a self-identified problem before they have complete information, often without knowing whether a criminal prosecution is likely. If the decision is made to cooperate, the cooperation should be real, not cosmetic. Parties should provide assistance in response to the government's requests and communicate a willingness to go the extra mile. In order to maximize the benefit of their cooperation, parties should consider establishing similar relationships with other agencies that may seek to prosecute. Finally, companies can cooperate with government investigations without agreeing to waive the attorney-client privilege, 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 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. The pending Martha Stewart prosecution illustrates the danger of making statements that appear incomplete, evasive, or even flat out false, regardless of whether the statements were made under the guise of cooperation (Ms. Stewart agreed to be interviewed by the SEC) or were compelled by subpoena. For the same reason, companies and individuals under investigation should ensure appropriate and consistent document preservation and comprehensive and careful document production.
- ***Cooperation is a One-Way Street.*** Those who 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 (i) the SEC was (or was about to begin) preparing a civil enforcement action; and (ii) 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.
- ***Whistleblowers.*** Many securities fraud cases begin with or are aided by the cooperation of current or former insiders. Sometimes companies can avoid investigations by addressing promptly and efficiently allegations of impropriety made by employees. Conversely, existing problems become worse if reported by a potential whistleblower 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 actual 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 who penalize employees for assisting with federal investigations.

**Private Litigation Risks**

The successful resolution of parallel proceedings brought by the government can increase an issuer's exposure to parallel private shareholder litigation.

- ***Class Actions.*** Class action complaints can be drafted from admissions made by former officers who enter guilty pleas, or from (unproven) allegations taken from SEC complaints and press releases. Pending government investigations not only make it easier for plaintiffs to sue, but may subject those under investigation to discovery that they may prefer not to provide until the SEC and/or criminal charges are resolved.
- ***Waiver.*** Companies also risk waiver of 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 non-waiver agreement. Issuers should structure their cooperation to minimize the risk of future claims of waiver, such as by only providing the government with non-privileged information (as opposed to work-product analysis of, or privileged communications about, the information).
- ***Insurance.*** Cooperation also may jeopardize insurance coverage, which is what happened last September to Homestore, Inc. (formerly, Homestore.com) after its assistance resulted in felony pleas by three former officers, and an SEC settlement. Although Homestore avoided prosecution, praise from the U.S. Attorney and the SEC did not stop Homestore's D&O carrier from suing to rescind the policies two weeks after the former CEO's conviction for falsifying the same financial statements that had been submitted with the policy application. Companies should carefully evaluate their options when purchasing or renewing coverage, as products are now being offered that may protect innocent directors and officers from loss of coverage due to another's wrongdoing.

**An Occasional Silver Lining**

Parallel prosecutions sometimes create opportunities for defendants. The liberal discovery rules that apply in SEC civil enforcement proceedings allow defendants to request documents, take depositions and learn the identity of cooperating witnesses. Such discovery may prove invaluable in preparing a defense or negotiating a resolution to a parallel criminal case, where discovery rights ordinarily are far more limited. (For this reason, the SEC sometimes agrees to stay its civil proceedings, and thereby avoid discovery, pending resolution of a criminal matter.)

Occasionally, joint prosecutions backfire on the government, as occurred recently in the SEC's civil prosecution of HealthSouth Corp. and its former Chairman and CEO, Richard Scrushy. In *Securities and Exchange Comm. v. HealthSouth Corp. and Richard Scrushy*, No. CV-03-J-615-S, 2003 WL 21079647 (N.D. Ala. May 7, 2003), an Alabama federal court denied the SEC's emergency motion for an asset freeze and then stayed the civil enforcement action. The court questioned the fairness of the SEC's and U.S. Attorney's joint prosecution in a written decision that may hamper the government's ability to prosecute jointly other cases. (This was, by the way, the first prosecution for a violation of the Sarbanes-Oxley certification requirements.)

The background to the case reveals the SEC's close coordination with criminal authorities: In

March, the FBI executed a search warrant at HealthSouth's offices, including then-CEO Scrushy's office. On the following day, the SEC filed a civil complaint against HealthSouth and Scrushy and obtained a temporary restraining order (TRO) to escrow certain "extraordinary payments" by the issuer and to freeze Scrushy's personal assets. Later, 11 former HealthSouth executives pled guilty to various securities fraud charges, and several implicated Scrushy in their crimes. Although criminal charges have not yet been brought against Scrushy or the company, the prosecutors have disclosed the pendency of their investigation and, along with the SEC, have emphasized their teamwork in joint press releases and public statements.

The SEC's trouble began when it asked the court to extend the freeze on Scrushy's assets until all proceedings (including the contemplated but not-yet-filed criminal charges) were resolved. During a two-week hearing, the SEC introduced evidence that had come from the DOJ *criminal investigation*, including statements made in open court by former executives at their plea hearings, an FBI agent's testimony, and a tape-recording of a conversation between Scrushy and a former CFO (who had been wearing a wire). Scrushy invoked his Fifth Amendment privilege when called to the stand.

The court granted Scrushy's request to dissolve the asset freeze, and criticized the SEC's use of evidence obtained from a criminal investigation to advance a civil claim. The court refused to consider the statements made by former officers at their criminal plea hearings because, when Scrushy tried to cross-examine those defendants/witnesses, each invoked his Fifth Amendment privilege. The judge also admonished the SEC for denying Scrushy access to the evidence it planned to use against him in this civil proceeding, despite the government's position that Scrushy was not entitled to discovery of criminal evidence against him until he was indicted. Most notably, the SEC had refused to provide the defense team with a copy of the taped conversation, even after the court ordered it to do so (the SEC claimed it lacked authority to turn over a recording that belonged to the FBI).

The court ruled that the government had placed Scrushy in the "precarious position" of either waiving his Fifth Amendment privilege or asserting it and losing his assets. It addressed that unfairness by staying the case until after criminal charges against Scrushy are resolved, or upon notification that none will be brought. The ruling was particularly significant because it focused on the defendant's access to the evidence that the SEC wanted to use against him, not on whether the SEC had a right to obtain the evidence from criminal authorities. (The SEC is legally entitled to use evidence gathered by the FBI, provided that it was obtained without the aid of grand jury subpoenas, e.g., confidential informant disclosures to FBI agents, statements in open court.)

The *HealthSouth* case provides a useful example of the potential pitfalls to the government of parallel proceedings and the successful use of defense strategies taking advantage of those pitfalls.

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